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14th Annual Conference on Legal Issues For Financial Institutions

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

M. Brooks Senn
Kentucky Bankers Association

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Morgan and Pottinger

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14th Annual Conference on

LEGAL ISSUES FOR FINANCIAL INSTITUTIONS

MARCH 1994
14th Annual Conference on
LEGAL ISSUES FOR FINANCIAL INSTITUTIONS
MARCH 1994
Presented by the
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW
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14th ANNUAL CONFERENCE ON

LEGAL ISSUES FOR FINANCIAL INSTITUTIONS

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1994 KENTUCKY GENERAL ASSEMBLY UPDATE

M. Brooks Senn
Vice President and General Counsel
Kentucky Bankers Association
Louisville, Kentucky

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1994 Kentucky General Assembly Update

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A. OVERVIEW.

As of March 3, 1994, 942 House Bills and 340 Senate Bills had been introduced in the 1994 Session of the Kentucky General Assembly. No more House Bills may be introduced since the last day for introducing House Bills was March 2, 1994; the last day for Senate Bill introductions was March 4, 1994. Compared to the 1992 Session, 948 House and 431 Senate Bills were introduced.

This outline contains summaries of 16 Senate Bills and 44 House Bills which had the following status as of March 3, 1994:

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</table>

Bills passed during the 1994 General Assembly and not vetoed by the Governor will take effect ninety days after adjournment (approximately July 13, 1994) unless provided differently in the bill.
B. BILLS DIRECTLY AFFECTING FINANCIAL INSTITUTIONS.

DEPARTMENT OF FINANCIAL INSTITUTIONS REORGANIZATION
Senate Bill 78
Introduced by Senator Joseph U. Meyer

This bill amends KRS 287.011 relating to organization of the Department of Financial Institutions and approves reorganization of the Department into three divisions: Law and Regulatory Compliance, Planning and Management and Supervision.

This bill confirms a reorganization plan previously implemented by the Commissioner; it passed the House on January 25, 1994 and was posted in the Senate State Government Committee on March 1, 1994.

ABANDONED PROPERTY/ESCHEAT *
House Bill 79
Introduced by Representative Marshall Long

This bill, among other things, reduces the escheat period for bank demand deposits and the contents removed from safe deposit boxes from 10 to 7 years and non-demand deposits from 25 to 7 years.

The bill passed the House on February 13, 1994. A Senate Committee Substitute passed on February 28, 1994 and the bill was returned to the House which concurred in the Senate Substitute on March 3, 1994.

BANK SHARES TAX
House Bill 82
Introduced by Representative Marshall Long

This bill amends KRS 136.270 to provide that the fair cash value of bank shares may be determined in any manner by the Revenue Cabinet and repeals the present statutory formula for determining fair cash value method.

This bill is currently in the House Appropriations and Revenue Committee
DEEDS OF TRUST
House Bill 114
Introduced by Representative Michael Bowling

This bill amends KRS 381.190 to permit sale of real estate covered by a deed of trust to be "pursuant to a power of sale clause" instead of pursuant to a court judgment and prescribes the form which a deed of trust covering single or multi-family property must take.

This bill passed the House on February 23, 1994, and is currently in the Senate Judiciary Committee.

REAL ESTATE TRANSFER TAX *
House Bill 157
Introduced by Representative William Lear

This bill amends KRS 142.050 to exempt from the real property transfer tax certain transfers by or to a trust so long as the transfer, if made by the grantor of the trust to the trust’s beneficiaries, would have been exempt.

This bill has passed the House and Senate and was delivered to the Governor on March 1, 1994 for signing.

LIEN INFORMATION SYSTEM
House Bill 464
Introduced by Representatives Ramsey Morris and James Bruce

This bill adds new sections to KRS Ch. 14 and creates a lien information system in the Secretary of State’s office who is responsible for developing and implementing and coordinating, on a statewide level, the strategic planning and regulations relating to the creation, operation and maintenance of the system and a master index listing all UCC filings as well as motor vehicle, mobile home, boat and certain tax liens.

In implementing the lien information system, the Secretary of State is authorized to, among other things, adopt administrative rules and regulations and require standardized information for entry into the system’s master index. In short, the Secretary of State is charged with developing the procedures, acquiring the necessary computer hardware and software and otherwise implementing the system.

Once the system is in place, filing of financing statements and perfection of security interests will remain unchanged. Secured parties will continue to file financing statements and other UCC documents with the local county clerks or in the Secretary of State’s office depending upon the residency of the debtor and the type of collateral. The same is true with respect to notation of security interests relating to motor vehicles, mobile homes and boats required to be
titled in Kentucky. Perfection will continue to be done locally through the county clerk of the
debtor’s residence or where the motor vehicle is principally operated if the debtor is a non-
resident. The sole means of perfecting and discharging a security interest in such property will
continue to be by notation on the title certificate.

At the time a financing statement, other UCC document or title lien statement is filed,
the local county clerk or Secretary of State is required to transmit the information contained in
the documents, together with the date and time of filing, to the Secretary of State’s office for
inclusion in the master index.

Following receipt in the Secretary of State’s office, a written notice confirming the
receipt of the information and reflecting all information received will, if requested by the secured
party, be sent to the secured party of record or other lienholder. This will enable the secured
party to determine if the information has been correctly recorded in the master index.

At the time the system first becomes operable, searches of the master index for effective
financing statements, lien notations and other UCC filings will be conducted by, and at the
offices of, the local county clerks. Non-residents of Kentucky may request the Secretary of
State’s office to conduct the search.

A report of the search (as of a specified date and hour) will be issued in the form of a
certificate listing the file number, date, hour and filing location of each filing and the names and
addresses of each secured party, lessor or consignor. Neither the county clerks nor the
Secretary of State’s office is, however, personally liable for any damage which may arise due
to information furnished pursuant to the search which is subsequently shown to be inaccurate or
incomplete, and House Bill 464 provides that any person obtaining information from the system
should examine the individual filings referred to in the certificate for any legal reliance.

It is contemplated that the system will be self supporting and funded by increases in the
filing fees for most UCC documents, one dollar of which will be credited to a trust fund and
used to pay for the necessary start-up costs, software, hardware, maintenance and other costs
of developing and operating the network. The fee for searching the master index will be fixed
by administrative regulation.

The system will come into existence as well as the increase in the UCC and other filing
fees will take effect on the effective date of House Bill 464 in July, 1994. However, in order
to provide sufficient time to implement the necessary computer programs and related matters,
the system is not required to be operational until April 15, 1996.

This bill was reported favorably by the House State Government Committee on February
24, 1994, but was recommitted to the House Appropriations and Revenue Committee on March
RECORDING INSTRUMENTS IN COUNTY CLERK'S OFFICES
House Bill 553 (See Senate Bill 176)
Introduced by Representatives Thomas Kerr and Arnold Simpson

This bill amends KRS 382.335 to prohibit county clerks from recording "any instrument" unless it "complies with the official indexing system of the county," which has been in existence for at least 24 months prior to the effective date of the Bill or which is implemented for the purpose of allowing computerized instrument searches.

This bill was posted in the House Judiciary Committee on February 24, 1994.

INSURANCE
House Bill 599
Introduced by Representative Steven Riggs

This bill adds new sections to Subtitle 11 of KRS Ch. 304 authorizing the Commissioner of Insurance to issue cease and desist orders against persons violating provisions of Subtitle 11 (e.g., transacting unauthorized insurance) and providing for a hearing.

GOVERNMENT INVESTMENTS
House Bill 754
Introduced by Representative Mark Farrow

This bill amends KRS 66.480 to require local governments, including school districts, to obtain bids from at least three banks or savings and loan associations prior to investing monies in repurchase agreements or interest-bearing deposits, i.e., opening bank accounts.

This bill is currently in the House Counties and Special Districts Committee.

MORTGAGE LOAN COMPANIES AND BROKERS
House Bill 855
Introduced by Representative Billy Ray Smith

This bill amends KRS Ch. 294, relating to mortgage loan companies, by adding certain consumer protection provisions and, among other things, providing that anyone conducting a mortgage loan business without a license is guilty of a misdemeanor and subject to a fine of not less than $500 nor more than $1,000.

This bill was posted in the House Banking and Insurance Committee on March 3, 1994.
CREDIT CARD APPLICATIONS
House Bill 892
Introduced by Representative Ruth Ann Palumbo

This bill creates a new section of KRS Ch. 367 to make it unlawful for a credit card issuer, or anyone acting under the insurer's direction, to knowingly send or distribute a credit card application to a minor.

This bill is currently in the House Banking and Insurance Committee.
C. BILLS IMPACTING FINANCIAL INSTITUTIONS.

PARTNERSHIPS
Senate Bill 38
Introduced by Senator Michael Moloney

This bill authorizes a partnership to sue and be sued in the partnership name; it is currently in the Senate Judiciary Committee.

FORFEITURE OF CORPORATE CHARTER
Senate Bill 47
Introduced by Senators Mike Moloney and Kelsey Friend

This bill amends KRS Chs. 271B, 272, 273 and 274 to provide, among other things, for possible corporate charter forfeiture if a corporation or any officer or agent is convicted of bribery of a public servant.

The bill passed the Senate on January 24, 1994 and is currently posted in the House Judiciary Committee.

LINKED DEPOSIT LOAN PROGRAM
Senate Bill 100
Introduced by Senator Larry Saunders

This bill establishes a linked deposit loan program. Lending institutions are not required to participate in the program but may elect to do so.

This bill has been recommitted to the Senate Appropriations and Revenue Committee.

SECURITY SERVICES AND SECURITY OFFICERS
Senate Bill 145
Introduced by Senator Fred Bradley

This bill creates new sections of KRS Ch. 15B to establish a licensing program for private security officers.

This bill is currently in the Senate Judiciary Committee.
ELIMINATION OF MARGINAL NOTATIONS
Senate Bill 163
Introduced by Senator Nick Kafoglis

This bill amends KRS 382.290 to eliminate marginal notation of assignments or releases of retained liens or mortgages in the county clerk's records and requires that such assignments or releases be by separate instrument.

This bill is currently in the Senate Local Government Committee.

RECORDING INSTRUMENTS IN COUNTY CLERKS' OFFICES
Senate Bill 176 (See House Bill 553)
Introduced by Senate Joseph U. Meyer

This bill amends KRS 382.335 to prohibit county clerks from recording "any instrument" unless it "complies with the official indexing system of the county."

This bill is currently in the Senate Judiciary Committee.

STATE DEPOSITORIES *
House Bill 85
Introduced by Representative Marshall Long

This bill amends KRS 41.070 to provide that the Revenue Cabinet may deposit tax receipts directly with a depository designated by the State Treasurer and transfers the abandoned property function currently in the Revenue Cabinet to the State Treasurer.

This bill has passed the House and Senate and was delivered to the Governor on March 1, 1994.

INTEREST ON JUDGMENTS
House Bill 160
Introduced by William Lear

This bill adds new sections to KRS Ch. 360 authorizing the court - not the jury - to award pre-judgment interest and amends KRS 360.040 to fix post judgment interest (now 12%) at a rate equal to the "prime" rate set by Federal Reserve Board in effect on December 5 of the year prior to the year the judgment is entered plus 2%. The bill also permits recovery of attorney fees "in a contract action".

This bill was posted in the House Judiciary Committee on January 11, 1994.
CONTROLLED SUBSTANCE TAX AND LIEN
House Bill 171
Introduced by Representatives Charles Geveden and Stan Cave

This bill imposes tax upon dealers in marijuana and controlled substances and creates a lien upon the real and personal property of the dealer for payment of the tax and penalties.

This bill was reported favorably by the House Appropriations and Revenue Committee on March 1, 1994. Posted for passage on March 4, 1994.

DEEDS OF RELEASE
House Bill 451
Introduced by Representative Mark Farrow

This bill amends KRS 382.020 to provide that no deed of release may be recorded unless it contains the names of both the mortgagor and mortgagee.

This bill was posted in the House Judiciary Committee and reported favorably on March 3, 1994.

CONSTITUTIONAL AMENDMENT/RESTRICTING RECOVERY OF DAMAGES
House Bill 454
Introduced by Representative Billy Ray Smith

This bill amends Section 54 of the Kentucky Constitution and authorizes the General Assembly to limit non-economic loss, punitive damages and non-pecuniary damages arising from injuries resulting in death or to a person or property.

This bill is currently in the House Elections and Constitutional Amendments Committee.

CREDIT CARDS
House Bill 611
Introduced by Louis Johnson

This bill adds new sections to KRS Ch. 365 prohibiting a credit card application from being sent into the state unless it is expressly requested by the receiving consumer.

This bill was posted in the House Banking and Insurance Committee on February 25, 1994.
TESTAMENTARY ADDITIONS TO TRUSTS
House Bill 623
Introduced by Representative Richard Lewis

This bill adds the "Uniform Testamentary Additions to Trusts Act" to KRS Ch. 394 and permits property to be transferred by will to a life insurance or other trust so long as the trust was established by a separate instrument executed before, concurrently with or after execution of the will. Moreover, the transfer is effective even though the trust is amendable or revocable or was amended after the execution of the will or the testator's death.

This bill is currently posted in the House Judiciary Committee.

COUNTY CLERK FEES
House Bill 647
Introduced by Representatives Marshall Long, Don Gedling, Ron Cyrus and June Lyne

This bill amends KRS Chs. 64, 186 and 186A relating to fees payable to county clerks by establishing new fees or increasing present recording and other fees.

This bill was posted in the House Appropriations and Revenue Committee on February 28, 1994.

MORTGAGE FORECLOSURE
House Bill 779
Introduced by Representative Michael Dean Bowling

This bill amends KRS 382.135 to delete requirements that a commissioner's foreclosure deed contain a statement of consideration; amends KRS 426.006 to prohibit the Commonwealth or any local government having an ad valorem tax lien from being named as defendants in foreclosure actions; and amends KRS 426.705 to clarify the bond requirements of purchasers at foreclosure sales.

This bill was posted in the House Judiciary Committee on March 3, 1994.

AUTHORIZATION OF TRUST AMENDMENTS
House Bill 833
Introduced by Representatives Jim LeMaster and Louis Johnson

This bill creates a new section of KRS Ch. 386, relating to trusts, to establish methods of amending all types of trusts (other than charitable trusts) in order to enable the trust to qualify as a marital deduction trust or to take advantage of "any other federal or state income, estate, excise, or inheritance tax benefit."

This bill was posted in the House Judiciary Committee on March 3, 1994.
D. BILLS OF INTEREST.

INTEREST ON INCOME TAX REFUNDS
Senate Bill 3
Introduced by Senators John D. Rogers and Tom Buford

This bill would require Kentucky income tax refunds to bear interest 60 (rather than 90) days after the return is filed.

The bill is currently in the Senate Appropriations and Revenue Committee.

INTANGIBLE TAX
Senate Bill 28
Introduced by Senator Tom Buford

This bill amends KRS 132.020 to reduce the ad valorem tax on intangibles from $.25 to $.10 per $100 of value over a three year period beginning January 1, 1995.

This bill is currently in the Senate Appropriations and Revenue Committee.

FALSE REGULATORY REPORTS
Senate Bill 58
Introduced by Senator Tom Buford

This bill amends KRS 519.040 to make it a Class A misdemeanor to file a false report with a regulatory or administrative agency.

This bill is currently in the Senate Judiciary Committee.

INHERITANCE AND ESTATE TAXES
Senate Bill 102 (See House Bills 196 and 279)
Introduced by Senators Richard L. Roeding, David L. Williams, Charlie Borders, Tom Buford, Lindy Casebier, Gene Huff, Dan Kelly, Virgil Moore, Tim Philpot, John Rogers and Gex Williams

This bill repeals existing Kentucky inheritance tax and imposes a tax equal to the "federal credit."

This bill is currently in the Senate Appropriations and Revenue Committee.
KENTUCKY CONSTITUTION/INTANGIBLE TAX
Senate Bills 103 and 105 (See House Bills 156 and 219)
Introduced by Senators Richard L. Roeding, David L. Williams, Charlie Borders, Tom Buford, Lindy Casebier, Gene Huff, Dan Kelly, Virgil Moore, Tim Philpot, John Rogers, Gex Williams and Joseph U. Meyer

These bills amend Kentucky's Constitution to exempt intangible personal property from taxation after January 1, 1995.

These bills are currently in the Senate State Government Committee.

LIMITED LIABILITY COMPANIES
Senate Bill 184
Introduced by Senator Fred Bradley

This bill, among other things, creates KRS Ch. 175 relating to limited liability companies - taxed as partnerships but with the company's owners having the same limited liability as corporate shareholders.

This bill passed the Senate on February 25, 1994 and was posted in the House Judiciary Committee on March 3, 1994.

ELECTRONIC EDITION OF THE KENTUCKY REVISED STATUTES
Senate Bill 301 (See House Bill 553)
Introduced by Senator Walter A. Baker

This bill amends KRS 7.138 to permit the Legislative Research Commission to designate an electronic version of the statutes as an "official electronic version" upon certain conditions.

The bill was posted favorably to the Consent Calendar by the Senate State Government Committee on March 3, 1994.

LIVING WILL DIRECTIVE ACT
Senate Bill 311
Introduced by Senator David K. Karem

This bill repeals Kentucky's current Living Will Act (KRS 311.622 to 311.644) and Health Care Surrogate Act (KRS 311.970 to 311.986) and establishes a comprehensive living will statutory scheme relating to health care decisions.

The bill is currently in the Senate Judiciary Committee
MECHANIC'S LIENS
House Bill 9
Introduced by Representatives Marshall Long, Jim Callahan and William Donnermeyer

This bill amends KRS 376.010 to grant mechanic's lien rights to suppliers and lessors.

This bill passed the House on February 24, 1994 and is currently in the Senate Judiciary Committee.

MOTOR VEHICLE REGISTRATION *
House Bill 19
Introduced by Representative Jim Callahan

This bill amends KRS 186A.035 to provide for joint/survivorship ownership of motor vehicle by husband and wife unless registration states to the contrary.

This bill passed both the House and Senate. It was signed by the Governor on February 24, 1994.

LIABILITY FOR REAL PROPERTY TAX
House Bill 20
Introduced by Representative Frank Rasche

This bill amends KRS 132.220 to provide that if real property is transferred after the tax assessment date (January 1), the transferee is obligated for payment of the tax and is considered to be the owner of the property from the date the tax become delinquent.

This bill is currently in the House Appropriations and Revenue Committee.

PAYMENT OF SALES AND INCOME TAXES *
House Bill 80
Introduced by Representative Marshall Long

This bill permits the Revenue Cabinet to require taxpayers, whose average monthly liability for sales tax or income tax withholding exceeds $25,000, to pay the taxes by electronic fund transfer.

This bill passed both the House and Senate. It was signed by the Governor on February 11, 1994.
INCOME TAX *
House Bill 107
Introduced by Representative Marshall Long

This bill incorporates the federal Internal Revenue Code in effect on December 31, 1993 into Kentucky’s income tax provisions (KRS Ch. 141).

This bill passed both the House and Senate. It was delivered to the Governor on February 28, 1994 for signing.

CAMPAIGN FINANCE
House Bill 148
Introduced by Representative Marshall Long

This bill requires political contributions by individual contributors to a candidate or committee to be by single check - thereby prohibiting "bundling" of contributions.

This bill was posted in the Elections and Constitutional Amendments Committee on February 25, 1994.

KENTUCKY CONSTITUTION/INTANGIBLE TAX
House Bill 156 (See House Bill 219 and Senate Bills 103 and 105)
Introduced by Representatives William Lear, Kenneth Harper and Leslie Trapp

This bill amends the Kentucky Constitution to exempt intangible property from taxation; it is currently in the House Elections and Constitutional Amendments Committee.

STANDBY GUARDIANS *
House Bill 173
Introduced by Representative Gross Lindsay

This bill creates a new section of KRS Ch. 387 to provide a procedure for appointment of a "standby" guardian to be appointed following disability.

This bill passed the House on February 1, 1994 and the Senate on March 2, 1994; it was delivered to the Governor for signing on March 3, 1994.
LOANS BY KENTUCKY HOUSING CORPORATION
House Bill 234
Introduced by Representative Jim Wayne

This bill amends KRS 198A.065, relating to the Kentucky Housing Corporation, expanding the Corporation's authority to participate in residential housing project loans.

This bill passed the House on March 3, 1994.

LIMITED LIABILITY COMPANIES
House Bill 255 (See Senate Bill 184)
Introduced by Representatives Louis Johnson and Stan Cave

This bill creates a new KRS Ch. 275 relating to limited liability companies and is currently in the House Judiciary Committee.

The bill is currently in the House Judiciary Committee.

OPEN RECORDS OF PUBLIC AGENCIES
House Bill 274
Introduced by Representatives William Donnermeyer and Denver Butler

This bill amends KRS 61.872 to require public agencies to make an effort reasonably calculated to locate a public record if requested to do so.

This bill was posted in the House State Government Committee on February 22, 1994.

"GOING OUT OF BUSINESS" AND "FIRE" SALES
House Bill 314
Introduced by Representative Steven Riggs

This bill creates new provisions in KRS Ch. 367 regulating "going out of business" and "fire" sales.

This bill is currently in the House Business Organizations and Professions Committee.
ADMINISTRATIVE REGULATIONS

House Bill 322
Introduced by Representative Rex Smith

This bill amends or adds sections to KRS Ch. 13A revising the procedure for adoption of administrative regulations.

This bill passed the House on February 15, 1994 and is currently in the Senate Economic Development and Tourism Committee.

INHERITANCE AND ESTATE TAXES

House Bill 372

This bill enacts new sections of KRS Ch. 140A (effective for estates and decedents dying after 1/1/98) which provides for 4-year phase-in of new "pick-up" tax, i.e., equal to "federal credit."

This bill is currently in the House Appropriations and Revenue Committee.

CIVIL JURISDICTION OF DISTRICT COURTS

House Bill 461
Introduced by Representative Dave Stengel

This bill amends KRS 24A.120 to increase the amount in controversy jurisdiction of District Courts from $4,000 to $10,000.

This bill was posted in the House Judiciary Committee on February 24, 1994.

GIFTS BY ATTORNEY-IN-FACT

House Bill 589
Introduced by Representative Jim LeMaster

This bill creates or amends sections of KRS Ch. 386 and 387 to authorize an attorney-in-fact to make gifts of the principal’s property to establish an estate plan and minimize taxes subject to certain conditions and appointment by the district court of any attorney to represent the principal.

This bill passed the House on March 1, 1994; it was received in the Senate March 2, 1994 and is currently in the House Judiciary Committee.
SIMULTANEOUS DEATH
House Bill 615
Introduced by Representative Richard Lewis

This bill adds new sections of KRS Ch. 397 relating to presumptions in the event of simultaneous deaths unless the governing instrument deals explicitly with simultaneous deaths or common disasters.

This bill was posted in the House Judiciary Committee on March 3, 1994.

EXEMPTING PENSIONS FROM INCOME TAX
House Bill 654
Introduced by Representative Leslie Trapp

This bill creates new sections of KRS. Ch. 141 exempting pension distributions for Kentucky income taxes over a five year period beginning with the 1994 tax year.

This bill is currently in the House Appropriations and Revenue Committee.

WAGE AND HOUR VIOLATION LIENS
House Bill 660
Introduced by Representative Mark S. Brown

This bill creates new sections of KRS Ch. 337 to impose a lien upon an employer for the amount of any civil penalty assessed for wage and hour violations. The lien is superior to encumbrances created after recording and continues for ten years unless released.

This bill was posted in the House Labor and Judiciary Committee on March 1, 1994 and reported favorably on March 3, 1994.

OCCUPATIONAL SAFETY AND HEALTH VIOLATION LIENS
House Bill 661
Introduced by Representative Mark S. Brown

This bill creates new sections of KRS Ch. 338 to impose a lien upon an employer for the amount any penalty fixed for occupational safety and health violations. The lien is superior to encumbrances created after recording and continues for ten years unless released.

This bill was posted in the House Labor and Industry Committee on March 1, 1994 and reported favorably on March 3, 1994.
BUSINESS ENTITIES
House Bill 717
Introduced by Representative Jim LeMaster

This bill creates new sections of KRS Ch. 271B and 362 authorizing merger of Kentucky corporations with limited liability companies and limited partnerships and specifying the merger procedure.

This bill was posted in the House Judiciary Committee on March 2, 1994.

WAIVER OF RIGHTS PROHIBITED
House Bill 762
Introduced by Representative Joe Barrows

This bill creates new sections of KRS Ch. 336 prohibiting an employer from requiring, as a condition of employment, that an employee waive any right under Kentucky or federal law.

This bill is currently in the House Labor and Industry Committee.

DECEDENT'S ESTATES
House Bill 910
Introduced by Representative Arnold Simpson

This bill amends KRS 395.455 to include surviving children as persons to whom assets of an estate may be distributed when administration of the estate is dispensed with.

The bill is currently in the House Judiciary Committee.

SOCIAL SECURITY NUMBERS
House Bill 924
Introduced by Representative Tom Riner

This bill amends various provisions of the Kentucky Revised Statutes making social security numbers confidential and, among other things, prohibiting social security numbers from appearing on driver’s licenses issued after July 1, 1995.

This bill is currently in the House State Government Committee.
RECENT FEDERAL LEGISLATIVE/FEDERAL & STATE ADMINISTRATIVE AND JUDICIAL DEVELOPMENTS AFFECTING FINANCIAL INSTITUTIONS

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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.
Recent Federal Legislative/Federal & State Administrative and Judicial Developments Affecting Financial Institutions

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SECTION B
Federal Legislative Developments


A. New section 6050P of the Internal Revenue Code created to impose information reporting requirements for any discharge of indebtedness over $600 after December 31, 1993.

B. Every financial institution described in IRS §581 or 591(a) must file a return with the IRS and provide a statement to the debtor whenever it discharges indebtedness of $600 or more. Banks, savings institutions, and credit unions included.

C. Return is made "at such time and in such form as the Secretary may be regulations describe".

D. Contents of return to IRS:
   1. The name, address and TIN of each person whose indebtedness was discharged during the calendar year;
   2. The date of the discharge and the amount of the indebtedness discharged;
   3. Such other information as the Secretary may prescribe.

E. Statement To Be Given To Debtor:
   1. Any financial institution required to make a return for a discharge of indebtedness must furnish to each person whose name is set forth in the return a written statement showing:
      a. the name and address of the entity required to make the return;
      b. the information required to be shown on the return with respect to that person.
   2. Statement must be furnished on or before January 31 of the year following the calendar year for which the return was made.

F. Penalties For Failure To Comply.

B - 1
1. Failure to file with the IRS is subject to the penalties of IRC §6274(d)(1)(B) for failing to file a correct information return.

2. Failure to provide a debtor with a correct written statement is subject to the penalties of IRC §6274(d)(2) for failure to provide a correct payee statement.


1. Amount discharged must be broken down into interest, principal, administrative costs, and fines.

2. Must describe "origin of the indebtedness" (i.e., student loan, mortgage, credit card, etc.), and also an indication that the indebtedness was discharged in bankruptcy, if known.

3. Multiple discharges do not have to be aggregated to reach $600 threshold unless separate discharges "are pursuant to a plan to evade the reporting requirements."

4. Indebtedness considered discharged "upon the occurrence of an identifiable event indicating that the indebtedness will never have to be paid by the debtor, taking into account all the facts and circumstances". Identifiable event includes, but is not limited to, the following:

   a. discharge in bankruptcy;

   b. agreement between creditor and debtor to discharge;

   c. "A cancellation or extinguishment by operation of law that renders the debt unenforceable (such as the expiration of the statute of limitations for collection of the indebtedness)".

Bookkeeping entry is not, of itself, an identifiable event, but it is a circumstances that may be taken into account in determining whether a discharge has occurred.

5. What if the creditor does not know the TIN? It "must be requested of the debtor for purposes of meeting the requirements" of the regulation.

A. Section 9 of the Act adds 5 U.S.C. §5520a relating to the garnishment of federal employees' pay.

B. §5520a(b): "Subject to the provisions of this section and the provisions of section 303 of the Consumer Credit Protection Act (15 U.S.C. §1673) pay from an agency to an employee is subject to legal process in the same manner and to the same extent as if the agency were a private person."

C. Definitions:

1. "agency" means "each agency of the Federal Government" and specifically includes
   a. an "executive agency, except for the General Accounting Office";
   b. "any agency of the judicial branch of the Government"; and
   c. "any agency of the legislative branch of the Government, including the General Accounting Office, each office of a Member of Congress, a committee of the Congress, or other office of the Congress;

2. "employee" means "an employee of an agency (including a Member of Congress as defined under section 2106)"

3. "legal process" means "any writ, order, summons, or other similar process in the nature of a garnishment, that --
   a. is issued by a court of competent jurisdiction within any State, territory, possession of the United States, or an authorized official pursuant to an order of such a court or pursuant to State or local law; and
   b. orders the employing agency of such employee to withhold an amount from the pay of such employee, and make a payment of such withholding to another person, for a specifically described satisfaction of a legal debt of the employee, or recovery of attorney's fees, interest, or court costs."

4. Procedure for serving "legal process":

B - 3
a. May be by certified or registered mail, return receipt requested or by personal service.

b. Served upon:

(1) appropriate agent designated for receipt of such service of process pursuant to regulations issued under this section; or

(2) the head of the agency, if no agent had been so designated.

c. Must be accompanied by "sufficient information to permit prompt identification of the employee and the payments involved."

d. Agent properly served must respond:

(1) to person serving legal process within 30 days or such longer period as may be prescribed by applicable State law

(2) give written notice that legal process has been served (together with a copy) to the affected employee within 15 days.

5. Agencies not required to vary their normal pay and disbursement cycles in order to comply with any such legal process.

6. If agency receives more than one legal process, priority is based on the time of service; except that process under 42 U.S.C. §659, 661 and 662 for the enforcement of employee’s legal obligation to provide child support or make alimony payments have priority over earlier legal process.

7. Regulations to be promulgated and the regulations "shall provide that an agency’s administrative costs in executing a garnishment action may be added to the garnishment, and that the agency may retain costs recovered as offsetting collections."

8. Special rules integrating the statute with the Soldiers’ and Sailors’ Civil Relief Act of 1940 for members of the uniformed services.

9. Effective Date: 120 days after date of enactment (which was October 6, 1993).

A. §933 of the Act creates a new statute regulating rebates in connection with consumer credit transactions and prohibiting the use of the "Rule of 78’s" in calculating such rebates in certain cases.

B. "If a consumer prepays in full the financed amount under any consumer credit transaction, the creditor shall promptly refund any unearned portion of the interest charge to the consumer".

C. In calculating the amount of the rebate in a precomputed consumer credit transaction of a term exceeding 61 months which is consummated after September 30, 1993, the creditor "shall compute the refund based on a method which is at least as favorable to the consumer as the actuarial method." This prohibits the use of the Rule of 78’s.

D. Any prepayment triggers the rebate provisions, including a prepayment for a financing or an acceleration due to a default or otherwise.

E. No refund is required if the total refund would be less than one dollar.

F. Statute adopts the Truth In Lending Act’s definitions of "consumer" and "creditor". See 15 U.S.C. §1502(h) and (f). In addition, the statute expressly states that "creditor" includes any "assignee" and "subassignee" of any creditor.

G. Creditor required, upon oral or written request, to provide a statement of (A) the amount necessary to prepay the account in full and (B) the amount of any refund.

1. The statement must be provided before the end of the 5-day period beginning on the date the request is received.

2. If the request is in writing, the statement must be in writing.

3. A customer is entitled to receive one free annual statement, and the creditor may impose a reasonable fee to cover the cost of producing additional statements provided the charge is disclosed to the consumer in advance.
Federal Administrative Developments

I. Problems With Non-Insured Investment Products.


1. Agencies expect all banks dealing in uninsured products to make it clear to customers that such products are not FDIC insured and that the purchase involves possible risk to principal.

2. Bank tellers are not to make specific recommendations about uninsured products and are not allowed to take customer orders for uninsured items.

3. Bank should advertise uninsured products in a clearly different manner from insured products.

4. Banks should obtain a signature from the customer acknowledging that the disclosures regarding the risks of investing in uninsured products are clearly understood.

5. Banks are expected to ensure that sales recommendations are suitable for a particular customer.

6. Compensation of sales staff should be structured to protect the customer.

B. Recent article in the March 1994 Consumer Reports magazine severely criticized bank involvement in the sale of mutual funds and did little to help the image of banks.

1. The article points out problems when mutual funds are being sold by employees with inadequate training. It also points out potential problems when third parties sell mutual funds from bank premises.

2. The tone of the article is evident from the following by-line appearing in large print on the first page: "Our investigation of 40 banks in five states found bad investment advice and outright lies about safety."
II. Regulation B - Availability Of Real Estate Appraisals.

A. FRB issues final rules adding a new §202.5a to its Regulation B (12 C.F.R. Part 202) to implement the appraisal report distribution requirements of FDICIA §223. See 58 Fed. Reg. 65657 (12/16/93).

B. §223 amended the Equal Credit Opportunity Act (15 U.S.C. §1691-1691f) ("ECOA") by adding a new paragraph (e) to ECOA §701 (15 U.S.C. §1691(e)) stating:

"Each creditor shall promptly furnish an applicant, upon written request by the applicant made within a reasonable period of time of the application, a copy of the appraisal report used in connection with the applicant's application for a loan that is or would have been secured by a lien on residential real property. The creditor may require the applicant to reimburse the creditor for the cost of the appraisal."

C. "Dwelling".

1. The FRB substituted the term "residential real property" in the statute with the term "dwelling". See 12 C.F.R. §202.5a(a). "Dwelling" is then defined as follows:

"[A] residential structure that contains one to four units whether or not that structure is attached to real property. The term includes, but is not limited to, an individual condominium or cooperative unit, and a mobile or other manufactured home." 12 C.F.R. §202.5a(c).

2. The FRB refused suggestions to expand the definition of "dwelling" to include larger, multifamily units in the belief that this "could impose a significant burden on institutions which could outweigh the benefits to consumers." However, the FRB reminded creditors that the nondiscrimination requirements of Regulation B "are applicable to transactions involving multifamily dwellings".

3. Note: the appraisal distribution requirement applies regardless of the purpose of the loan so long as it involves a loan secured or to be secured by a lien on a dwelling. Thus, a loan to start a small business would be covered if the requisite lien were taken.

D. "Appraisal Report".
1. 12 C.F.R. §202.5(c) defines the term as "the document(s) relied upon by a creditor in evaluating the value of the dwelling."

2. If a third party appraiser is used and his value is accepted, the FRB’s explained that this would be "the complete appraisal report signed by the appraiser, including all information submitted to the lender by the appraiser for the purpose of determining the value of the residential property."

3. If the third party appraiser’s value is not used, the FRB explained that the applicant would receive both the third party report and "a copy of documents that reflect the creditor’s valuation of the dwelling . . . includ[ing] staff appraisals or other notes indicated why the value assigned by the third party appraiser is not the appropriate valuation."

4. If the creditor performs an in-house appraisal, "the appraisal report would be the report of the creditor’s staff appraiser, where applicable, or the other documents of the creditor which assign value to the dwelling."

E. Means Of Compliance - "Routine" Delivery Or Delivery Upon Request.

1. Creditors may choose between two alternative methods of delivering appraisal reports. They may elect to automatically provide a copy of appraisal reports for all covered loan applications. See 12 C.F.R. §202.5a(a)(1). Alternatively, creditors may choose to provide a copy upon the applicant’s written request. See 12 C.F.R. §202.5a(a)(2).

2. For so-called "routine delivery", the regulation does not establish mandatory deadlines or timetables for delivery. The regulation does state that delivery must routinely occur "whether credit is granted or denied or the application is withdrawn." The FRB’s explanation assumed good faith compliance and merely expected delivery "when the appraisal is completed, or later in the application process (for example, when notice is given of action taken on the application)."

3. A creditor that only provides a copy upon receipt of a written request must comply with certain notice and timing requirements.

   a. First, the creditor must provide written notice to the applicant of his or her right to
receive an appraisal report. The notice may be given at any time during the application process but no later than when the creditor provides notice of action taken under the deadlines established by §202.9 of Regulation B.

b. The FRB decided not to require that the notice be in a separate form that the applicant can keep. Nor did the FRB impose size, typeface, or conspicuousness requirements. The FRB stated that the notice "may be included on or with the adverse action notice, the application, or other documents."

c. The written notice to the applicant "shall specify that the applicant’s request must be in writing, give the creditor’s mailing address, and state the time for making the request". Model Form C-9 was added by the FRB to Appendix C of Regulation B, and proper use of this form satisfies compliance with the notice requirement. Creditors are not required to use this form and may design their own provided the required information is included.

d. The "time for making the request" refers to the fact that an creditor need not provide the appraisal report if the request is received more than 90 days after the creditor has provided notice of action taken on the application or 90 days after the application is withdrawn.

4. The statute requires that the appraisal report be "promptly furnished", and the FRB’s regulation establishes a generally rule of thumb which is 30 days after the later of time the creditor receives an applicant’s request, receives the report, or receives reimbursement from the applicant for the report.

a. The 30-day period is somewhat ambiguous since the specific language of the Regulation says "promptly (generally within 30-days)" after the triggering events. The FRB wrote that this language "provide[s] greater flexibility" and allows a longer time for providing a copy "in exceptional circumstances". On the other hand, if the applicant has a special need for the report and the creditor could have provided a report sooner, is there a violation if the creditor waits until the 30th day?
F. How Much Can The Creditor Charge For Providing The Report Copy?

1. The statute states that a creditor may "require the applicant to reimburse the creditor for the cost of the appraisal." There is no provision in the regulation explaining this requirement.

2. The FRB did comment on this statutory language in its preamble to the regulation. It wrote that the "provision permits a creditor to require the consumer to pay for the cost of the appraisal prior to providing a copy." However, if the applicant has already paid for the appraisal as part of the application fee, another charge for a copy could not be imposed.

3. In any event, the FRB indicated that a creditor may "require reimbursement of photocopy and postage costs that are incurred in providing the copy of the report, unless prohibited by state or other law."

G. Effective Date - December 14, 1993, but compliance is optional until June 14, 1993.


A. Permits lending limits generally to be calculated based upon bank capital figures reported in quarterly call reports. "Unimpaired capital and surplus" is the total of a Bank's Tier 1, Tier 2, and ALLL not calculated in Tier 1 and Tier 2.

B. Additional rules apply for investment securities and insider loans.

C. Calculations will be made when a loan is made and quarterly thereafter unless (a) there is a adverse change in the bank's capital category for prompt corrective action, (b) a material event occurs that event causes bank's capital to decrease or increase by 10% or more, or (c) the OCC requires a specific bank to use more frequent capital calculations.

D. If a loan that was within a bank's limit when made becomes non-conforming, a bank must exercise its "best efforts" to bring the loan into conformity with the lending limit. Special 5 business day conformity deadline for a loan is becomes nonconforming because collateral securing the loan to satisfy a lending limit exception has declined in value.
E. New exception to the lending limit that would permit a national bank to complete the financing of a project in progress in accordance with prior commitments up to an additional 5% of bank's capital and surplus.

F. Clarifies other lending limit rules by incorporating prior significant OCC interpretations.

IV. Department of Justice - ERISA: ERISA is violated when trust companies earn interest for their own account from the "float" between the time benefit checks are written to ERISA plan participants and the time the checks are presented for payment. Trustee for ERISA plans would be directed to pay benefits. Trustee then transferred sufficient funds to a general account and issued checks to participants. Until the checks were cashed, the trustee would earn income on the funds in the general account under a retail repurchase agreement with another financial institution. [Department of Labor Advisory Opinion No. 93-24A (9/13/93)].

V. Department of Justice - ATM Accessibility Requirements. Effective February 17, 1994, the Department of Justice adopted amendments to regulations implementing the Americans with Disabilities Act of 1990 to change the reach requirements for accessible automated teller machines. 28 C.F.R. Part 36, Appendix A, §4.34.3 (59 Fed. Reg. 2674, 2677 (1/18/94).

VI. Environmental Protection Agency - CERCLA Secured Lender Exemption: On February 4, 1994, the United States Court of Appeals for the District of Columbia held in a 2-1 decision that the federal Environmental Protection Agency "lacks statutory authority" to promulgate its "lender liability" rule protecting lenders from having to pay under federal law for cleanups at hazardous waste sites (Subpart L of 40 C.F.R. Part 300). Chemical Mfgs. Ass’n v. Environmental Protection Agency, No. 92-1414 (1994 WL27881) (D.C. Cir.).

However, two major decisions have been rendered recently in favor of lenders using analysis almost identical to the EPA's Rule but relying exclusively on the plain language of the statute: Waterville Industries, Inc. v. Finance Authority of Maine, 984 F.2d 549 (1st Cir. 1993) (secured lender does not automatically lose its exemption merely by taking title to real property collateral when the debtor defaults "so long as the owner proceeds within a reasonable time to divest itself of ownership."); and United States v. McLamb, 5 F.3d 69 (4th Cir. 1993) (Wachovia Bank & Trust Co. was protected from liability by the secured creditor exemption even though Wachovia purchased contaminated property as the sole bidder at its foreclosure sale).
State Administrative Developments

Kentucky Real Estate Commission - Disclosure Of Condition Form.

A. KRS 324.360 (enacted by the 1992 General Assembly) requires the Kentucky Real Estate Commission to promulgate an administrative regulation creating a "seller's disclosure of conditions form". Regulations are codified at 201 KAR 11:250 (1993).

B. The form must be completed and signed by the seller of residential real estate if any licensed real estate agent receives compensation.
   1. If property is listed, form must be completed and signed by seller at the time of listing.
   2. If property is not listed, form must be completed and signed within 5 business days of any executory contract for sale.

C. No form is required for:
   1. Residential purchases of new homes if written warranty is offered.
   2. Sale of real estate at auction.
   3. Court supervised foreclosure.

D. Copy retained by real estate agent and delivered to prospective purchaser:
   1. Upon request and
   2. When makes a signed written offer to purchase.

E. If seller refused to complete and sign the form, real estate agent must advise the prospective purchaser in writing and "without unreasonable delay".

F. Question: If you were representing a lending bank, would you allow a closing to occur if the statute had not been complied with?

Judicial Developments

I. Kentucky Supreme Court.

A. LENDER LIABILITY:


   b. Honda Motor Co. v. Oberg, ___ U.S. ___, 114 S.Ct. 751 (No. 93-644) (1/14/94) (granting certiorari on the issue of the constitutionality of Oregon’s procedure for reviewing punitive damages in which an appellate court only examines whether the jury was properly instructed and whether there was evidence justifying punitive damages and cannot review actual dollar amount award).

2. Denies motion for discretionary review of Liberty National Bank and Trust Co. v. Donaldson, Ky.App., No. 91-CA-2416 (jury verdict of $7 million (less directed verdict on unpaid promissory note) for failure to act in good faith in connection with claimed line of credit), on September 22, 1993.

3. Steelvest, Inc. v. Scansteel Service Center, Jefferson Circuit Court, No. 86-CI-4607 (on remand after Kentucky Supreme Court decision) finds violation of fiduciary duty by former officer who established competing business but insufficient proof of damages.

B. CLOSING ATTORNEYS - DANGERS OF DUAL REPRESENTATION:

   Reversing dismissal of seller’s claim for fraud and malpractice against closing attorney who (a) represented both the seller and the purchaser of a car dealership and (b) was married to the principal individual controlling the purchaser. Conrad Chevrolet, Inc. v. Rood, Ky., 862 S.W.2d 312 (1993).

   1. Seller claimed that security agreement in his favor and personal guaranty from the attorney’s spouse were not included in closing documents.

   2. Waiver of conflicts that was signed at the closing but backdated to the date the representation started was, "as a matter of law", an insufficient basis for granting summary judgment in favor of the attorney.
a. The waiver could be considered evidence of overreaching instead of evidence of proper conduct, and this created a genuine issue of fact requiring trial.

b. The waiver could not constitute "consent after consultation" under Kentucky Rules of Professional Conduct governing attorneys because the conflict was so great that the attorney could not engage in the dual representation even with a client's purported consent.

c. Merely including the waiver as a closing document was not sufficient "consultation" to support a client's consent to the dual representation.

C. STATUTE OF LIMITATIONS:

1. First Kentucky Trust Co. v. Christian, Ky., 849 S.W.2d 534 (1993). "An action against a trustee for breach of fiduciary duty where the trust is continuing and subsisting and no repudiation has occurred may be brought at any time during the existence of the trust pursuant to KRS 413.340 and KRS 386.735." Action filed in 1989 based upon 1977 trust activity was timely.

2. Munday v. Mayfair Diagnostic Laboratory, Ky., 831 S.W.2d 912 (1992). Failure of partners doing business under assumed name to comply with statute requiring filing of certificate of assumed name was sufficient to create estoppel under tolling statute, thereby tolling statute of limitations during period of non-compliance. In dicta, court states that "Parties are at liberty to contract for limitation period less than period fixed by statute."


1. Enforcing written mechanic's lien waiver demanded by bank before bank would make a loan to property owner. Consideration for waiver was bank approval and disbursement of loan. In any event, an implied waiver would arise since the bank detrimentally relied upon potential lien claimant's statements that he would not claim a lien if the loan was made.

2. Court made this ruling even though lien claimant argued that the bank orally represented to him that he would be paid if he executed the lien waiver and
the loan proceeds were disbursed. Trial court had found that lien claimant had not proven the alleged modification of the lien waiver.

E. APPEAL OF AN AWARD OF ATTORNEY’S FEES: Where a judgment awards an attorney's fee, the attorney is required to be named as a party to an appeal thereof only if the judgment is "directed in favor of [the] attorney and enforce[able] in his name." If the judgment is "simply by way of reimbursing a party for an expense incurred", then the attorney is not required to be named in the notice of appeal. Knott v. Crown Colony Farm, Inc., 865 S.W.2d 326 (11/24/93) (Liebson, J.).

F. WILLS: Generally describing requirements for a holographic will and finding that the document in question did not meet those requirements. Mallory v. Mallory, Ky., 862 S.W.2d 879 (9/30/93).

G. INTERLOCUTORY REVIEW OF DISCOVERY ORDERS:

1. Refusing to issue writ of prohibition to set aside trial court’s order authorizing discovery of peer review records in medical malpractice case. Appalachian Regional Health Care, Inc. v. Johnson, Ky., 862 S.W.2d 868 (May 27, 1993).

2. Affirming Court of Appeal’s writ of prohibition which set aside trial court’s order prohibiting discovery for other car owners who allegedly had suffered sudden acceleration incidents. Volvo Car Corp. v. Hopkins, Ky., 860 S.W.2d 777 (Sept. 2, 1993).

II. Kentucky Court of Appeals.

A. FRAUD CLAIMS: "Where a fraudulent representation is discerned while the contract is executory and before either party has substantially performed in conformance with the terms of the contract, we deem the appropriate rule to be that affirmance or continued performance by the defrauded party under the contract also effectively waives the right to sue for damages" in addition to waiving the right to rescind the contract. This rule applied to bar fraud claim brought by purchasers of tire company who completed closing after learning that the accounts payable were substantially understated by the seller. Hopkins v. Performance Tire & Auto Service Center, Inc., Ky.App., 866 S.W.2d 438 (12/10/93).

B. JEOPARDY TAX ASSESSMENTS AND FORECLOSURE ACTIONS: In a foreclosure action, another lien claimant has standing to require the Revenue Cabinet prove that the
amount of a tax lien based upon a jeopardy tax assessment is correct even if the taxpayer did not contest the assessment. Revenue Cabinet v. Liberty National Bank of Lexington, Ky.App., 858 S.W.2d 199 (1993).

C. ATTORNEY’S LIEN/SET-OFF: Attorney’s lien on proceeds of borrower’s "lender liability" crossclaim is superior to bank’s set-off claim based upon borrowers unpaid debt. Exchange Bank of Mt. Sterling v. Wells, Ky.App., 860 S.W.2d 785 (3/19/93).

D. RIGHTS OF REDEMPTION: Second mortgagee does not have right of redemption after foreclosure sale since right of redemption is limited to owner of property. Redemption by owner does not resurrect prior mortgages or liens when property sold free and clear of the liens. Kirklevington Associates, Ltd. v. Kirklevington North Associates, Ltd., Ky.App., 848 S.W.2d 453 (1993).

E. COVENANT AGAINST ENCUMBRANCES: In purchaser’s suit against seller of real property for breach of general warranty based upon judgment lien against the property, Court of Appeals held that the warranty against encumbrances was breached upon conveyance and purchaser did not have to wait until eviction. Blankenship v. Stovall, Ky.App., 862 S.W.2d 333 (1993).


1. Defines general and special powers of appointment which generally are "the power or authority given by a donor, such as a testator, to a donee to appoint the beneficiaries of the donor’s property, or interest therein which is vested in a person other than the donee of the power. The power may be created by deed or will and is in the nature of a trust."

   a. General power - may be exercised in favor of any person including the donee.

   b. Special power - may be exercised only for the benefit of a particular group or class, which does not include the donee.

2. Law governing a power of appointment is the law in effect at the time of the exercise of the power by the donee not the law in effect at the time the donor creates the power.

3. KRS 394.060 applies to both general and special powers of appointment. Statute since 1972 has provided that a devise or bequest of property over
which the testator has any power of appointment is deemed to be an exercise of the power unless a contrary intention appears in the donee's will. Prior to 1972, statute only applied to general powers of appointment.

4. Adopting the rule that "Under a power of appointment, either general or special, containing no restriction as to the nature of the estate to be raised, the donee is not limited to an appointment of the legal estate, but may execute the power by an appointment in trust for the objects of the power, except where the instrument expressly or impliedly shows that the donor intended the appointees to take absolutely and not in trust."

5. Applying "blue-pencil" rule to a Rule Against Perpetuities problem.

G. DISCRIMINATION: (A) Union employee may bring a claim for sexual and racial discrimination under Kentucky's Civil Rights statute (KRS 344.010 et seg.) without first utilizing union grievance procedure. Presumably the same would be true for a non-unionize employer's personnel manual. (B) Although sexual or racial harassment by a co-worker is not a violation of KRS 344.010 et seg if employer did not know and should not have known of harassment, summary judgment against employee was improper where employee testified that supervisory personnel were informed of at least some of objectionable conduct and were participating in some. Kirkwood v. Courier-Journal and Louisville Times Co., Ky.App., 858 S.W.2d 194 (1993).

H. WHAT ARE "MINUTES"?: There are no such thing as "unofficial minutes" because "a body's minutes do not have any legal existence until they are actually adopted or approved." In this case, Planning Commission's decision based upon minutes that had not yet been formally approved was invalid because the decision was not based upon an official "public record". Helm v. Citizens To Protect the Prospect Area, Inc., Ky.App., 864 S.W.2d 312 (10/29/93).

I. APPEAL OF ORDER CONFIRMING SALE: Notice of Appeal from an order confirming a foreclosure sale must include purchasers. Lagatella v. Farm Credit Services of Mid-America, Inc., No. 92-CA-31118 (3/15/93) (unpublished).

III. United States Supreme Court.

1. To be actionable as an "abusive work environment", discriminatory harassment need not seriously affect an employee's psychological well-being" or lead the employee to "suffer injury".

2. What is unlawful sexual discrimination:

"When the workplace is permeated with 'discriminatory intimidation, ridicule, and insult' that is "sufficiently severe or pervasive to alter the conditions of the victim's employment and create an abusive working environment,' Title VII [of the Civil Rights Act of 1964] is violated." [Quoting Meritor Savings Bank v. Vinson, 477 U.S. 57, 65-67 (1986)].

3. Combination of objective and subjective test measured under the facts and circumstances.

a. Test is objective - would the environment reasonably be perceived as hostile or abusive?

b. Test is subjective - was the environment actually perceived as hostile or abusive?

c. "Whether an environment is 'hostile' or 'abusive' can be determined only by looking at all the circumstances."

4. What is not unlawful sexual discrimination:

a. "mere utterance of an . . . epithet which engenders offensive feelings in an employee" because it does not "sufficiently affect the conditions of employment".

b. "if the victim does not subjectively perceive the environment to be abusive" because the conduct "has not actually altered the conditions of the victim's employment".

B. RICO:

1. Reves v. Ernst & Young, ___ U.S. ___, 113 S.Ct. 1163 (1993). Supreme Court affirmed grant of summary judgment dismissing RICO claim against accounting firm that had prepared certain auditing reports for a bankrupt agricultural cooperative which allegedly overvalued gasohol plant owned by the cooperative.

a. Plaintiff claiming a violation of 18 U.S.C. §1962(c) must, in opposing a motion for summary judgment, adduce facts from which a jury
could reasonably conclude that the defendant took "some part in directing the enterprise’s affairs."

b. In dicta, Supreme Court indicated that liability nevertheless may extend to "lower-rung participants in the enterprise who are under the direction of upper management" and to "others ‘associated with’ the enterprise who exert control over it as, for example, by bribery." Section 1962(c) makes it illegal "to conduct or participate, directly or indirectly, in the conduct of such enterprise’s affairs through a pattern of racketeering activity". However, analysis explicitly does not apply to claims under §1962(a) or (b).

2. **NOW v. Scheidler,** U.S. ___ (No. 92-780) (reversing dismissal of RICO claims against anti-abortion activists and ruling that RICO does not contain an economic-motive requirement).


1. Federal government sought civil forfeiture of a residence purchased with funds ($216,000 wire transferred to her) she allegedly received as a gift from a convicted drug dealer, the dealer now being a fugitive. Woman claims that she did not know the funds were drug proceeds.

2. Government argued that there is no "innocent owner" defense to civil forfeiture, only to criminal forfeiture. Government argued that under the "relation back" doctrine, title to the tainted funds vested in the government at the time the crime was committed, so drug dealer could not transfer ownership of those funds at all.

3. Supreme Court (6-3) rejected government’s theory and held that title does not vest in the government until a judicial decree of forfeiture is entered. Accordingly, a transferee of even tainted property was an "owner" and could assert an innocent owner defense.

IV. **U.S. Court of Appeals for the Sixth Circuit.**

A. **FRAUDULENT INDUCEMENT/LIABILITY OF GUARANTOR:** In case arising out of the sale of a marina on Lake Cumberland, the Sixth Circuit held that genuine issues of material
fact existed as to whether or not guarantor of promissory note was fraudulent induced by alleged misstatements in seller's financial statements to enter into guaranty agreement. Furthermore, guarantor's liability could not be determined until amount of debtor's liability was finally determined which could not occur until resolution of debtor's set-off claims against the creditor. Moore, Owen, Thomas & Co. v. Coffey, 992 F.2d 1439 (6th Cir. 1993).

B. **METHOD OF CALCULATING DEFICIENCY JUDGMENT:** General rule is that "a debtor's deficiency judgment is calculated as of the time that the creditor has repossessed the secured property, has liquidated it in a commercially reasonable manner, and all cash from all transactions was realized." Parties may contract around this general rule, and Sixth Circuit holds that parties did so in this case. Specifically, bank and debtor agreed that deficiency judgment would be determined when bank disposed of house which it received pursuant to deed in lieu of foreclosure and disposal was deemed to occur when bank traded debtor's house for another house. Disposal did not occur two years later when bank sold second house for lesser amount due to general decline in real estate market. Abrams v. F.D.I.C., 5 F.3d 1013 (6th Cir. 10/4/93).

C. **FAIR DEBT COLLECTION PRACTICES ACT:** FDCPA was "not intended to govern attorneys engaged solely in the practice of law." Green v. Hocking, 9 F.3d 18 (6th Cir. 1993).


1. Enforcing a choice of law provision in a franchise agreement between a Michigan franchisee and a Georgia franchisor selecting Georgia law.

2. Federal court in diversity will apply the rules of the state where it sits in deciding whether or not to enforce a choice of law provision.

3. Although Michigan law applied to decide enforceability, Sixth Circuit noted that "we move cautiously when asked to hold contract clauses unenforceable on public policy grounds." Also, party challenging choice of law had burden of showing the specific differences in the two laws and the specific public policy of the home state that would be violated by application of the choice of law clause.
4. The following choice of law provision was sufficiently broad to cover not only contract claims but fraud claims which were "directly related to the franchise agreement" and were not "tangentially related to the franchise relationship":

"This Agreement was made and entered into in the State [of] Georgia and all rights and obligations of the parties shall be governed by and construed in accordance with the laws of the State of Georgia."

E. **BANKRUPTCY STAY:** A creditor, having obtained a final judgment of non-dischargeability from a bankruptcy court as to its debt, is not required to seek relief from the bankruptcy automatic stay prior to execution on the judgment against property which is not a part of the bankruptcy estate. *In re: Embry*, 10 F.3d 401 (12/3/93).

V. **U.S. District Court for the Eastern District of Kentucky.**


1. Under Kentucky law, a plaintiff who presents enough evidence to go to a jury on a fraud claim is not automatically entitled to go to the jury on punitive damages.

2. A judge may refuse to instruct the jury on a punitive damages claim on the ground that the plaintiff has not met his burden of producing sufficient evidence to justify punitive damages.

3. However, Judge Heyburn did note that he would "defer to the sound judgment of the . . . Kentucky Supreme Court to state an unequivocal rule of law to the contrary."

B. **FORUM SELECTION CLAUSES:** Presence of a valid contractual forum selection clause selecting Tennessee as the forum does not automatically render venue in Kentucky improper. However, such a forum selection clause "constitutes a significant factor that figures centrally in a district court’s calculus when evaluating a discretionary transfer under [28 U.S.C.] §1404(a). Such clauses are prima facie valid and should be enforced unless enforcement is shown by the resisting party to be unreasonable under the circumstances." *Creditors Collection Bureau, Inc. v. Access Data, Inc.*, 820 F. Supp. 311 (W.D. Ky. 1993) (Heyburn, J.).
C. ENVIRONMENTAL: Property owner cannot state a viable negligence claim under Kentucky law based upon pollution crossing over onto owner's property where level of contamination is less than federally mandated safety levels. Also, nuisance claim cannot be based upon public's perception of contamination if such contamination, in fact, does not exist. Lamb v. Martin Marietta Energy Systems, Inc., 835 F. Supp. 959 (W.D. Ky. 7/27/93) (Foreman, J.).


1. Court held "that, as a matter of law, the contamination of plaintiffs' land by a substance widely accepted as hazardous constitutes" a nuisance, that is a condition that "would substantially annoy or interfere with the use and enjoyment of property by a person of ordinary health and normal sensitivities." (quoting KRS 411.550(2)).

2. The Court ruled that in the absence of a claim by Tenneco, Inc. that the statutes and regulations regulating PCP's are invalid, the Court could not override the regulatory decision as to the danger of PCB's by considering extrinsic evidence that the PCB contamination would not cause health problems.

3. Disposal of PCP's was an ultrahazardous activity for which Tenneco was liable even if Tenneco did not know at the time of disposal that the substance was toxic.

E. LIEN PRIORITY IN JOINTLY OWNED REAL PROPERTY: Where real property is jointly owned by husband and wife, lien of judgment creditor of husband (who subsequently become sole owner of property upon death of wife) is inferior to later judgment creditor of husband and wife. Raybro Electric Supplies, Inc. v. Barclay, 813 F. Supp. 1267 (W.D. Ky. 1992).

F. SUBSTANTIVE DUE PROCESS: Declaring that the Interstate Horeseracing Act of 1978 (15 U.S.C. §§3001-3007) is an unconstitutional violation of substantive due process because it "is an unreasonable means of advancing a legitimate governmental interest." Specifically, its grant to private parties a absolute veto power over simulcasting of horse races assures that the statute will be applied to "favor selfish interests over public ones." Kentucky Division Horsemen's Benevolent & Protective Ass'n v. Turfway Park Racing, 832 F. Supp. 1097 (E.D. Ky. 1993) (Bertelsman, C.J.).
VI. U.S. Bankruptcy Courts for the Eastern and Western Districts of Kentucky.

A. PUNITIVE DAMAGES NOT DISCHARGEABLE: Award of punitive damages arising out of bankrupt's sale of house in which he misrepresented the quality of the house were nondischargeable pursuant to 11 U.S.C. §523(a) and adopting the reasoning of the Eleventh Circuit in In re St. Laurent, 991 F.2d 672 (11th Cir. 1993). In re Winters, 159 B.R. 789 (Bkrtcy. E.D.Ky. 10/18/93).

B. APPROVED RATE FOR PARALEGALS: Maximum compensation for paralegal work will be one-third of the highest hourly rate allowed to attorneys (which is $175/hr). In re: Optical Corporation of America, Inc., 157 B.R. 823 (Bkrtcy. W.D. Ky. 8/30/93).

C. DISMISSEL OF CHAPTER 7 CASE WHERE DEBTORS COULD REHABILITATE UNDER CHAPTER 13: Chapter 7 debtors were not sufficiently "needy" and their case could be dismissed as "substantial abuse" of Chapter 7 under 11 U.S.C. §707(b) where debtors had sufficient income to fund three-year Chapter 13 plan that would pay all or almost all of their debts. In re: Hutton, 158 B.R. 648 (Bkrtcy. E.D. Ky. 1993).

COMMENT - Forum shopping is now important in Kentucky. Substantial differences exist between state and federal courts concerning discovery, summary judgment standards, and judicial attitudes.

VII. Kentucky Cases To Watch In The Coming Months.

A. Owensboro National Bank v. Stephens, 6th Cir., Nos. 92-6330/6331. Appeal of District Court's decision that Kentucky national banks may act, pursuant to 12 U.S.C. §92, as insurance agents from their offices in towns of less than 5,000.

Related cases are (a) Barnett Bank of Marion County, N.A. v. Gallagher, 11th Cir., No. 93-3508, which is an appeal from a contrary decision by the U.S. District Court for the Middle District of Florida; (b) Variable Annuity Life Insurance Co. v. Clarke, 998 F.2d 1295 (1993), holding that §92 impliedly restricts sales of fixed and variable annuities to national banks in small towns. Petition for certiorari to be filed with U.S. Supreme Court.; (c) New York State Association of Life Underwriters v. New York State Banking Department, N.Y.Ct. App., DOL#91133613, which raises the issue of whether a state bank's incidental powers only allows a bank to engage in activities necessary to put into effect an express power and that the sale of annuities is not incidental in such respect.
B. **Peoples Bank of Sandy Hook v. Office of the Comptroller of the Currency**, E.D. Ky., No. 93-91. Petition by two state banks and the Kentucky Bankers Association to challenge decision of the OCC that a national bank may relocate its main office across county lines and retain branches in the county where the main office was located prior to the relocation. Companion case is **Peoples Bank of Sandy Hook v. Kentucky Department of Financial Institutions**, Franklin Circuit Court, No. 93-CI-1502 (challenging DFI's parity letter on main office relocations).

1. OCC has also approved two interstate main office relocations.

   a. Pennsylvania national bank relocates main office to Salem, New Jersey and then merges with New Jersey bank. Approved 1/10/94.

   b. National bank headquartered in D.C. with branches in Maryland relocated main office to Aspen Hill, Maryland and then merge with Maryland bank. Approved 2/4/94.

C. **General Motors Acceptance Corporation v. Hulette**, Kentucky Court of Appeals, No. 93-CA-000499 (Oral argument scheduled for April). Is County Clerk who fails to note a lien upon a motor vehicle when tendered a properly completed lien statement insulated from liability by the doctrine of sovereign immunity?


E. **U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership**, U.S. Sup. Ct., No. 93-714. Supreme Court has granted certiorari to determine whether "new value" exception to absolute priority rule in bankruptcy survived the enactment of the Bankruptcy Code of 1978. The absolute priority rule disallows reorganizations plans in which the debtor retains an interest in the reorganized entity unless creditors consent to such plan or they receive full repayment of debts owed to them. The "new value" exception allows for a debtor to retain some interest in the property if new capital is infused as part of the reorganization plan.

F. **Arkansas v. Federated Department Stores**, 6th Cir., No. 92-4198. Appeal of bankruptcy decision allowing states to file proof of claims alleging entitlement under dormant account and escheat laws to various uncashed employee paychecks, dividend checks and accounts payable.
checks of Federal Department Stores. Bankruptcy Court had held that the only proper claimants were the "rightful owners" and thus had disallowed state claims.

VIII. Other Decisions Rendered.

A. California Grocers Ass’n v. Bank of America, Cal.App. 1st Dist., Nos. A055112 & A056217. Action by California Grocers Ass’n to declare invalid a bank’s $3 fee charged to account holders who deposit NSF checks. Trial court held that bank’s markup was 73.4% over cost and fair profit, that this was too high, and that the bank was required to return excess. On appeal, Court of Appeals reversed because a $3 fee was not unconscionable and was reasonable where it was toward the low end of similar charges assessed by other California banks.

B. ABA Standing Committee On Ethics and Professional Responsibility, Formal Opinion No. 93-379.

1. Reported to be the Committee’s first ever opinion on hourly billing.

2. Lawyers may not bill more than one client for the same hours spent. Example - airplane trip to meeting for Client A during which you do work for Client B. Cannot bill both clients for same time.

3. Lawyers cannot add a surcharge for expenditures on behalf of a client. Example - buying donuts for meeting at a cost of $10.00 and billing $20.00.

4. Lawyers must pass on any discounts for third party services.

5. In most circumstances, attorneys may recoup only their actual costs for services performed in-house such as photocopying, long-distance phone calls, computer research and secretarial overtime.
FAIR LENDING ISSUES:

The Community Reinvestment Act
and Other Parts Of The Puzzle

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SECTION C
INTRODUCTION

For generations, many Americans have shared a common dream -- taking charge of their lives, and through hard work and individual responsibility, making both a success of themselves and a contribution to a better society. For many -- perhaps most -- people in our capitalist society, access to credit is the key to achieving this dream. A person's ability to go to school, to buy a house, to start a business, is often determined by whether credit is available. Further, by enabling borrowers to become producers, credit can be the means through which people in a capitalist system escape poverty. Put simply: Credit is often the hammer that allows people to forge their future.

Credit is critical to the workings of the capitalist economy. And credit allows people outside the mainstream of that economy to enter it. For all of these reasons, fair and equal access to credit is in the public interest.

THE COMMUNITY REINVESTMENT ACT

The effort to reform the CRA has been a daily concern of mine for nearly a year. The proposed rule is intended to fulfill a directive from President Clinton to breathe new life and new purpose into the CRA. Fifteen years ago, Congress passed the CRA to ensure that banks and thrifts served the financial needs of their entire communities, and, in particular, to help economically empower persons of low and moderate income. For a number of reasons, however, the CRA never achieved the full promise Congress had intended. Recognizing this, President Clinton last July told the four federal bank and thrift regulatory agencies to rethink the entire system of regulation through which we put the CRA into effect. In December, we proposed our reform package.

We crafted the reform package to achieve the goals the President established for us. The proposal is intended to set forth more objective, performance-based CRA assessment factors that focus on lending, investment, and the provision of banking reviews.

In proposing these changes, we are eager for the public to comment on the package. We are more than half of the way through the 90-day comment period, so there is plenty of time left to do so. We want to hear if we have gotten things wrong, if we could do a better job. But we also want to hear if we have gotten things right. We will need positive reinforcement, as well as constructive criticism, when we craft the final package of reforms.
As you know, from the very beginning, we have been dedicated to a painstaking process of consultation and deliberation so the final product would be right. The President gave us a difficult mission. We knew from the start that we could not perform it in a vacuum. Before we made a single decision on proposing reform, we turned to the public for direction. We held a series of hearings throughout the country -- hearings in Washington, Los Angeles, Albuquerque, San Antonio, Chicago, New York City, and Henderson, North Carolina -- the most extensive series of hearings ever held on CRA. We heard more than 250 witnesses and recorded thousands of pages of testimony. We walked through South Central Los Angeles and a minority neighborhood in New York to see with our own eyes and to listen with our own ears to what should be done. We talked with representatives of the Navajo Nation -- to bankers large and small -- to poor people in rural America. What we saw and what we heard shaped the reform package we proposed.

Here in Washington, we heard the Reverend Charles Cummings, Junior, tell us: "Low-income and minority communities here in D.C. are ravaged by a shortage of jobs and of affordable housing. Bank redlining has contributed to the spiral of decline in our communities. Abandoned houses, check-cashing outlets, vacant lots and boarded-up store fronts are the symptoms of a credit famine in our neighborhoods. Community reinvestment is not the only solution to our urban problems, but without bank participation, any plan to turn things around is doomed to fail."

At the same hearing, we heard a banker describe how the current system undercut lenders that were dedicated to achieving meaningful community reinvestment.

"I would like to show you a photo," she said, "and believe it or not it's real, it's not a staged picture. The printouts here make up a pile about 20 feet high and represent the quarterly reports documenting just one aspect of our CRA efforts. Think of the people and the resources that it takes to produce those reports. Would any of you sitting here today wade through that stack of paper in order to make a decision? I don't think so. And our managers, who must balance the need to make community development loans with all of their other responsibilities, feel exactly the same way."

In Arizona, Richard Mike, a small businessman who is a member of the Navajo Nation, testified to his frustration in obtaining bank credit to expand his operations on the reservation. He was told that a government agency guarantee would be required for such a loan. Mr. Mike stated: "If the Navajo Nation and its people are to become financially independent, it is essential that they have access to credit and banking services. I believe the U.S. insured banks in Arizona have a long way to go to meet the requirements of the Community Reinvestment Act when an established businessman from the Navajo Nation is willing to offer a high equity loan, full personal guarantees, waiver of sovereign immunity by the Navajo Nation, liens on all other assets and properties, and still be unable with a good business record, a good location, and a good financial position, to secure any loan without a government guarantee."
I would also like to briefly mention what Angela Roberts told us. Ms. Roberts works with the BEC New Community Shepherds Program, an organization in Brooklyn, New York, that provides counseling to credit applicants.

Ms. Roberts said: "There is no great mystery about the reasons our cities and rural areas are in trouble. Reinvestment is the key. Recycle our capital in part back into our communities so that we can build housing and small businesses and we will see the end of guns and drugs and an enormous decline to crime. Do that and we will see a new American renaissance."

If that sounds moving coming from me, imagine how moving it was listening to her.

We had a big job to do.

In setting the goals of reform last July, the President could not have been clearer. The implementation of CRA, he said, "has focused too much on documentation and process, and not enough on actual performance. Banks complain about excessive paperwork and inconsistent implementation of the law. Community groups complain that their communities remain unserved, and the CRA evaluations often fail to reflect actual community reinvestment activities."

We were challenged to revise our regulatory approach to reduce unnecessary compliance burdens and to reward improved performance by lenders.

We were challenged to recognize the diversity of lenders -- in size, in the product lines lenders offer -- and the diversity of the markets that lenders serve. Our regulations were to be made flexible to address that diversity.

We were challenged to strengthen enforcement of CRA, particularly in regard to lenders with consistently poor performance.

In our reform package, we have tried to meet all of those goals.

To provide clearer guidance to lenders, the reform package would eliminates the 12 qualitative assessment factors that appear in current regulation. It would eliminate subjective evaluations of minutes, meetings, marketing efforts, and so forth. The proposed rule would make significant reductions in regulatory burden.

No longer would lenders have to prepare CRA statements, review these statements annually and note these reviews in the minutes of the board of directors meetings, or justify the basis for their community delineations, or ascertain community credit needs and explain their methods of doing so.

Instead of public relations or documentation, the proposal would stress quantitative
measures of performance: lending, service and investment performance -- the kind of performance you can bank on. No longer would a lender get an "A" just for effort. Under the proposed rule, not every institution would be subject to assessment in each measure of performance. Rather, the regulator would consider the products and services an institution offers in its normal course of business. Retail banks -- those that focus on individual consumers -- would be evaluated primarily on their lending performance. Wholesale banks -- those that focus on serving business -- and limited purpose banks that do not engage in significant retail lending would be evaluated primarily on their investments. In this way, the proposal would respond to the diversity of markets that banks serve. The proposal would also respond to the range in bank size. It would provide for streamlined -- but rigorous -- examinations of small institutions, while stressing that these institutions would still be responsible for helping to meet the credit needs of their entire communities.

Under the proposal, the regulators would publish a list of the institutions that are scheduled to undergo examinations and the public would be invited to submit comments on the CRA performance of any institution on the list.

The proposed regulation would make clear that a lender found in substantial noncompliance with the law would be subject to formal enforcement actions.

And we would work together to improve public access to data required by the Home Mortgage Disclosure Act and the proposed CRA regulations.

CONCLUSION

In the specific ways I have discussed the proposal would meet the goals the President set -- and would address the concerns and needs that we heard expressed in our public hearings.

Let there be no mistake, this is an aggressive proposal. It responds to long and loud criticism of CRA: Bankers, community activists, academic experts, members of Congress and others identifying flaws in our current CRA approach and advocating change.

The proposal would restructure the system of evaluation under CRA -- because virtually everyone agrees that a restructuring is needed. The proposal would judge lenders by what they do, not by what they say -- because virtually everyone agrees that this shift in emphasis is needed. Our proposal would allow differing lenders to meet their CRA obligations in differing ways -- because virtually everyone agrees that this flexibility is needed. This proposal is aggressive -- an aggressive effort to cure the problems in the current system.

Is the proposal perfect? If it were, we would not have had to put it out for comment. Public comment is -- and is intended to be -- a stress test that will reveal flaws and imperfections.
One problem has already come to light: We were not sufficiently clear in communicating several elements of the proposal and as a result there has been some confusion. I would like to address those elements briefly to clear up that confusion.

First of all, there is a misconception that small banks are exempted from CRA. That is certainly not the case. Under the proposal, small banks would be subject to a different kind of examination from large banks -- one that takes into account the differences in the way small banks operate and the size of their portfolios. But we would continue to examine small banks and hold them accountable for meeting all their CRA obligations.

Second, some people have expressed concerns about the 60 percent loan-to-deposit ratio that would be applied to small banks. They have assumed that, if a small bank did not have 60 percent loans-to-deposits, it would automatically receive a less than satisfactory CRA rating. That is not true.

The 60 percent ratio is a screen -- not a test -- one of five screens for small banks in the proposal. If a bank is picked up by this screen, it simply means that examiners will take a closer look at the bank’s loans in its local community. There may be good reasons for the lower ratio. For example, it is certainly understandable that a local recession might translate into all banks in a community dropping below a 60 percent loan-to-deposit ratio. If that is the case, the banks' lending may well be satisfactory.

Incidentally, some people have asked the source of that 60 percent ratio. It is nothing more than the median loan-to-deposit ratio for all banks with less than $250 million in assets. That means that at least half of all small banks will pass this screen -- though passing this screen will not alone ensure a satisfactory rating. I hope we will get comments on whether that is the correct ratio or whether we should adopt a more appropriate standard.

A final point of confusion is the notion that the proposal would create a self-contained, stand-alone compliance system -- that once the final rule is in place, nothing more will need to be done. Not true. After the rule is in place we will need to write detailed examination procedures and develop examiner training to ensure consistent application of CRA requirements. We will need to address managerial and day-to-day problems. We will need to establish procedures to govern a range of activities from approving CRA plans to collecting and analyzing data. And we will.

Public comments are an essential part of rulemaking. Already, comments on our propose CRA rule have highlighted points that need clarification or a second look. As we go forward, the regulators will continue to listen to the voice of the public, and respond to it.

Thank you.
CRA REFORM PROPOSAL WOULD INCREASE LOW-INCOME LENDING AND REDUCE REGULATORY BURDEN ON BANKS

A new regulatory proposal would encourage banks to provide credit, services, and investments to America’s low- and moderate-income communities, while reducing the regulatory burden on financial institutions. The proposal carries out President Clinton’s initiative to reemphasize the original goal of the Community Reinvestment Act (CRA) by making credit and financial opportunities available to all people in all communities throughout urban and rural America.

Comptroller of the Currency Eugene A. Ludwig today released a copy of the new proposed regulation for public comment. The other federal financial institution supervisory agencies (the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision) are expected to announce similar proposals later this week.

"The proposed reform package we are unveiling today follows the President’s directive and fulfills the promise of the law," said Comptroller Ludwig at a White House news conference. "It would channel billions of dollars in new credit into America’s distressed communities, while at the same time reducing unnecessary burdens on the banks. It would make the law work."

The proposed CRA rule emphasizes performance over documentation. The following three evaluation standards, or tests, would replace the current 12 assessment factors for CRA review and rating:

- The lending test would evaluate direct lending, and if the institution chose, indirect lending through loan pools, lending consortia, subsidiaries, funded non-chartered affiliates, or other lenders in which the institution had invested.
- The service test would evaluate the provision of branches accessible to low- and moderate-income areas, and the provision of services that promote credit availability.
• The investment test would take into account investment in organizations or initiatives that foster community development, small and minority-owned business development, or affordable housing lending.

Banks would not be required to meet all three tests to get satisfactory ratings. Retail banks would be evaluated primarily on their lending, although their services and investment records would also be assessed. Wholesale and limited purpose banks would be evaluated primarily on their investment in organizations and initiatives that promote credit availability or funding for affordable housing, community development and small and minority-owned business development.

Small independent banks with under $250 million in assets, or members of a holding company structure with less than $250 million in assets, would be eligible for streamlined examinations. Larger banks would be required to report additional data to regulators on the geographic distribution of their small business and some consumer loans. New data reporting requirements would not apply to small institutions.

A bank would also have the option of submitting to its regulator a CRA plan for approval and then be evaluated under that plan. The plan would have to be publicly available and have measurable goals. The regulator would consult with community groups to determine whether the plan responded to community credit needs.

The Comptroller said that the proposed changes would improve the consistency of CRA examination and enforcement. Banks would continue to make CRA ratings public, and the public would have an opportunity to comment on CRA performance.

The proposed changes would be phased in, and banks could elect to be evaluated under either the old or new standards until July 1995.

"This reform package reflects -- not just the thinking of regulators -- but the best thinking of the American people," said Mr. Ludwig. "It represents the result -- not just of technical analysis -- but of participatory government. It stands -- not as a policy imposed from above -- but as a consensus -- and a compromise -- forged among those who will live with its results."

The proposed rule will be published in the Federal Register. The public will have 60 days to comment on the proposal from the date of publication.

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COMMUNITY REINVESTMENT ACT REFORM PROPOSAL

Major Issues

1. What will be the underlying basis for CRA performance evaluations under the reform proposal?

   In assessing an institution's CRA performance, regulators recognize that the institution is expected to help meet the credit needs of its entire community. In examinations, however, particular attention will be paid to the institution's record of helping to meet the credit needs in low- and moderate-income census tracts or rural areas (collectively referred to as low- and moderate-income geographies in the regulation) and of low- and moderate-income individuals. That record will be evaluated primarily using three measures -- a lending test, a service test, and an investment test. An institution's fair lending record will also be considered.

2. Do banks and thrifts need to engage in all three CRA activities -- lending, investment, and service -- in order to earn a satisfactory or better CRA rating?

   No. As a general rule, banks and thrifts will be evaluated on the basis of the product lines offered to their customers in the normal course of business.

   The lending test will apply to all retail banks and thrifts and will evaluate direct lending by the institution itself and, if the institution elects, indirect lending through loan pools; lending consortia; bank subsidiaries and funded non-charter affiliates; and other entities, in whom the bank or thrift has made investments, that lend in low- and moderate-income individuals or geographies.

   The service test evaluates the accessibility of a retail bank's branches and the extent to which the bank provides other facilities and services that enhance credit availability. The service test does not require any bank to expand its branch network or to operate its facilities at a loss. It considers non-traditional branches, including mini-branches in grocery stores or branches operated in conjunction with other banks, other local businesses, churches, or other non-profit organizations. Wholesale and limited purpose institutions will be evaluated on the extent to which they provide other services that enhance credit availability.

   The investment test evaluates banks on the amount of their investments that benefit low- and moderate-income geographies or persons. The investment test will constitute the principal test in evaluating the CRA performance of wholesale and limited-purpose institutions (instead of the lending test). The investment test will apply to provide extra
credit to retail institutions that make qualified investments (community development investments or investments that otherwise benefit low- and moderate-income communities).

3. Will banks and thrifts still delineate communities for purposes of their CRA examinations?

The geographic area in which a retail bank or thrift does the bulk of its lending shall be used to define an institution’s service area. A bank or thrift may elect to delineate its service area for its supervisory agency, but will not be evaluated on the method used to delineate its service areas.

A rebuttable presumption shall exist that an institution’s service area is acceptable if that area:

- is broad enough to include low- and moderate-income geographies; and
- does not arbitrarily exclude low- and moderate-income geographies.

An institution could demonstrate that its service area is acceptable despite its failure to satisfy these requirements by demonstrating, for example, that a service area that does not include low- and moderate-income geographies does not do so because there are no such geographies within any reasonable distance given the size and financial condition of the institution.

Separate service areas shall exist where institutions serve substantial areas across state lines or across MSA lines.

4. How will a bank or thrift’s performance be evaluated under the lending test?

The guiding principle will be whether the bank or thrift is making loans in low- and moderate-income geographies as well as to wealthier geographies. At its core, the lending test requires a comparison of a lender’s market share of loans made in low-and moderate-income geographies with its market share of loans in other geographies in its service area. A bank and thrift will also be evaluated on whether it makes loans throughout its service area or the percentage of its lending in low- and moderate-income geographies. Institutions will receive extra credit under the lending test for "second-look" programs, creative or innovative underwriting, loans for which there is a particularly pressing need, and loans to third parties, such as community development organizations or intermediaries that make or facilitate lending in low- and moderate-income geographies.
5. Will the loans have to be made directly by the bank or thrift to be considered in the institution's performance evaluation?

No. An institution may elect to count under the lending test loans made through a loan pool, a lending consortium, by subsidiaries or funded non-charter affiliates, or through community development and affordable housing lenders, women-owned or minority-owned financial institutions, low-income credit unions, and others that lend directly to the low- and moderate-income community.

Regulators will attribute to the institution its percentage (based on the level of the bank or thrift’s investment or participation) of each loan in a loan pool, a loan consortium, subsidiary, funded non-charter affiliate or community lending organization in which the bank has invested or participated. Lending by the consortia or the community development lender need not be restricted to the institution’s service area for it to be considered as helping to meet the institution’s CRA responsibilities.

6. What criteria will be used to evaluate an institution’s performance under the lending test?

- outstanding

Subject to rebuttal, the regulator will rate a bank or thrift’s lending performance outstanding if:

- The institution’s market share of reported loans in low- and moderate-income geographies in its service area significantly exceeds its market share of reported loans in other geographies in its service area; and

- Either it has made a significant amount of loans in the vast majority of the low- and moderate-income geographies in its service area

- Or its loans to low- and moderate-income geographies in its service area represent a substantial percentage of its loans in its service area.

- high satisfactory

Subject to rebuttal, the regulator will rate a bank or thrift’s lending performance high satisfactory fashion if:

- The institution’s market share of reportable loans in low- and moderate-income geographies in its service area is at least roughly comparable to its market share of reported loans in other geographies in its service area; and
• **Either** it has made a significant amount of loans in *most* of the low- and moderate-income geographies in its service area

• **Or** its loans to low- and moderate-income geographies in its service area represent a *very significant* percentage of its loans in its service area.

### Low Satisfactory

Subject to rebuttal, the regulator will rate a bank or thrift’s performance low satisfactory if:

• The institution’s market share of reportable loans in low- and moderate-income geographies in its service area is *at least roughly comparable* to its market share of reported loans in its entire service area; and

• **Either** it has made a significant number of loans to *many* of the low- and moderate-income geographies in its service area

• **Or** its loans to low- and moderate-income geographies in its service area represent a *significant* percentage of its loans in its service area.

### Needs to Improve

Subject to rebuttal, the regulator will rate a bank or thrift’s performance needs to improve if:

• The institution’s market share of reportable loans in low- and moderate-income geographies in its service area is *less than, and not roughly comparable to*, its market share of reported loans in other geographies in its service area; or

• It has made a significant amount of reportable loans in only a few of the low- and moderate-income geographies in its service area; and its reportable loans to low- and moderate-income geographies in its service area represent an insignificant percentage of its reportable loans to its service area.

### Substantial Noncompliance

Subject to rebuttal, the regulator will rate a bank or thrift’s performance as substantial noncompliance if:
• The institution's market share of reportable loans in low- and moderate-income geographies in its service area is significantly less than its market share of reported loans in its entire service area; and

• It made very few, if any, loans in the low- and moderate-income geographies in its service area.

7. Will regulators take other information into account in assessing a bank or thrift's performance under the lending test?

Yes. The regulator may increase a presumptive rating if the bank or thrift participates in a program for giving second reviews to loan applications, particularly if done in conjunction with community organizations who participate in the review or offer applications from low- and moderate-income individuals that the bank will consider for credit. Regulators may also increase a presumptive rating if the institution makes a substantial amount of loans that require creative or innovative underwriting (while maintaining a safe and sound quality) or loans for which there is a particular need. Regulators will also consider favorably loans to third parties, such as a community development organizations and intermediaries that make or facilitate lending in low- and moderate-income geographies.

In exceptional cases, the regulator may reduce a presumptive rating if it concludes that the quantitative measures fail to reflect the institution's actual record of lending to low- and moderate-income individuals or geographies.

8. What factors will be considered under the service test?

In order to keep the test relatively straightforward and to reflect the law's expectation that banks and thrifts be encouraged to help meet the credit needs of their communities, the service test for retail institutions will emphasize branch location in or readily accessible to low- and moderate-income geographies in the institution's service area.

Provision of services such as accessible ATMs, credit counseling, low-cost check cashing, "lifeline" checking accounts, and other programs will be considered favorably, but generally will not be required. If a bank or thrift offers or provides support for these or other services designed to facilitate access to the institution in low- and moderate-income communities, those programs will enhance the institution's service record.

Wholesale and limited purpose institutions will be evaluated on the extent to which they provide other services that enhance credit availability.

9. What criteria will be used to evaluate an institution's record under the service test?

For retail banks, the service test addresses the availability of branches throughout an
institution's service area. A rebuttable presumption will exist that an institution's service record in each area is:

- **Outstanding**

  If a *substantial* percentage of its branches are located in or readily accessible to low- and moderate-income geographies.

- **High Satisfactory**

  If a *very significant* percentage of its branches are located in or readily accessible to low- and moderate-income geographies.

- **Low Satisfactory**

  If a *significant* percentage of its branches are located in or readily accessible to low- and moderate-income geographies.

- **Needs to Improve**

  If an *insignificant* percentage of its branches are located in or readily accessible to low- and moderate-income geographies.

- **Substantial Noncompliance**

  If *very few, if any,* of its branches are located in or readily accessible to low- and moderate-income geographies.

No bank or thrift will be required to expand the size of its branching network or to operate facilities at a loss. Appropriate consideration will be given to the limitations faced by institutions with a small number of branches. As described above, services that increase credit availability will not be required but a strong record of offering or providing support to other organizations that offer such services could improve an institution’s rating by up to one level.

10. **Will other factors be taken into account under the service test?**

Yes. The regulator may adjust an institution’s rating upward to reflect a strong record of offering or supporting services that promote credit availability for low- and moderate-income geographies or individuals. These services include credit counseling, low-cost check cashing, "lifeline" checking accounts, financial planning, home ownership counseling, loan packaging assisting small and minority businesses, partnerships with community-based organizations to promote credit-related services, extensive provision of ATMs that are particularly accessible and convenient to low- and moderate-income
geographies or individuals, and similar programs.

A regulator may adjust a bank's record upward or downward to reflect more accurately its branch service to low- or moderate-income geographies or individuals. In determining the appropriateness and degree of any adjustment the regulator may consider the institution's record of opening and closing branches. The regulator might also consider whether branches in or readily-accessible to low- or moderate-income geographies serve low- and moderate-income individuals. Regulators may also take into account significant differences in the quantity, quality, or types of services offered to low- and moderate-income individuals or geographies and similar considerations.

A bank or thrift could rebut a presumption raised by the quantitative measures by demonstrating that they present an inaccurate picture of its service of low- and moderate-income geographies and individuals because of peculiarities in the demographics of its service area, limitations imposed by its financial condition, economic limitations on branch operation, or similar considerations.

11. **Can wholesale banks and limited-purpose banks be evaluated under the service test?**

   Yes. Wholesale and limited-purpose banks would be evaluated based on the extent to which they offer services to promote credit availability, or provide support to organizations that offer such services, in low- and moderate-income geographies or to low- and moderate-income individuals.

12. **What factors will be considered under the investment test?**

   Wholesale and limited-purpose institutions will normally be evaluated under the investment test instead of the lending test. Retail institutions will be evaluated under the investment test (in addition to the lending and service tests), but investment performance cannot reduce their composite rating.

   Institutions will be evaluated based on the amount of capital they have devoted to qualified investments not already considered under the lending test. Qualified investments include investments: in support of local affordable housing and community, economic, or small business development; in community development banks, community development corporations, community development projects, small business investment corporations (including minority small business investment corporations), and minority- and women-owned financial institutions and other community development financial intermediaries; in consortia or other structures serving low- and moderate-income individuals and areas; and in state and local government agency housing bonds or state and local government revenue bonds specifically aimed at helping low- and moderate-income geographies and individuals.

   The focus of the investment test is the ultimate impact of the bank or thrift's investment
not the investment per se. Therefore, qualified investments will not be credited under the test unless they have had a demonstrable impact, e.g. in providing loans to low- and moderate-income individuals or areas or community development projects that benefit low- and moderate-income individuals and geographies.

13. What criteria will be used to assign ratings under the investment test?

There will be a rebuttable presumption that an institution’s investment performance is:

- **Outstanding**
  
  If it has devoted a *substantial* amount of its capital to qualified investments;

- **High Satisfactory**
  
  If it has devoted a *very significant* amount of its capital to qualified investments;

- **Low Satisfactory**
  
  If it has devoted a *significant* amount of its capital to qualified investments;

- **Needs to Improve**
  
  If it has devoted an *insignificant* amount of its capital to qualified investments;

- **Substantial Noncompliance**
  
  If it has devoted *very little, if any*, capital to qualified investments.

An institution’s rating under the investment test may be increased up to one level if a large portion of its investments support community development activities that are particularly complex, innovative, or intensive for an institution its size. Examples of such activities include helping establish a new entity to conduct community development activities or providing significant service or assistance in support of a qualified investment. In addition, qualified investments outside an institution’s service area will be taken into consideration unless the institution has neglected investments that would benefit its service area.

14. How will an institution’s composite rating be determined?

For retail institutions, the institution’s rating under the lending test will form the basis for its composite rating. For wholesale or limited-purpose institutions, the institution’s rating under the investment test will serve as the basis for the composite rating.
For retail institutions, the base rating may be increased by up to two levels (on the five rating scale) in the case of outstanding investment performance or by one level in the case of high satisfactory investment performance. This base rating may be increased by one level in the case of outstanding service and decreased by one level in the case of substantial non-compliance in service.

The rating will then be converted to the statutorily-required four level rating system, with high satisfactory and low satisfactory both scored as satisfactory. An institution that would otherwise receive a needs to improve rating will be rated in substantial noncompliance if the institution received no better than a needs to improve rating on both of its last two examinations.

Finally, the rating will be adjusted, if necessary, to take into account illegal lending discrimination by the institution to arrive at a final composite rating.

15. **How will a reason to believe that an institution has engaged in illegal lending discrimination affect its CRA rating?**

There will be a rebuttable presumption that to receive a composite rating of satisfactory or better a bank or thrift has not:

- Engaged in a pattern or practice of discrimination that it has not fully corrected; and

- Committed an isolated act of illegal discrimination of which it has knowledge that it has not corrected fully or is not in the process of correcting fully.

16. **Will extenuating circumstances (little or no loan demand, an innovative product that did not or is taking time to catch on, etc.) be taken into account in assessing CRA ratings?**

Yes, in at least two ways. First, the tests are set up as rebuttable presumptions. Therefore a bank or thrift will have the opportunity to rebut the presumptive case by citing extraordinary circumstances. Second, the tests generally take into account any special circumstances related to the financial condition of the institution, its product lines, and the environment within which it is operating.

17. **Will banks and thrifts still be required to assess the credit needs of their communities?**

To perform under the quantitative measures, banks and thrifts will have to offer products for which there is a market. Therefore, they have an incentive to perform needs assessments in their communities. Under the proposal, however, the regulators will not
evaluate the methods used by an institution to assess credit needs.

18. Will a bank or thrift have the option to submit to its regulators a CRA plan for approval and then be evaluated on its performance under the plan?

Yes. As an alternative to being rated ex post under the lending, service and investment tests, an institution may submit a CRA plan with measurable goals against which its subsequent performance will be assessed.

A bank submitting a proposed plan for approval must provide notice to the community that its plan is available for public comment. An institution's regulator will consider public comments in the assessment of the institution's plan.

Regulators will not approve a plan unless it provides measurable goals against which subsequent performance can be evaluated and the proposed performance is at least overall satisfactory. If an institution fails to meet or exceed the preponderance of the measurable goals set forth in the plan, its performance will be evaluated under the lending, service, and investment tests.

19. Will there be differences between the examinations of small banks and large banks?

Yes. Small institutions will be fully subject to the CRA, but examinations will be streamlined and data reporting requirements will be less stringent than for larger institutions. The streamlined exam procedures and reduced reporting requirements will apply to:

- Independent banks and thrifts with total assets of $250 million or less, and
- Members of a holding company, the total banking and thrift assets of which are $250 million or less.

20. What will a small bank CRA examination entail?

A small bank's overall CRA performance will be presumed to be satisfactory if the bank:

- Has a reasonable loan-to-deposit ratio (a ratio of 60 percent, adjusted for seasonal variation, is presumed to be reasonable) given its size, its financial condition, and the credit needs in its service area;
- Makes the majority of its loans in its service area;
- Has a good loan mix (i.e., makes, to the extent permitted by law and regulation, a variety of loans to customers across economic levels);
• Has no legitimate, bona-fide complaints from community members;

• Has not engaged in a pattern or practice of illegal lending discrimination that it has not fully corrected; or committed isolated acts of discrimination, of which it has knowledge, that it has not corrected fully or is not in the process of correcting fully; and

• For a bank or thrift already subject to reporting home mortgage lending data under HMDA, has a reasonable geographic distribution of HMDA loans;

A small bank or thrift that meets each of the standards for a satisfactory rating and exceeds some or all of those standards may warrant consideration for an overall rating of outstanding. In assessing whether a small bank’s CRA record is outstanding, its regulator will consider the extent to which the bank’s loan to deposit ratio, its lending to its service area, and its loan mix exceed the standards for a satisfactory rating. In addition, at the option of the bank, the OCC will evaluate:

• Its record of making qualified investments, especially those in its local service area; and

• Its record of providing branches, ATMs, and other services that enhance credit availability or in other ways serve the convenience and needs of low- and moderate-income persons in its service area.

21. Can a small bank or thrift receive a less than satisfactory rating using the streamlined procedures?

Yes. A small bank or thrift that fails to meet or exceed all of the standards for a satisfactory rating under the small bank examination is not presumed to be performing in a less than satisfactory manner, however. Rather, for those institutions, the regulator conducts a more extensive examination of the bank or thrift's loan to deposit record, its record of lending to its local community, and its loan mix. The regulator will also contact members of the community, particularly in response to complaints about the bank, and review the findings of its most recent fair lending examination. In addition, at the option of the bank or thrift, its regulator will assess:

• Its record of making qualified affordable housing and community development investments, especially those in its local service area; and

• Its record of providing branches, ATMs, and other services that enhance credit availability or in other ways meet the convenience and needs of low- and moderate-income persons in its service area.

22. How will enforcement of the CRA be strengthened?
Under the revised regulation, an bank or thrift will have a continuing and affirmative obligation to help meet the credit needs of their communities, including low- and moderate-income areas, consistent with safe and sound operation. Banks with a composite rating of Substantial Noncompliance will be subject to formal enforcement actions.

23. What data disclosure will be required?

Every bank, except small banks electing the small bank assessment method, will collect and maintain the data on its government insured and other reportable loans (home purchase, home improvement, small business, small farm, and consumer loans) as follows:

- number of written applications,
- number of application denials,
- number and amount of approvals,
- number and amount of loans purchased, and
- number and amount of indirect loans the bank elects to have evaluated using the lending test.

All information is to be provided by census tract or block numbering area where the loan is located. A bank choosing to be rated under the strategic plan assessment is not relieved from its obligation to report these data.

Summary data will be available to the public and to the banks. The data will be used by the regulators to apply the Lending Test.

24. What small business loan data will be required?

Small business loan data will be collected, reported, and disclosed in a summary format the following categories:

- small businesses with average annual gross receipts of less than $250,000;
- those with average annual gross receipts of more than $250,000 and less than $1 million;
- those with average annual gross receipts of more than $1 million and less than $10 million; and
- manufacturing businesses with average annual gross receipts of more than $10 million and less than 500 employees.

25. What home mortgage loan data will be required?

Home mortgage loan data will be collected, reported, and disclosed in the summary format as follows:
• Home purchase (1-4 family);
• Home improvement (1-4 family);
• Refinancings (1-4 family);
• Multifamily (home purchase, home improvement, refinancings)

Where possible, data collected on home mortgages will be consistent with data collected under the Home Mortgage Disclosure Act.

26. Will all consumer loans be included in the consumer loan category?

No. Credit card loans and auto and other vehicular loans will not be included in the consumer loan category.

27. When will the data be collected?

The information will be collected beginning July 1, 1994, for the remaining six months of 1994. The data for the six months will be submitted to a lending institution's primary regulator by January 31, 1995.

Beginning January 1, 1995, on an annual basis, a summary of a bank or thrift's data collected under this regulation will be submitted to its primary regulator by January 31, of the following year. The summary data will be submitted in a format that will be prescribed in an appendix to the regulation.

28. Will banks and thrifts be required to report data on indirect loans?

A bank or a thrift will not be required to report indirect loans unless the institution elects to have the indirect loans attributed for purposes of the lending test. If a bank or thrift elects to report its indirect loans, it will report all attributable indirect loans outside low- or moderate-income geographies as well as loans inside such geographies.

29. Will CRA performance evaluations continue to be made public?

Yes. The format will be revised to ensure that the evaluations include all data relevant in reaching a conclusion about an institution's CRA performance.

30. How will the regulators conduct examinations involving affiliated banks or thrifts?

Multiple Branches operating under a Single Charter

- The primary regulator will conduct complete lending and service tests in a sample of the service areas in which a bank operates.
Separate composite CRA ratings will be assigned to the institution’s performance in each of the service areas studied. A list of the service areas in which the institution’s CRA performance was examined, along with the rating assigned to the institution’s CRA record in the service area, shall be included in the institution’s public performance evaluation.

The overall bank rating will reflect the performance of the bank in the service areas studied.

**Affiliated Banks operating under Separate Charters**

CRA ratings are presently assigned to each separately chartered bank in a multibank holding company, but those ratings are in no way consolidated for purposes of assigning a CRA rating to the holding company as a whole. An interagency agreement will be developed on methodology to assign a corporate or consolidated CRA rating on a statewide, regional, and/or national level to bank holding companies with multiple affiliates.

As called for in the law, CRA ratings will be assigned and public performance evaluations prepared for each separately chartered bank or thrift.

As with the case of multiple branches operating under a single bank charter, the holding company rating will reflect the performance of the separately chartered affiliated banks studied.

### 31. Will the new regulations go into effect immediately or will there be a transition period?

There will be a transition period.

Data collection will begin July 1, 1994. Data collected from July 1, 1994 to year end will be reported the regulators no later than January 31, 1995. Thereafter banks will collect data on an annual basis and the data shall be reported no later than January 31 of the following year.

From April 1, 1995 to July 1, 1995, an institution could elect to be evaluated under the standards that were in place under the old system rather than the new standards. After July 1, 1995, the new standards will be mandatory except that, until April 1, 1996, an institution showing good cause could request evaluation under the old standards. An institution could also elect to be evaluated under a strategic plan during the transition period.
INTERAGENCY TASK FORCE ON FAIR LENDING

POLICY STATEMENT

The Interagency Task Force on Fair Lending met on March 8, 1994 to consider the following Policy Statement on Discrimination in Lending. The Department of Housing and Urban Development, the Department of Justice, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Housing Finance Board, and the Office of Federal Housing Enterprise Oversight have adopted the Policy Statement. Governor Lawrence Lindsey was authorized by the Board of Governors of the Federal Reserve System to adopt the Policy Statement on behalf of the Board of Governors and has done so. The participants in the Task Force meeting representing the Board of the Federal Deposit Insurance Corporation, the Board of the National Credit Union Administration, and the Federal Trade Commission fully support the Policy Statement and have agreed to seek approval of the Policy Statement from their agencies. The Task Force participants have agreed that the Policy Statement may be made public pending this process. Upon completion of this process, the Policy Statement will be published in the Federal Register as a Notice. The Notice will state that the agencies welcome comments about the application of the principles in the Policy Statement to specific policies and practices. The agencies anticipate providing further clarification and elaboration on the application of the principles in the future.
Policy Statement on Discrimination in Lending

The Department of Housing and Urban Development ("HUD"), the Department of Justice ("DOJ"), the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation ("FDIC"), the Federal Housing Finance Board ("FHFB"), the Federal Trade Commission ("FTC"), the National Credit Union Administration ("NCUA"), and the Office of Federal Housing Enterprise Oversight ("OFHEO") (collectively, "the Agencies") are concerned that some prospective home buyers and other borrowers may be experiencing discriminatory treatment in their efforts to obtain loans. The 1992 Federal Reserve Bank of Boston study on lending discrimination, Congressional hearings, and agency investigations have indicated that race is a factor in some lending decisions. Discrimination in lending on the basis of race or other prohibited factors is destructive, morally repugnant, and against the law. It prevents those who are discriminated against from enjoying the benefits of access to credit. The Agencies will not tolerate lending discrimination in any form. Further, fair lending is not inconsistent with safe and sound operations. Lenders must continue to ensure that their lending practices are consistent with safe and sound operating policies.

This policy statement applies to all lenders, including mortgage brokers, issuers of credit cards, and any other person who extends credit of any type. The policy statement is being issued for several reasons, including:

- To provide guidance about what the agencies consider in determining if lending discrimination exists; and
- To provide a foundation for future interpretations and rulemakings by the Agencies.

A number of federal statutes seek to promote fair lending. For example, the Home Mortgage Disclosure Act ("HMDA") seeks to prevent lending discrimination and redlining by requiring public disclosure of certain information about mortgage loan applications. The Community Reinvestment Act ("CRA") seeks affirmatively to encourage institutions to help to meet the credit needs of the entire community served by each institution covered by the statute, and CRA ratings take into account lending discrimination by those institutions. The Americans with Disabilities Act prohibits discrimination against persons with disabilities in the provision of goods and services, including credit services. This policy statement, however, is based upon and addresses only the Equal Credit Opportunity Act and the Fair Housing Act, the two statutes that specifically prohibit discrimination in lending.

This policy statement has been approved and adopted by the signatory Agencies listed above as a statement of the Agencies' general position on the Equal Credit Opportunity Act and the Fair Housing Act for purposes of administrative enforcement of those statutes. It is intended to be consistent with those statutes and their implementing regulations and to provide
guidance to lenders seeking to comply with them. It does not create or confer any substantive or procedural rights on third parties which could be enforceable in any administrative or civil proceeding.

This policy statement will discuss what constitutes lending discrimination under these statutes and answer questions about how the Agencies will respond to lending discrimination and what steps lenders might take to prevent discriminatory lending practices.

A. Lending Discrimination Statutes and Regulations

(1) The Equal Credit Opportunity Act ("ECOA") prohibits discrimination in any aspect of a credit transaction. The ECOA is not limited to consumer loans. It applies to any extension of credit, including extensions of credit to small businesses, corporations, partnerships, and trusts.

The ECOA prohibits discrimination based on:

- Race or color;
- Religion;
- National origin;
- Sex;
- Marital status;
- Age (provided the applicant has the capacity to contract);
- The applicant's receipt of income derived from any public assistance program; and
- The applicant's exercise, in good faith, of any right under the Consumer Credit Protection Act.

The Federal Reserve Board's Regulation B, found at 12 C.F.R. Part 202, implements the ECOA. Regulation B describes lending acts and practices that are specifically prohibited, permitted, or required. Official interpretations of the regulation are found in Supplement I to 12 C.F.R. Part 202.

(2) The Fair Housing Act ("FH Act") prohibits discrimination in all aspects of residential real-estate related transactions, including, but not limited to:

- Making loans to buy, build, repair or improve a dwelling;
- Purchasing real estate loans;
- Selling, brokering or appraising residential real estate; and
- The sale or rental of a dwelling.

The FH Act prohibits discrimination based on:
• Race or color;
• National origin;
• Religion;
• Sex;
• Familial status (defined as children under the age of 18 living with a parent or legal custodian, pregnant women and people securing custody of children under 18); and
• Handicap.

HUD's regulations implementing the FH Act are found at 24 C.F.R. Part 100.

Because both the FH Act and the ECOA apply to mortgage lending, lenders may not discriminate in mortgage lending based on any of the prohibited factors in either list.

Liability under these two statutes for discrimination on a prohibited basis is civil, not criminal. However, there is criminal liability under the FH Act for various forms of interference with efforts to enforce the FH Act, such as altering or withholding evidence or forcefully intimidating persons seeking to exercise their rights under the FH Act.

**What is prohibited.** Under the ECOA, it is unlawful for a lender to discriminate on a prohibited basis in any aspect of a credit transaction and, under both the ECOA and the FH Act, it is unlawful for a lender to discriminate on a prohibited basis in a residential real estate related transaction. Under one or both of these laws, a lender may not, because of a prohibited factor:

- Fail to provide information or services or provide different information or services regarding any aspect of the lending process, including credit availability, application procedures, or lending standards;
- Discourage or selectively encourage applicants with respect to inquiries about or applications for credit;
- Refuse to extend credit or use different standards in determining whether to extend credit;
- Vary the terms of credit offered, including the amount, interest rate, duration, or type of loan;
- Use different standards to evaluate collateral;
- Treat a borrower differently in servicing a loan or invoking default remedies; or
- Use different standards for pooling or packaging a loan in the secondary market.
A lender may not express, orally or in writing, a preference based on prohibited factors or indicate that it will treat applicants differently on a prohibited basis.

A lender may not discriminate on a prohibited basis because of the characteristics of:

- A person associated with a credit applicant (for example, a co-applicant, spouse, business partner, or live-in aide); or
- The present or prospective occupants of the area where property to be financed is located.

Finally, the FH Act requires lenders to make reasonable accommodations for a person with disabilities when such accommodations are necessary to afford the person an equal opportunity to apply for credit.

B. Types of Lending Discrimination

The courts have recognized three methods of proof of lending discrimination under the ECOA and the FH Act:

- "Overt evidence of discrimination," when a lender blatantly discriminates on a prohibited basis;

- Evidence of "disparate treatment," when a lender treats applicants differently based on one of the prohibited factors; and

- Evidence of "disparate impact," when a lender applies a practice uniformly to all applicants but the practice has a discriminatory effect on a prohibited basis and is not justified by business necessity.

Overt Evidence of Discrimination. There is overt evidence of discrimination when a lender openly discriminates on a prohibited basis.

Example. A lender offered a credit card with a limit of up to $750 for applicants aged 21-30 and $1500 for applicants over 30. This policy violated the ECOA's prohibition on discrimination based on age.

There is overt evidence of discrimination even when a lender expresses -- but does not act on -- a discriminatory preference:

Example. A lending officer told a customer, "We do not like to make home mortgages to Native Americans, but the law says we cannot discriminate and
we have to comply with the law." This statement violated the FH Act’s prohibition on statements expressing a discriminatory preference.

Evidence of Disparate Treatment. Disparate treatment occurs when a lender treats a credit applicant differently based on one of the prohibited bases. Disparate treatment ranges from overt discrimination to more subtle disparities in treatment. It does not require any showing that the treatment was motivated by prejudice or a conscious intention to discriminate against a person beyond the difference in treatment itself. It is considered by courts to be intentional discrimination because no credible, nondiscriminatory reason explains the difference in treatment on a prohibited basis.

Example. Two minority loan applicants were told that it would take several hours and require the payment of an application fee to determine whether they would qualify for a home mortgage loan. In contrast, a loan officer took financial information immediately from nonminority applicants and determined whether they qualified in minutes, without a fee being paid. The lender’s differential treatment violated both the ECOA and the FH Act.

Example: Redlining refers to the illegal practice of refusing to make residential loans or imposing more onerous terms on any loans made because of the predominant race, national origin, etc., of the neighborhood in which the property is located. Redlining violates both the FH Act and the ECOA.

Disparate treatment may more likely occur in the treatment of applicants who are neither clearly well-qualified nor clearly unqualified. Discrimination may more readily affect applicants in this middle group for two reasons. First, because the applications are all "close cases," there is more room and need for lender discretion. Second, whether or not an applicant qualifies may depend on the level of assistance the lender provides the applicant in preparing an application. The lender may, for example, propose solutions to problems on an application, identify compensating factors, and provide encouragement to the applicant. Lenders are under no obligation to provide such assistance, but to the extent that they do, the assistance must be provided in a nondiscriminatory way.

Example: A nonminority couple applied for an automobile loan. The lender found adverse information in the couple’s credit report. The lender discussed the credit report with them and determined that the adverse information, a judgment against the couple, was incorrect since the judgment had been vacated. The nonminority couple was granted their loan. A minority couple applied for a similar loan with the same lender. Upon discovering adverse information in the minority couple’s credit report, the lender denied the loan application on the basis of the adverse information without giving the couple an opportunity to discuss the report.
Example: Two minority borrowers inquired with a lender about mortgage loans. They were given applications for fixed-rate loans only and were not offered assistance in completing the loan applications. They completed the applications on their own and ultimately failed to qualify. Two similarly situated nonminority borrowers made an identical inquiry about mortgage loans to the same lender. They were given information about both adjustable-rate and fixed-rate mortgages and were given assistance in preparing applications that the lender could accept.

Both of these are examples of disparate treatment of similarly situated applicants, apparently based on a prohibited factor, in the amount of assistance and information the lender provided. The lender might also generally exercise its discretion to disfavor some individuals or favor others in a manner that results in a pattern or practice of disparate treatment that cannot be explained on grounds other than a prohibited basis.

If a lender has treated similar applicants differently on the basis of a prohibited factor, it must provide an explanation for the difference in treatment. If the lender is unable to provide a credible and legitimate nondiscriminatory explanation, the agency may infer that the lender discriminated.

If an agency determines that a lender’s explanation for treating some applicants differently is a pretext for discrimination, the agency may find that the lender discriminated, notwithstanding the lender’s explanation.

Example: A lender rejected a loan application made by a female applicant with flaws in her credit report but accepted applications by male applicants with similar flaws. The lender offered the explanation that the rejected application had been processed by a new loan officer who was unfamiliar with the bank’s policy to work with applicants to correct credit report problems. However, an investigation revealed that the same loan officer that processed the rejected application had accepted applications from males with similar credit problems after working with them to provide satisfactory explanations.

When a lender’s treatment of two applicants is compared, even when there is an apparently valid explanation for a particular difference in treatment, further investigation may establish disparate treatment on a prohibited basis. For example, seemingly valid explanations for denying loans to minority applicants may have been applied consistently to minority applicants and inconsistently to nonminority applicants; or "offsetting" or "compensatory" factors cited as the reason for approving nonminority applicants may involve information that the lender usually failed to consider for minority applicants but usually considered for nonminority applicants.

A pattern or practice of disparate treatment on a prohibited basis may also be established through a valid statistical analysis of detailed loan file information, provided that the analysis
controls for possible legitimate explanations for differences in treatment. Where a lender's underwriting decisions are the subject of a statistical analysis, detailed information must be collected from individual loan files about the applicants' qualifications for credit. Data reported by lenders under the HMDA do not, standing alone, provide sufficient information for such an analysis because they omit important variables, such as credit histories and debt ratios. HMDA data are useful, though, for identifying lenders whose practices may warrant investigation for compliance with fair lending laws. HMDA data may also be relevant, in conjunction with other evidence, to determine whether a lender has discriminated.

**Evidence of Disparate Impact.** When a lender applies a policy or practice equally to credit applicants, but the policy or practice has a disproportionate adverse impact on applicants from a group protected against discrimination, the policy or practice is described as having a "disparate impact." Policies and practices that are neutral on their face and that are applied equally may still, on a prohibited basis, disproportionately and adversely affect a person's access to credit.

Although the precise contours of the law on disparate impact as it applies to lending discrimination are under development, it has been clearly established that proof of lending discrimination using a disparate impact analysis encompasses several steps. The single fact that a policy or practice creates a disparity on a prohibited basis is not alone proof of a violation. Where the policy or practice is justified by "business necessity" and there is no less discriminatory alternative, a violation of the PH Act or the ECOA will not exist.

The existence of a disparate impact may be established through review of how a particular practice, policy or standard operates with respect to those who are affected by it. The existence of disparate impact is not established by a mere assertion or general perception that a policy or practice disproportionately excludes or injures people on a prohibited basis. The existence of a disparate impact must be established by facts. Frequently this is done through a quantitative or statistical analysis. Sometimes the operation of the practice is reviewed by analyzing its effect on an applicant pool; sometimes it consists of an analysis of the practice's effect on possible applicants, or on the population in general. Not every member of the group must be adversely affected for the practice to have a disparate impact. Evidence of discriminatory intent is not necessary to establish that a policy or practice adopted or implemented by a lender that has a disparate impact is in violation of the FH Act or ECOA.

Identifying the existence of a disparate impact is only the first step in proving lending discrimination. When an Agency finds that a lender's policy or practice has a disparate impact, the next step is to seek to determine whether the policy or practice is justified by "business necessity." The justification must be manifest and may not be hypothetical or speculative. Factors that may be relevant to the justification could include cost and profitability.
Even if a policy or practice that has a disparate impact on a prohibited basis can be justified by business necessity, it still may be found to be discriminatory if an alternative policy or practice could serve the same purpose with less discriminatory effect.

**Example:** A lender's policy is not to extend loans for single family residences for less than $60,000.00. This policy has been in effect for ten years. This minimum loan amount policy is shown to disproportionately exclude potential minority applicants from consideration because of their income levels or the value of the houses in the areas in which they live. The lender will be required to justify the "business necessity" for the policy.

**Example:** In the past, lenders primarily considered net income in making underwriting decisions. In recent years, the trend has been to consider gross income. A lender decided to switch its practices to consider gross income rather than net income. However, in calculating gross income, the lender did not distinguish between taxable and nontaxable income even though nontaxable income is of more value than the equivalent amount of taxable income. The lender's policy may have a disparate impact on individuals with disabilities and the elderly, both of whom are more likely than the general applicant pool to receive substantial nontaxable income. The lender's policy is likely to be proven discriminatory. First, the lender is unlikely to be able to show that the policy is compelled by business necessity. Second, even if the lender could show business necessity, the lender could achieve the same purpose with less discriminatory effect by "grossing up" nontaxable income (i.e., making it equivalent to gross taxable income by using formulas related to the applicant's tax bracket).

Lenders will not have to justify every requirement and practice every time that they face a compliance examination. The Agencies recognize the relevance to credit decisions of factors related to the adequacy of the borrower's income to carry the loan, the likely continuation of that income, the adequacy of the collateral to secure the loan, the borrower's past performance in paying obligations, the availability of funds to close, and the existence of adequate reserves. While lenders should think critically about whether widespread, familiar requirements and practices have an unjustifiable disparate impact, they should look especially carefully at requirements that are more stringent than customary. Lenders should also stay informed of developments in underwriting and portfolio performance evaluation so that they are well positioned to consider all options by which their business objectives can be achieved.

C. **Answers to Questions Often Asked by Financial Institutions and the Public**
Lending institutions and others often ask the Agencies questions about various aspects of lending discrimination. The Agencies have compiled this list of common questions, with answers, in order to provide further guidance.

Q1: Are disparities in application, approval, or denial rates revealed by Home Mortgage Disclosure Act ("HMDA") data sufficient to establish lending discrimination?

A: HMDA data alone do not prove lending discrimination. The data do not contain enough information on major credit-related factors, such as employment and credit histories, to prove discrimination. Despite these limitations, the data can provide "red flags" that there may be problems at particular institutions. Therefore, regulatory and enforcement agencies may use HMDA data, along with other factors, to identify institutions whose lending practices warrant more scrutiny. Furthermore, HMDA data can be relevant, in conjunction with other data and information, to determine whether a lender has discriminated.

Q2: Does a lending institution that submits inaccurate HMDA data violate lending discrimination laws?

A: An inaccurate HMDA data submission constitutes a violation of the HMDA, the Federal Reserve Board's Regulation C, and other applicable laws, and may subject the lending institution to an enforcement action, which could include civil money penalties, and, if the lender is a HUD-approved mortgagee, the sanctions of the HUD Mortgagee Review Board. An inaccurate HMDA data submission, however, is not in itself a violation of the ECOA or the FH Act. However, a person who intentionally submits incorrect or incomplete HMDA data in order to cover up a violation of the FH Act may be subject, under the FH Act and federal criminal statutes, to a fine or prison term or both. In addition, a failure to ensure accurate HMDA data may be considered as a relevant fact during a FH Act investigation or an examination of the institution’s lending activities.

Q3: Does a second review program only for loan applicants who are members of a protected class violate laws prohibiting discrimination in lending?

A: Such programs are permissible if they do no more than ensure that lending standards are applied fairly and uniformly to all applicants. For example, it is permissible to review the proposed denial of applicants who are members of a protected class by comparing their applications to the approved applications of similarly qualified individuals who are not members of a protected class to determine if the applications were evaluated consistently. It is impermissible, however, to review the applications
of members of a protected class in order to apply standards to those applications different from the standards used to evaluate other applications for the same credit program or to apply the same standards in a different manner, unless such actions are otherwise permitted by law, as described in Question 4.

Other types of second review programs are also permissible. For example, lenders could review the proposed denial of all applicants within a certain income range. Lenders also could review a sampling of all applications proposed for denial, or even review all such applications.

Q4:  May a lender apply different lending standards to applicants who are members of a protected class in order to increase lending to that sector of its community?

A:  Generally, a lender that applies different lending standards or offers different levels of assistance on a prohibited basis, regardless of its motivation, would be violating both the FH Act and the ECOA. There are exceptions to the general rule; thus, applying different lending standards or offering different levels of assistance to applicants who are members of a protected class is permissible in some circumstances. For example, the FH Act requires lenders to provide reasonable accommodation to people with disabilities. In addition, providing different treatment to applicants to address past discrimination would be permissible if done in response to a court order or otherwise in accord with applicable legal precedent. However, the law in this area is complex and developing. Before implementing programs of this sort, a lender should seek legal advice.

Of course, affirmative advertising and marketing efforts that do not involve application of different lending standards are permissible under both the ECOA and the FH Act. For example, special outreach to a minority community would be permissible.

Q5:  Should a lender engage in self-testing?

A:  Principles of sound lending dictate that adequate policies and procedures be in place to ensure safe and sound lending practices and compliance with applicable laws and regulations, and that a lender adopt appropriate audit and control systems to determine whether the institution’s policies and procedures are functioning adequately. This is as true in the area of fair lending as in other operations. Lenders should employ reliable measures for auditing fair lending compliance. A well-designed and implemented program of self-testing could be a valuable part of this process. Lenders should be aware, however, that data documenting lending discrimination discovered in a self-test generally will not be shielded from disclosure.
Corrective actions should always be taken by any lender that discovers discrimination. Self-testing and corrective actions do not expunge or extinguish legal liability for the violations of law, insulate a lender from private suits, or eliminate the primary regulatory agency’s obligation to make the referrals required by law. However, they will be considered as a substantial mitigating factor by the primary regulatory agencies when contemplating possible enforcement actions. In addition, HUD and DOJ will consider as a substantial mitigating factor an institution’s self-identification and self-correction when determining whether they will seek additional penalties or other relief under the FH Act and the ECOA. The Agencies strongly encourage self-testing and will consider further steps that might be taken to provide greater incentives for institutions to undertake self-assessment and self-correction.

Q6: What should a lender do if self-testing evidences lending discrimination?

A: If a lender discovers discriminatory practices, it should make all reasonable efforts to determine the full extent of the discrimination and its cause, e.g., determine whether the practices were grounded in defective policies, poor implementation or control of those policies, or isolated to a particular area of the lender’s operations. The lender should take all appropriate corrective actions to address the discrimination, including, but not limited to:

- Identifying customers whose applications may have been inappropriately processed, offering to extend credit if they were improperly denied; and compensating them for any damages, both out-of-pocket and compensatory; and notifying them of their legal rights;

- Correcting any institutional policies or procedures that may have contributed to the discrimination;

- Identifying, and then training and/or disciplining, the employees involved;

- Considering the need for community outreach programs and/or changes in marketing strategy or loan products to better serve minority segments of the lender’s market; and

- Improving audit and oversight systems in order to ensure there is no recurrence of the discrimination.

An institution is not required to report to the Agencies a lending discrimination problem it has discovered. However, a lender that reports its discovery can ensure that the corrective actions it develops are appropriate and complete and thereby minimize the damages to which it will be subject.
Q7: Will a lender be held responsible for discriminatory lending engaged in by a single loan officer where the lending institution has good policies and procedures in place, is otherwise in full compliance with all applicable laws and regulations and neither knows or reasonably could have known that the officer was engaged in illegal discriminatory conduct?

A: Fair lending violations can occur even in the most well-run lending institutions that have good policies in place to ensure compliance with fair lending laws and regulations. Of course, the chances that such violations will occur can be greatly reduced by backing up those policies with proper employee training and supervision and subjecting the lending process to proven systems of oversight and review. Self-testing can further reduce the likelihood that violations may occur. Notwithstanding these efforts, a single loan officer might still improperly apply policies or, worse yet, deliberately circumvent them and manage to conceal or disguise the true nature of his or her practices for a time. It may be particularly difficult to discover this type of behavior when it occurs in the pre-application process.

In any case where discriminatory lending by a lending institution is identified, the lender will be expected to identify and fairly compensate victims of discriminatory conduct just as it would be expected to compensate a customer if an employee’s conduct resulted in physical injury to the customer. In addition, such a violation might constitute a "pattern or practice" that must be referred to DOJ or a violation that must be referred to HUD.

As in other cases of discriminatory behavior, where a lender takes self-initiated corrective actions, such actions will be considered as a substantial mitigating factor by the Agencies in determining the nature of any enforcement action and what penalties or other relief would be appropriate.

Q8: If a federal financial institutions regulatory agency has "reason to believe" that a lender has engaged in a pattern or practice of discrimination in violation of the ECOA, the ECOA requires the agency to refer the matter to DOJ. What constitutes a "reason to believe"?

A: A federal financial institutions regulatory agency has reason to believe that an ECOA violation has occurred when a reasonable person would conclude from an examination of all credible information available that discrimination has occurred. This determination requires weighing the available evidence and applicable law and determining whether an apparent violation has occurred. Information supporting a reason to believe finding may include loan files and other documents, credible observations by persons with direct knowledge, statistical analysis, and the financial institution’s response to the preliminary examination findings.
Reason to believe is more than an unfounded suspicion. While the evidence of discrimination need not be definitive and need not include evidence of overt discrimination, it should be developed to the point that a reasonable person would conclude that a violation exists.

Q9: If a federal financial institutions regulatory agency has reason to believe that a lender has engaged in a "pattern or practice" of discrimination in violation of the ECOA, the agency will refer the matter to DOJ. What constitutes a "pattern or practice" of lending discrimination?

A: Determinations by federal financial institutions regulatory agencies regarding a pattern or practice of lending discrimination must be based on an analysis of the facts in a given case. Isolated, unrelated or accidental occurrences will not constitute a pattern or practice. However, repeated, intentional, regular, usual, deliberate, or institutionalized practices will almost always constitute a pattern or practice. The totality of the circumstances must be considered when assessing whether a pattern or practice is present. Considerations include, but are not limited to:

- Whether the conduct appears to be grounded in a written or unwritten policy or established practice that is discriminatory in purpose or effect;

- Whether there is evidence of similar conduct by a financial institution toward more than one applicant. Note, however, that this is not a mathematical process, e.g., "more than one" does not necessarily constitute a pattern or practice;

- Whether the conduct has some common source or cause within the financial institution's control;

- The relationship of the instances of conduct to one another (e.g., whether they all occurred in the same area of the financial institution's operations); and

- The relationship of the number of instances of conduct to the financial institution's total lending activity. Note, however, that, depending on the circumstances, violations that involve only a small percentage of an institution's total lending activity could constitute a pattern or practice.

Depending on the egregiousness of the facts and circumstances involved, singly or in combination, these factors could provide evidence of a pattern or practice.

Q10: How does the employment of few minorities and individuals from other protected classes in lending positions -- e.g., Account Executive, Underwriter, Loan Counselor, Loan Processor, Staff Appraiser, Assistant Branch Manager and Branch Manager -- affect compliance with lending discrimination laws?
A: The employment of few minorities and others in protected classes, in itself, is not a violation of the FH Act or the ECOA. However, employment of few members of protected classes in lending positions can contribute to a climate in which lending discrimination could occur by affecting the delivery of services.

Therefore, lenders might consider the following steps, as appropriate to their institutions:

- Advertising lending job openings in local minority-oriented publications;
- Notifying predominantly minority organizations of such openings;
- Seeking employment referrals from current minority employees, minority real estate boards and local historically minority colleges and other institutions that serve minority groups in the community; and
- Seeking qualified independent fee appraisers from local minority appraisal organizations.

Similar outreach steps could be considered to recruit women, persons with disabilities, and other persons protected by the FH Act and the ECOA.

Q11: What is the role of the guidelines of secondary market purchasers and private and governmental loan insurers in determining whether primary lenders practice lending discrimination?

A: Many lenders make mortgage loans only when they can be sold on the secondary market, or they may place some loans in their own portfolios and sell others on the secondary market. The principal secondary market purchasers, Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac"), publish underwriting guidelines to inform primary lenders of the conditions under which they will buy loans. For example, ability to repay the loan is measured by suggested ratios of monthly housing expense to income (28%) and total obligations to income (36%). However, these guidelines allow considerable discretion on the part of the primary lender. In addition, the secondary market guidelines have in some cases been made more flexible, for example, with respect to factors such as stability of income (rather than stability of employment) and use of nontraditional ways of establishing good credit and ability to pay (e.g., use of past rent and utility payment records). Lenders should ensure that their loan processors and underwriters are aware of the provisions of the secondary market guidelines that provide various alternative and flexible means by which applicants may demonstrate their ability and willingness to repay their loans. Fannie Mae and Freddie Mac not infrequently purchase mortgages exceeding the suggested ratios, and their guidelines contain
detailed discussions of the compensating factors that can justify higher ratios (and which must be documented by the primary lender).

A lender who rejects an application from an applicant who is a member of a protected class and who has ratios above those of the guidelines and approves an application from another applicant with similar ratios should be prepared to show that the reason for the rejection was based on factors that are applied consistently without regard to any of the prohibited factors.

These same principles apply equally to the guidelines of private and governmental loan insurers.

Q12: What criteria will be employed in taking enforcement actions or seeking remedial measures when lending discrimination is discovered?

A: Enforcement sanctions and remedial measures for lending discrimination violations vary depending on whether such sanctions are sought by the appropriate federal financial institutions regulatory agencies, DOJ, HUD or other federal agencies charged with enforcing either the ECOA or the FH Act. The following discussion sets out the criteria typically employed by the federal banking agencies (i.e., OCC, OTS, the Board and FDIC), NCUA, DOJ, HUD, OFHEO, FHFB and FTC in determining the nature and severity of sanctions that may be used to address discriminatory lending practices. As discussed in Questions 8 and 9, above, in certain situations, the primary regulatory agencies will also refer enforcement matters to HUD or DOJ.

The federal banking agencies:

The federal banking agencies are authorized to use the full range of their enforcement authority under 12 U.S.C. § 1818 to address discriminatory lending practices. This includes the authority to seek:

- Enforcement actions that may require both prospective and retrospective relief; and

- Civil money penalties ("CMPs") in varying amounts against the financial institution or any institution-affiliated party ("IAP") within the meaning of 12 U.S.C. § 1813(u), depending, among other things, on the nature of the violation and the degree of culpability.

In addition to the above actions, the federal banking agencies may also take removal and prohibition actions against any IAP where the statutory requirements for such actions are met.
The federal banking agencies will make determinations as to the appropriateness of any potential enforcement action after giving full consideration to a variety of factors. In making these determinations, the banking agencies will take into account:

- The number and duration of violations identified;
- The nature of the evidence of discrimination (i.e., overt discrimination, disparate treatment or disparate impact);
- Whether the discrimination was limited to a particular office or unit of the financial institution or was more pervasive in nature;
- The presence and effectiveness of any anti-discrimination policies;
- Any history of discriminatory conduct; and
- Any corrective measures implemented or proposed by the financial institution.

The severity of the federal banking agencies' enforcement response will depend on the egregiousness of the financial institution's conduct. Voluntary identification and correction of violations disclosed through a self-testing program will be a substantial mitigating factor in considering whether to initiate an enforcement action.

In addition, the federal banking agencies may consider whether an institution has provided victims of discrimination with all the relief available to them under applicable civil rights laws.

The federal banking agencies may seek both prospective and retrospective relief for fair lending violations.

Prospective relief may include requiring the financial institution to:

- Adopt corrective policies and procedures and correct any financial institution policies or procedures that may have contributed to the discrimination;
- Train financial institution employees involved;
- Establish community outreach programs and changing marketing strategy or loan products to better serve all sectors of the financial institution's service area;
- Improve internal audit controls and oversight systems in order to ensure there is no recurrence of discrimination; or
- Monitor compliance and provide periodic reports to the primary federal regulator.
Retrospective relief may include:

- Identifying customers who may have been subject to discrimination and offering to extend credit if the customers were improperly denied;

- Requiring the financial institution to make payments to injured parties:
  
  - **Restitution:** This may include any out-of-pocket expenses incurred as a result of the violation to make the victim of discrimination whole, such as: fees or expenses in connection with the application; the difference between any greater fees or expenses of another loan granted elsewhere after denial by the discriminating lender; and, when loans were granted on disparate terms, appropriate modification of those terms and refunds of any greater amounts paid.

- **Other Affirmative Action As Appropriate to Correct Conditions Resulting From Discrimination:** The federal banking agencies also have the authority to require a financial institution to take affirmative action to correct or remedy any conditions resulting from any violation or practice. The banking agencies will determine whether such affirmative action is appropriate in a given case and, if such action is appropriate, the type of remedy to order.

- Requiring the financial institution to pay CMPs:

  The banking agencies have the authority to assess CMPs against financial institutions or individuals for violating fair lending laws or regulations. Each agency has the authority to assess CMPs of up to $5,000 per day for any violation of law, rule or regulation. Penalties of up to $25,000 per day are also permitted, but only if the violations represent a pattern of misconduct, cause more than minimal loss to the financial institution, or result in gain or benefit to the party involved. CMPs are paid to the U.S. Treasury and therefore do not compensate victims of discrimination.

**National Credit Union Administration:**

For federally insured credit unions, NCUA will employ criteria comparable to those of the other federal financial institutions regulatory agencies, pursuant to its authority under 12 U.S.C. § 1786.

**The Department of Justice:**

The Department of Justice is authorized to use the full range of its enforcement authority under the Fair Housing Act, 42 U.S.C. § 3601 et seq., and the Equal Credit Opportunity Act, 15 U.S.C. § 1691 et seq. DOJ has authority to commence pattern
or practice investigations of possible lending discrimination on its own initiative or through referrals from the federal financial institutions regulatory agencies, and to file lawsuits in federal court where there is reasonable cause to believe that such violations have occurred. DOJ is also authorized under the FH Act to bring suit based on individual complaints filed with HUD where one of the parties to the complaint elects to have the case heard in federal court.

The relief sought by DOJ in lending discrimination lawsuits may include:

- An injunction which may require both prospective and retrospective relief; and,
- In enforcement actions under the FH Act, CMPs not to exceed $50,000 per defendant for a first violation and $100,000 for any subsequent violation.

Prospective injunctive relief may include:

- A permanent injunction to insure against a recurrence of the unlawful practices;
- Affirmative measures to correct past discriminatory policies, procedures, or practices, so long as consistent with safety and soundness, such as:
  - Expansion of the lender's service areas to include previously excluded minority neighborhoods;
  - Opening branches or other credit facilities in under-served minority neighborhoods;
  - Targeted sales calls on real estate agents and builders active in minority neighborhoods;
  - Advertising through minority-oriented media;
  - Self-testing;
  - Employee training;
  - Changes to commission structures which tend to discourage lending in minority and low-income neighborhoods; and
  - Changes in loan processing and underwriting procedures (including second reviews of denied applications) to ensure equal treatment without regard to prohibited factors; and
- 20 -

- Record keeping and reporting requirements to monitor compliance with remedial obligations.

Retrospective injunctive relief may include relief for victims of past discrimination, actual and punitive damages, and offers or adjustments of credit or other forms of loan commitments.

The Department of Housing and Urban Development:

The Department of Housing and Urban Development is fully authorized to investigate complaints alleging discrimination in lending in violation of the FH Act and has the authority to initiate complaints and investigations even when an individual complaint has not been received. HUD issues determinations on whether or not reasonable cause exists to believe that the FH Act has been violated. HUD also may authorize actions for temporary and preliminary injunctions to be brought by DOJ and has authority to issue enforceable subpoenas for information related to investigations.

Following issuance of a determination of reasonable cause under the FH Act, HUD enforces the FH Act administratively unless one of the parties elects to have the case heard in federal court in a case brought by DOJ.

Relief under the FH Act that may be awarded by an administrative law judge ("ALJ") after a hearing, or by the Secretary on review of a decision by an ALJ, includes:

- Injunctive or other appropriate relief, including a variety of actions designed to correct discriminatory practices, such as changes in loan processes or procedures, modifications of loan service areas or branching actions, approval of previously denied loans to aggrieved persons, additional record-keeping and reporting on future activities or other affirmative relief;

- Actual damages suffered by persons who are aggrieved by any violation of the FH Act, including damages for mental distress and out-of-pocket losses attributable to a violation; and

- Civil penalties of up to $10,000 for each initial violation and up to $25,000 and $50,000 for successive violations within specific time frames.

HUD also is authorized to direct Fannie Mae and Freddie Mac to undertake various remedial actions, including suspension, probation, reprimand, or settlement, against lenders found to have engaged in discriminatory lending practices in violation of the FH Act or the ECOA.

The Office of Federal Housing Enterprise Oversight:
The Office of Federal Housing Enterprise Oversight is authorized to use its enforcement authority under 12 U.S.C. §§ 4631 and 4636, including cease and desist orders and CMPs for violations by Fannie Mae and Freddie Mac of the fair housing regulations promulgated by the Secretary of HUD pursuant to 12 U.S.C. § 4545.

The Federal Housing Finance Board:

While the Federal Housing Finance Board does not have enforcement authority under the ECOA or the FH Act, in reviewing the members of the Federal Home Loan Bank System for community support, it may restrict access to long-term System advances to any member that within two years prior to the due date of submission of a Community Support Statement, had a final administrative or judicial ruling against it based on violations of those statutes (or any similar state or local law prohibiting discrimination in lending). System members in this situation are asked to submit to the Finance Board an explanation of steps taken to remedy the violation or prevent a recurrence.

The Federal Trade Commission:

The Federal Trade Commission enforces the requirements of the ECOA and Regulation B for all lenders subject to the ECOA, except where enforcement is specifically committed to another agency. The FTC may exercise all of its functions and powers under the Federal Trade Commission Act ("FTC Act") to enforce the ECOA, and a violation of any requirement under the ECOA is deemed to be a violation of a requirement under the FTC Act. The FTC has the power to enforce Regulation B in the same manner as if a violation of Regulation B were a violation of an FTC trade regulation rule.

This means that the FTC has the power to investigate lenders suspected of lending discrimination and to use compulsory process in doing so. The Commission, through DOJ or on its own behalf where the Justice Department declines to act, may file suit in federal court against suspected violators and seek relief including:

- Injunctions against the violative practice;
- Civil penalties of up to $10,000 for each violation; and
- Redress to affected consumers.

In addition, the Commission routinely imposes recordkeeping and reporting requirements to monitor compliance.
Q13: Will a financial institution be subjected to multiple actions by DOJ or HUD and its primary regulator if discriminatory practices are discovered?

A: In all cases where referrals to other agencies are made, the appropriate federal financial institutions regulatory agency will engage in ongoing consultations with DOJ or HUD regarding coordination of each agency's actions. The Agencies will coordinate their enforcement actions and make every effort to eliminate unnecessarily duplicative actions. Where both a federal financial institutions regulatory agency and either DOJ or HUD are contemplating taking actions under their own respective authorities, the Agencies will seek to coordinate their actions to ensure that each agency's action is consistent and complementary. The financial institutions regulatory agencies also will discuss referrals on a case-by-case basis with DOJ or HUD to determine whether multiple actions are necessary and appropriate.
CHANGING ISSUES IN
FINANCIAL INSTITUTION ACQUISITIONS AND MERGERS

Alternatives For Geographic Expansion

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SECTION D
Changing Issues In
Financial Institution Acquisitions and Mergers
Alternatives For Geographic Expansion

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I. Introduction

For decades, Kentucky commercial banks were limited in their geographic scope. They were prohibited from establishing branches outside their home county and from forming multi-bank holding companies. In the meantime, market forces were pressuring commercial banks to expand across county lines. Over the last decade a number of changes have taken place that enable Kentucky commercial banking organizations to cross county and even state lines. While commercial banking organizations are still limited in many respects in their ability to establish or acquire banking offices outside their home county, they now have a remarkable amount of flexibility in doing so.
II. What Changes Have Occurred?

A. Multi-bank holding companies (KRS §§287.900 through 910)
   2. Permits a bank holding company to acquire control of banks that have been in existence at least five years.
   3. Permits out of state bank holding companies to acquire Kentucky banks on a reciprocal basis.
   4. Contains a different definition for "bank" than the rest of KRS Chapter 287: "any institution organized under this chapter, the banking laws of another state, or the National Bank Act, as amended, to do a banking business."
      a. General definitions for Chapter 287:
         (1) "'Bank' means any bank which is now or may hereafter be organized under the laws of this state...."
         (2) "'National bank' or 'national bank association' means a bank created by congress and organized pursuant to the provisions of federal law.

B. Financial Institutions Reform, Recovery, and Enforcement Act of 1989
   1. Authorizes bank holding companies to acquire thrift institutions.
   2. Permits the merger of thrifts and commercial banks (Oakar transaction).
3. Permits the conversion of thrifts into commercial banks (Sasser transaction).

C. Commissioner of Financial Institutions Finding 92-3
1. Issued in 1993.
2. Permits a state chartered commercial bank to relocate across county lines (up to 30 miles) and retain its branch offices (but not its main office).
3. Finding is based on previous ruling by the Comptroller of the Currency that national banks may do the same (12 U.S.C. §30(b)).
4. Presently subject of litigation brought by the Kentucky Bankers Association.

D. Branch by Acquisition (KRS §287.915)
2. Permits a bank holding company controlling more than one bank in Kentucky to "combine" two or more of them into a single bank and to retain branching rights in each county where any of the combining banks could branch.
   a. Each combining bank must then be in existence for at least five years.
   b. "Combine" means either a merger or the acquisition of all or substantially all of the assets of a bank.
c. "Control" means direct or indirect ownership of at least 80% of the issued and outstanding voting securities of the bank.

III. Expansion Opportunities

A. Commercial bank acquisitions

1. Straight acquisition
   a. Bank holding company may acquire a bank that is at least five years old.

2. Stake-out
   a. Bank holding company may obtain non-controlling interest in a younger bank and may hold an option to acquire control exercisable once the bank becomes five years old.

3. Guppy Swallowing Whale
   a. A bank holding company controlling a bank less than five years old may nonetheless acquire control of banks five or more years old -- even if the acquiring holding company is much smaller than the target.
   b. As "loophole" to five year rule, this approach has limitations.
      (1) May only be done every five years.
      (2) Requires shareholder vote of "target".
      (3) Requires securities law compliance for "target" shareholders.
B. Thrift Acquisitions

1. No age limit for first thrift acquired (thrift is not a bank for purposes of KRS §287.900).
   a. KRS §289.900 imposes five year rule on second and subsequent thrifts.
      (1) Younger thrifts may be acquired by merging them into thrift subsidiaries rather than holding them separately.
   b. If bank holding company controls no thrifts, it may establish a de novo thrift.
   c. Federally chartered thrifts may branch statewide (actually, nationwide).
   d. Bank holding companies may acquire mutual thrifts ("merger conversions").
      (1) These transactions are very attractive to acquirors but are presently subject to a moratorium imposed by the OTS.

C. Opportunities to Establish Out-of-County Commercial Bank Offices.

1. Combination of commonly controlled commercial banks under KRS §287.915.
   a. May not include banks less than five years old.

2. Convert a thrift into a commercial bank.
   a. Sasser transaction -- FDIC insurance continues in SAIF.
b. Federal savings banks are national banks under KRS §287.010.

c. KRS §287.170 et seq. provides for conversion of national bank to state commercial bank.

d. Once converted, state bank's existence continues (i.e., existence does not begin at conversion).

3. Combine Thrifts into Bank.
   a. Oakar transaction -- FDIC insurance split between BIF and SAIF.
   b. Federal savings banks are national banks for purposes of KRS §287.915.
   c. Post combination branching rights?

4. Relocate Commercial Bank Office.
   a. Bare charter relocation.
      (1) Involves relocation of main office of bank to new county leaving no offices of that bank in old county.
      (2) Has been done in Kentucky a number of times without challenge.
      (3) Typically done when holding company controls more than one bank in a single county -- one bank purchases and assumes substantially all of the other bank's assets and liabilities and establishes the other bank's offices as its branch
offices; the other bank is then relocated.

(4) Bare charter through KRS §287.915 combination?

(5) Bare charter through P & A by de novo thrift?

b. Relocation leaving behind branches.

(1) Supported by Commissioner and Comptroller (so long as old main office not to be retained as a branch).

(2) Not feasible until litigation resolved.

IV. Conclusion
The Commissioner of Financial Institutions issues this Finding of Permissible Activities, Services, or Products pursuant to KRS 287.020(3). Competitive inequality exists between state banks and national banks as a result of the difference in policies and rules governing relocation of the banks' main offices and retention of existing branches. The relocation of a state bank's main office is governed by KRS 287.185, while 12 USC Section 30(b) governs the relocation of a main office of a national bank. 12 USC Section 30(b) provides that a main office may be relocated not more than thirty miles from its present site. The Office of the Comptroller of the Currency has interpreted 12 USC Section 30(b) as allowing national banks to relocate their main offices across county lines and to retain existing branches in the original county of operation. Using this interpretation, the Office of the Comptroller of the Currency has approved several transactions involving main office relocations across county lines by national banks in Kentucky, some of which included retention of existing branches in the original county of operation.

Therefore, a state bank may, through a resolution of its board of directors, adopt the provisions of 12 USC Section 30(b); and upon a vote of the shareholders owning two-thirds of the stock of the bank and upon approval of the Commissioner of Financial Institutions, a state bank may relocate its main office within thirty miles from the city, town, or village in which the main office was originally located. Existing branches in the original county may be retained, but no new branches may be opened in the original county. The main office in the original county must close.

Effective date: August 24, 1993

EDWARD B. HATCHETT, JR.
COMMISSIONER
STATUTORY APPENDIX

* 12 USC 30
* KRS 287.010
* KRS 287.160
* KRS 287.170
* KRS 287.172
* KRS 287.173
* KRS 287.174
* KRS 287.900
* KRS 287.905
* KRS 287.910
* KRS 287.915
* KRS 289.900
* KRS 289.905
* KRS 289.910
§ 30. Change of name or location

(a) Any national banking association, upon written notice to the Comptroller of the Currency, may change its name, except that such new name shall include the word "National".

(b) Any national banking association, upon written notice to the Comptroller of the Currency, may change the location of its main office to any authorized branch location within the limits of the city, town, or village in which it is situated, or, with a vote of shareholders owning two-thirds of the stock of such association for a relocation outside such limits and upon receipt of a certificate of approval from the Comptroller of the Currency, to any other location within or outside the limits of the city, town, or village in which it is located, but not more than thirty miles beyond such limits.


HISTORICAL AND STATUTORY NOTES

Revision Notes and Legislative Reports

Amendments
1983 Amendment. Subsec. (b). Pub. L. 97-457 added “for a relocation outside such limits” following “stock of such association”.
1982 Amendment. Subsec. (a). Pub. L. 97-320 designated existing provisions as subsec. (a), and in subsec. (a) as so designated, substituted provisions permitting a change of name upon written notice to the Comptroller, such new name to include “National”, for provisions permitting a change of name or location of the main office, with approval of the Comptroller, within city limits, etc., or outside such limits by vote of shareholders, such change to be validated by certificate of approval.
1999 Amendment. Pub.L. 86-230 required approval of the Comptroller of the Currency before a national bank could change the location of its main office within the limitations of the city, town, or village in which it is situated.
287.010. Definitions. — As used in this chapter, unless the context requires otherwise:

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

(2) "National bank" or "national bank association" means a bank created by congress and organized pursuant to the provisions of federal law;

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

(4) "Department" means the department of financial institutions;

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

(6) "Trust company" includes every corporation authorized by this chapter to do a trust business;

(7) "Undivided profits" means the composite of the bank's net retained earnings from current and prior years' operations;

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

(9) "Surplus" means the amount of consideration received by the corporation for all shares issued without par value that has not been allocated to capital stock or the amount of consideration received by the corporation in excess of par value for all shares with a par value or both. (165a-1, 577, 603, 612a, 883c-1, 883c-3: amend. Acts 1946, ch. 191, § 7; 1970, ch. 92, § 82; 1982, ch. 251, § 1, effective April 1, 1982; 1984, ch. 324, § 1, effective July 13, 1984; 1984, ch. 388, § 2, effective July 13, 1984.)
287.160. State bank may reorganize as national bank. — Any state bank desiring to reorganize under the laws of the United States as a national bank may, after its dissolution, and as soon as it obtains authority from the comptroller of the currency to commence business, retain any of the assets, real or personal, which it acquired as a state bank, subject to all liabilities existing against the bank at the time of its reorganization. (588.)

287.170. National bank may reorganize as state bank. — Whenever any national bank is authorized to dissolve, a majority of the directors of the bank, upon authority in writing of the owners of two-thirds (2/3) of its capital stock, may organize a state bank. The articles of incorporation shall include a statement of the authority derived from the stockholders of the dissolved bank. All assets, real and personal, of such bank shall be vested in and become the property of the state bank, subject to all liabilities existing against the bank at the time of its reorganization. (589.)

287.172. Conditions of and procedure for conversion of National Banking Association to state bank or merger with state bank. — (1) A National Banking Association may convert into or merge with a state bank under a state charter, provided that:
   (a) The action taken complies with federal law;
   (b) In the case of a merger, the institutions to be merged are located in the same city or county.

   (2) In the case of each conversion, a written plan of conversion shall be submitted, in duplicate, to the commissioner. Such plan shall be in form satisfactory to the commissioner, shall prescribe the terms and conditions of the conversion and the mode of carrying it into effect, and shall have annexed thereto and forming a part thereof the proposed articles of incorporation of the state bank which is to result from the conversion. Such articles of incorporation shall be in the form prescribed by law for the organization of state banks, with such variations, if any, as shall be satisfactory to the commissioner. With such plan of conversion there shall be submitted, in duplicate, to the commissioner a certificate of the president, secretary or cashier of the National Banking Association certifying that all steps have been taken which are necessary under federal law to the consummation of the conversion. The commissioner shall approve or disapprove such plan of conversion within sixty (60) days of the submission thereof to him. In considering the approval or disapproval of the conversion plan the commissioner shall take into account:
   (a) Any pending administrative or judicial action to which the bank or any officer or director of the bank is a party;
   (b) The performance of the converting national bank for the five (5) years preceding the application for conversion as compared to similarly situated state-chartered banks; and
   (c) The proposed name of the bank after conversion which shall not be the same as or deceptively similar to any existing state-chartered bank.
If the commissioner shall approve such plan, he shall file one (1) duplicate thereof, together with one (1) duplicate of such certificate submitted therewith and the original of the approval of the commissioner, in the office of the commissioner, and the other duplicate of such plan, together with a duplicate of such certificate and a duplicate of the commissioner’s approval, shall be filed in the office of the clerk of the county in which the principal office of the state bank is to be located. After such filing in the office of the commissioner, the conversion shall become effective upon the filing and recording of the articles of incorporation as provided in KRS 287.050, unless a later date is specified in the plan, in which event the conversion shall become effective upon such later date. If the commissioner shall disapprove the conversion plan, he shall state his reasons for such disapproval in writing to which the converting national bank shall have the right of appeal as permitted by law.

(3) In the case of each merger, a written plan of merger shall be submitted, in duplicate, to the commissioner. Such plan shall be in form satisfactory to the commissioner and shall prescribe the terms and conditions of the merger and the mode of carrying it into effect. Such plan may provide the name to be borne by the state bank, as receiving corporation, if such name is to be changed. Such plan may also name the persons who shall constitute the first board of directors of the state bank after the merger shall have been accomplished, provided that the number and qualifications of such person shall be in accordance with the provisions of KRS Chapter 287 relating to the number and qualifications of directors of a state bank; or such plan may provide for a meeting of the stockholders to elect a board of directors within sixty (60) days after such merger, and may make provision for conducting the affairs of the state bank meanwhile. With such plan of merger there shall be submitted, in duplicate, to the commissioner the following:

(a) By the National Banking Association, a certificate of the president, secretary or cashier of such association certifying that all steps have been taken which are necessary under federal law to the consummation of their merger;

(b) By the state bank, a certificate of the president, secretary or cashier certifying that such plan of merger has been approved by the board of directors of the state bank by a majority vote of all the members thereof, that such plan has been submitted to the stockholders of the state bank at a meeting thereof held; upon notice of at least fifteen (15) days, specifying the time, and place and object of such meeting and addressed to each stockholder at the address appearing upon the books of the state bank and published pursuant to KRS Chapter 424, and that such plan of merger has been approved at such meeting by the vote of the stockholders owning at least two thirds (2/3) in amount of the stock of the state bank.

(4) The commissioner shall approve or disapprove such plan of merger within sixty (60) days of such submission thereof to him. If the commissioner shall approve such plan, he shall file one (1) duplicate thereof, together with one (1) duplicate of each of such certificates and the original of the approval of the commissioner, in the office of the commissioner, and the other duplicate of such plan, together with a duplicate of each of such certificates and a duplicate of the commissioner’s approval, shall be filed in the office of the clerk of the county in which the principal office of the state bank is to be located. Upon such filing in the office of the commissioner, the merger shall become effective, unless a later date is specified in the plan, in which event the merger shall become effective upon such later date.
(5) At the time when such conversion or merger becomes effective:

(a) The resulting state bank shall be considered the same business and corporate entity as the National Banking Association, although as to rights, powers and duties, the resulting bank is a state bank;

(b) All of the property, rights and powers and franchises of the National Banking Association shall vest in the resulting state bank and the resulting state bank shall be subject to and deemed to have assumed all of the debts, liabilities, obligations and duties of the National Banking Association and to have succeeded to all of its relationships, fiduciary or otherwise, as fully and to the same extent as if such property, rights, powers, franchises, debts, liabilities, obligations, duties and relationships had been originally acquired, incurred or entered into by the resulting state bank; provided, however, that the resulting state bank shall not, through such conversion or merger, acquire power to engage in any business or to exercise any right, privilege or franchise which is not conferred by the provisions of KRS Chapter 287 upon such resulting state bank;

(c) Any reference to the National Banking Association in any contract, will or document, whether executed or taking effect before or after the conversion or merger, shall be considered a reference to the resulting state bank if not inconsistent with the other provisions of the contract, will or document;

(d) A pending action or other judicial proceeding to which the National Banking Association is a party, shall not be deemed to have abated or to have discontinued by reason of the conversion or merger, but may be prosecuted to final judgment, order or decree in the same manner as if the conversion or merger had not been made; or the resulting state bank may be substituted as a party to such action or proceeding, and any judgment, order or decree may be rendered for or against it that might have been rendered for or against the National Banking Association if the conversion or merger had not occurred. (Enact. Acts 1952, ch. 222, § 2; 1966, ch. 239, § 200; 1980, ch. 192, § 1, effective July 15, 1980.)
287.173. Conversion of state bank to or merger with National Banking Association. — (1) A state bank may convert into, or merge or consolidate with, a National Banking Association under the charter of a National Banking Association in the manner provided by federal law and without approval of any state authority.

(2) The franchise of a state bank as a state bank shall automatically terminate when its conversion into or its merger or consolidation with a National Banking Association under a federal charter is consummated and the resulting National Banking Association shall be considered the same business and corporate entity as the state bank, although as to rights, powers and duties the resulting bank is a National Banking Association.

(3) At the time when such conversion, merger or consolidation becomes effective:

(a) All of the property, rights, powers and franchises of the state bank shall vest in the National Banking Association and the National Banking Association shall be subject to and be deemed to have assumed all of the debts, liabilities, obligations and duties of the state bank and to have succeeded to all of its relationships, fiduciary or otherwise, as fully and to the same extent as if such property, rights, powers, franchises, debts, liabilities, obligations, duties and relationships had been originally acquired, incurred or entered into by the National Banking Association;

(b) Any reference to the state bank in any contract, will or document, whether executed or taking effect before or after the conversion, merger or consolidation, shall be considered a reference to the National Banking Association if not inconsistent with the other provisions of the contract, will or document;

(c) A pending action or other judicial proceeding to which the state bank is a party, shall not be deemed to have abated or to have discontinued by reason of the conversion, merger or consolidation, but may be prosecuted to final judgment, order or decree in the same manner as if the conversion, merger or consolidation had not been made; or the National Banking Association may be substituted as a party to such action or proceeding, and any judgment, order or decree may be rendered for or against it that might have been rendered for or against the state bank if the conversion, merger or consolidation had not occurred. (Enact. Acts 1952, ch. 222, § 3, effective March 21, 1952.)

Cross-References. Articles of incorporation of business corporations, contents, KRS 271B.2-020.

Collateral References. 9 C.J.S., Banks and Banking, §§ 468, 738, 739.

287.174. Provisions of KRS 287.172 and 287.173 to constitute alternative method — Legislative purpose declared. — The methods and procedures set out in KRS 287.172 and 287.173 are authorized in addition to any other methods or procedures for the accomplishment of the same or similar purposes which heretofore may have been established by law. It is the purpose of KRS 287.172, 287.173 and this section to make effective in this Commonwealth the provisions and purposes of the act of congress dated August 17, 1950, which is compiled as chapter 729 of volume 64 of the United States Statutes, and as 12 U.S.C.A. sec. 214. (Enact. Acts 1952, ch. 222, § 4, effective March 21, 1952; 1984, ch. 111, § 124, effective July 13, 1984.)
ACQUISITION OF BANKS

287.900. Definition of terms used in this section and KRS 287.905
— Acquisition of one or more banks, wherever located — Limitations
— Acquisition by out-of-state banks — Limitation — In-county
merger or consolidation. — (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. However, it shall not include an "interim bank" char­
tered solely for the purpose of facilitating the acquisition of an existing
bank unless the existing bank has been in existence for less than five (5)
years;

(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. Section 1841, et seq.). "Control" may be acquired by
acquisition of voting securities, by purchase of assets, by merger or consoli­
dation, by contract, or otherwise;

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

(d) "Deposit" has the meaning accorded it in the Federal Deposit Insur­
ance 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, di­
rectly or indirectly, control 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 ac­
quire 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 year-end reports made by the institu­
tions to their respective supervisory authorities which are available at the
time of the acquisition.

(4)(a) During the period expiring five (5) years after July 13, 1984, no
individual or company wherever located may, directly or indirectly, by
merger, consolidation, purchase, or any other means, acquire control of a
bank or bank holding company if as a result the individual or company
would acquire control of more than three (3) banks in this state during any
twelve (12) month period;

(b) Provided, however, a bank holding company wherever located, may
acquire control of a bank holding company which has its principal place of
business in this state and which controls more than three (3) banks located
in this state under conditions approved by the commissioner which would
require the following:

1. That an acquisition made under this subsection shall be limited to
only one (1) acquisition;

2. That the banks acquired in excess of the three (3) bank per year
limitation included in this acquisition shall be counted against future ac­
quisions during the remaining five (5) year period provided in this subsec­
tion; and

3. That the total bank acquisitions by a bank holding company shall not
exceed in the aggregate fifteen (15) banks during the five (5) year period
provided in this subsection.
(5) The limitations set forth in this section or any other provision of this chapter or any 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 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.

(6)(a) Any bank holding company having its principal place of business in a state which is contiguous to this state may acquire control of any bank or bank holding company having its principal place of business in this state, if the state wherein the bank holding company has its principal place of business shall authorize the acquisition of control of a bank or bank holding company in that state by a bank holding company having its principal place of business in this state under conditions substantially no more restrictive than those imposed by this section;

(b) From and after two (2) years after July 13, 1984, any bank holding company having its principal place of business in a state other than a state which is contiguous to this state may acquire control of any bank or bank holding company having its principal place of business in this state, if the state wherein the bank holding company has its principal place of business shall authorize the acquisition of control of a bank or bank holding company in that state by a bank holding company having its principal place of business in this state under conditions substantially no more restrictive than those imposed by this section; and

(c) For the purposes of this subsection, a bank holding company shall be deemed to be located or have its principal place of business in the state or other jurisdiction in which the total deposits of all the bank holding company’s banking subsidiaries are largest.

(7) 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. (Enact. Acts 1984, ch. 130, § 1, effective July 13, 1984; 1986, ch. 444, § 12, effective July 15, 1986; 1992, ch. 226, § 2, effective July 14, 1992.)
287.905. Filing of application to acquire bank with commissioner — Examination of applicant — Cooperative agreements by commissioner to examine out-of-state bank or exchange confidential information. — (1) Any bank holding company which proposes to acquire control of a bank chartered in this state or a bank holding company which includes a bank chartered in this state, shall concurrently file with the commissioner copies of the application filed with the federal reserve board under applicable federal law. The commissioner shall approve such acquisition within ninety (90) days of acceptance of a complete application if he finds that:

(a) The terms of the acquisition are in accordance with the laws of this state;

(b) The financial condition, or the competence, experience and integrity of the acquiring company or its principals are such as will not jeopardize the financial stability of the acquired bank or bank holding company;

(c) The public convenience and advantage will be served by the acquisition; and

(d) No federal regulatory authority whose approval is required has disapproved the transaction because it would result in a monopoly or substantially lessen competition.

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

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

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

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

(6) The cost of an examination shall be assessed against and paid by the company examined. The assessment for the examination shall be calculated in the same manner as that used for bank examinations. (Enact. Acts 1984, ch. 130, § 3, effective July 13, 1984; 1986, ch. 444, § 13, effective July 15, 1986.)

287.910. Illegal acquisitions. — For purposes of this chapter, it shall be illegal for any individual, corporation or bank holding company to directly or indirectly acquire, control, hold, charter, convert or operate any bank, as defined in KRS 287.900, located in this state which is an "insured bank" or eligible to become an "insured bank" as that term is defined in the Federal Deposit Insurance Act, which does not both accept deposits that the depositor has the legal right to withdraw on demand and actively engage in the business of making commercial loans. (Enact. Acts 1986, ch. 444, § 14, effective July 15, 1986.)
287.915. Bank combinations — Operation of a combined bank as a branch of the surviving bank — Other branches — Taxes — Definitions. — (1) Notwithstanding any other provision of KRS Chapter 287:

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

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

(2) Following any combination authorized by this section:

(a) The surviving bank may, subject to the approval of the commissioner as provided in KRS 287.180(2), establish and operate additional branches at any location where a combined bank could, on or after the combination authorized by this section, have established and operated a branch;

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

(c1) The surviving bank and each combined bank shall, for purposes of the tax which may be imposed pursuant to the provisions of subsections (2) or (3) of KRS 136.270, be deemed to be located in the city or county in which it was located prior to such combination, and that city or county may continue to impose the tax provided for in subsections (2) or (3) of KRS 136.270 upon that proportion of the taxable fair cash value of shares of the surviving bank as the deposits of the surviving bank within that city or county bears to the total deposits of the surviving bank wherever located as reported to the Federal Deposit Insurance Corporation or other applicable regulatory authorities by the surviving bank; provided, that, so long as the surviving bank maintains a branch or branches within a city or county imposing the tax provided for in subsections (2) or (3) of KRS 136.270, such tax shall in no event be less than the tax imposed by the city or county for the year immediately prior to such combination. A copy of the deposit report of the surviving bank and of any combined bank where deposits are not included in the report of the surviving bank shall be submitted to the Revenue Cabinet by the surviving bank with its annual report of banks and trust companies for Kentucky property tax purposes as of the beginning of each year and to the assessing officer of each city and county in which the surviving bank and any combined bank is deemed to be located pursuant to this subsection;

2. The surviving bank shall maintain a record of the deposits in each of its offices resulting from such combination or thereafter established as provided in paragraph (a) of this subsection and, except for deposits transferred or relocated at the request of the depositor, shall not cause or permit such deposits to be transferred or relocated to another branch with the intent to reduce the amount of any tax imposed by any city or county pursuant to subparagraph 1. of this paragraph;
(3) For purposes of this section:
   (a) The term "combine" or "combination" includes a merger or the acquisition of all or substantially all of the assets of a bank already controlled by an individual or bank holding company;
   (b) An individual or bank holding company "controls" a bank if that individual or company, directly or indirectly, owns, controls or has the power to vote at least eighty percent (80%) of the issued and outstanding voting securities of the bank;
   (c) "Combined bank" means any bank participating in a combination authorized by this section other than the surviving bank;
   (d) "Surviving bank" means a bank into which a combined bank has been combined;
   (e) "Bank" includes a national bank but does not include a bank which has been in existence less than five (5) years; and
   (f) "Individual", "bank holding company" and "deposit" shall have the same meanings attributed to them in KRS 287.900(1). (Enact. Acts 1990, ch. 181, § 1, effective July 13, 1990.)
ACQUISITION OF SAVINGS AND LOAN ASSOCIATIONS

289.900. Definitions. — As used in KRS 289.905 and 289.910, unless the context otherwise requires:

(1) "Control" shall have the meaning accorded the term in the Federal Savings and Loan Holding Company Act, 12 U.S.C. sec. 1730a(a)(2), as amended. "Control" may be acquired by acquisition of voting securities, by purchase of assets, by merger or consolidation, by contract, or otherwise;

(2) "Deposit" means any demand negotiable order of withdrawal, time certificate, savings deposit, or savings share account made by an individual, corporation, state or federal governmental unit or any other organization without regard to the location of the depositor; however, excluded from deposits are all inter-savings and loan association or interbank deposits and all deposits in foreign branches and international banking facilities as shown in the reports made by all savings and loan associations to their respective supervisory authorities;

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

(4) "Savings and loan association" means any savings and loan association or savings bank organized under the laws of this state, under the laws of any other state, or under the laws of the United States;

(5) "Kentucky savings and loan association" means a savings and loan association having its principal place of business in this state;

(6) "Principal place of business" means:

(a) With respect to a savings and loan association, the state or territory in which the savings and loan association’s total deposits are the largest, as shown in the most recent report of condition or summary report filed by the savings and loan association with its supervisory authority; and

(b) With respect to a savings and loan association holding company, the state or territory in which the total deposits of all direct and indirect savings and loan subsidiaries of the savings and loan association holding company are the largest, as shown in the most recent reports of condition or summary reports filed by the savings and loan association holding company and its savings and loan subsidiaries with their respective supervisory authorities;

(7) "Savings and loan association holding company" has the meaning accorded the term in the Federal Savings and Loan Holding Company Act, 12 U.S.C. sec. 1730a(a)(1)(D), as amended, except that the term shall include mutual savings and loan association holding companies organized pursuant to Section 408 of the National Housing Act, 12 U.S.C. sec. 1730a(s), as amended. (Enact. Acts 1988, ch. 156, § 1, effective July 15, 1988.)
289.905. Acquisition of one or more associations wherever located — Limitations — Acquisition by out-of-state associations — Merge or consolidation. — (1) Any individual, or any Kentucky savings and loan association holding company, may acquire control of one (1) or more savings and loan associations or savings and loan association holding companies wherever located, except that no individual who on July 15, 1988, controls a savings and loan association or savings and loan association holding company wherever located, and no savings and loan association holding company wherever located, shall acquire, directly or indirectly, control of a Kentucky savings and loan association if the Kentucky savings and loan association was chartered after July 15, 1988 and if, at the time of the acquisition, the Kentucky savings and loan association has been in existence less than five (5) years. The provisions of this subsection shall not prohibit the organization of a one (1) savings and loan association holding company for the purpose of acquiring control of a savings and loan association even if the savings and loan association was chartered after July 15, 1988, and has been in existence less than five (5) years at the time of the acquisition.

(2) No individual or savings and loan association holding company wherever located shall acquire control of any savings and loan association or savings and loan association holding company if, upon the acquisition, the individual or savings and loan association holding company would control Kentucky savings and loan associations holding more than fifteen percent (15%) of the total deposits in all Kentucky savings and loan associations as reported in the most recent year-end reports made by Kentucky savings and loan associations to their respective supervisory authorities which are available at the time of the acquisition.

(3) (a) During the period expiring five (5) years after July 15, 1988, no individual or corporation wherever located shall, directly or indirectly, by merger, consolidation, purchase or any other means, acquire control of a savings and loan association or savings and loan association holding company if as a result thereof such individual or corporation would acquire control of more than three (3) Kentucky savings and loan associations during any twelve (12) month period;

(b) However, a savings and loan association holding company wherever located, may acquire control of a savings and loan association holding company which has its principal place of business in this state and which controls more than three (3) Kentucky savings and loan associations under conditions approved by the commissioner which would require the following:
1. That an acquisition made under this subsection shall be limited to only one (1) acquisition;

2. That the Kentucky savings and loan associations acquired in excess of the three (3) Kentucky savings and loan associations per year limitation included in this acquisition shall be counted against future acquisitions during the remaining five (5) year period provided in this subsection; and

3. That the total Kentucky savings and loan association acquisitions by a savings and loan association holding company shall not exceed in the aggregate five (5) Kentucky savings and loan associations during any five (5) year period.

(4) The limitations set forth in this section or any other provision of this chapter or any regulation promulgated thereunder, as now in effect or amended after July 15, 1988, shall not apply to the acquisition of a Kentucky savings and loan association if, in his discretion, the commissioner, if the Kentucky savings and loan association is organized under the laws of this state, or the federal home loan bank board, if the Kentucky savings and loan association is federally chartered, determines that an emergency exists and the acquisition is appropriate in order to prevent the probable failure of a Kentucky savings and loan association or savings and loan holding company having its principal place of business in this state which is closed or is in danger of closing.

(5) Any savings and loan association holding company having its principal place of business in any state may acquire control of any Kentucky savings and loan association or of any savings and loan association holding company having its principal place of business in this state, if the state wherein the savings and loan association holding company has its principal place of business shall authorize the acquisition of control of a savings and loan association or savings and loan association holding company in that state by a savings and loan association holding company having its principal place of business in this state under conditions substantially no more restrictive than those imposed by this section;

(6) The provisions of this section shall not be construed to prohibit or restrict the merger, consolidation or other acquisition of Kentucky savings and loan associations or of savings and loan association holding companies having their principal places of business in this state and the operation by the merged or consolidated corporation of the Kentucky savings and loan associations, nor to prohibit the sale of any savings and loan association or savings and loan association holding company to, and the purchase thereof by, any Kentucky savings and loan association or any savings and loan association holding company with its principal place of business in this state or the operation of the savings and loan association as a branch.

289.910. Filing of application to acquire association or holding company — Examination of applicant — Cooperative agreements for examination of out-of-state associations or exchange of confidential information. — (1) Any savings and loan association holding company which proposes to acquire control of a Kentucky state chartered savings and loan association, or of a savings and loan association holding company which controls a Kentucky state chartered savings and loan association, shall concurrently file with the commissioner copies of the application filed with the applicable federal supervisory authority. The commissioner shall approve such acquisition within ninety (90) days of acceptance of a complete application if he finds that:

(a) The terms of the acquisition are in accordance with the laws of this state;

(b) The financial condition, or the competence, experience and integrity of the acquiring company or its principals are such as will not jeopardize the financial stability of the acquired savings and loan association or savings and loan association holding company;

(c) The public convenience and advantage will be served by the acquisition; and

(d) No federal regulatory authority whose approval is required has disapproved the transaction because it would result in a monopoly or substantially lessen competition, or has otherwise disapproved the transaction.

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

(3) The commissioner may enter into cooperative agreements with federal or state regulatory authorities to examine an out-of-state savings and loan association that is controlled by a savings and loan association holding company having its principal place of business in this state, or accept reports of examinations of such out-of-state regulatory authorities in lieu of conducting examinations.

(4) The commissioner may enter into cooperative agreements with federal or state regulatory authorities to exchange confidential information and reports of examination relating to interstate acquisitions of savings and loan associations and savings and loan association holding companies.

(5) The cost of an examination shall be assessed against and paid by the savings and loan association or savings and loan association holding company examined. The assessment for the examination shall be calculated in the same manner as that used for savings and loan association examinations. (Enact. Acts 1988, ch. 156, § 3, effective July 15, 1988.)
NON-TRADITIONAL BANKING PRODUCTS:
INSURANCE, ANNUITIES AND MUTUAL FUNDS

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Non-Traditional Banking Products:
Insurance, Annuities And Mutual Funds

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SECTION E
I. INTRODUCTION

A. The scope of this outline is to provide an overview as to current issues affecting a bank's ability to sell insurance, mutual funds and annuities. For anyone that has not followed this area, the banking industry is in a state of flux over the sale of insurance and retail nondeposit investments and substantial changes will likely occur in the near term which may substantially affect the contents of this outline. This outline does not purport to be a road-map or a comprehensive examination of the many issues facing banks in this area, but merely an overview of certain current issues.

B. Banks, insurance companies and mutual funds are increasingly competing with each other and offering each other's product lines to customers. As banks offer these non-traditional services to their customers, they are exposing themselves to new legal and regulatory issues that are complex, often overlapping, and not always consistent.

C. Banks are usually enticed to offer nondeposit investments and insurance products to enhance fee income and help solidify customer loyalty. A recent American Banker article on mutual funds indicated that bank-managed mutual funds grew by 34 percent in 1993. Bank trade groups recently indicated that Americans were purchasing approximately $30 billion per month of mutual funds with banks accounting for roughly 15 percent of that total. The current low interest rate environment, as measured by low yields on insured depository instruments, are partially responsible for this growth.

D. Banks may offer non-deposit investment products to customers in many ways. One way is for the bank to lease space to a distributor of the product and in return receive a rental fee for the space and, possibly, a percentage override of the net or gross profits. A second way is for the bank to permit an outside distributor to directly solicit its customers and the bank may perform administrative services for the mutual fund with respect to its customers and, possibly, investment advisory services to the fund for a fee. A third arrangement is for the bank to make mutual funds directly available to its customers using its own employees to market the product. While the manner in which the sale of uninsured products at banks may be conducted is varied, the legal issues presented and the degree of regulatory overlap is obviously directly related to the manner in which the product is marketed at each bank. The more direct involvement a bank chooses to take in offering the product results in greater fee generation, along with a more complex regulatory and legal environment for the bank to operate.

E. All retail sales of investment products by banks are regulated as follows:

1. National banks are subject to the rules and regulations of the Office of the Comptroller of the Currency ("OCC").
2. State chartered member banks are subject to the rules and regulations of the Federal Reserve System ("Federal Reserve").

3. State chartered non-member banks are subject to the rules and regulations of the Federal Deposit Insurance Corporation ("FDIC").

4. Federally chartered and insured state-chartered savings associations and savings banks are regulated by the Office of Thrift Supervision ("OTS").

At the present time, banks are exempt from registration under federal and state securities laws from registration as an investment company and as a broker/dealer. The federal securities laws include the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940 and the Investment Company Act of 1940. This exemption from registration with the SEC is not available for thrifts, subsidiaries of banks and holding companies or joint ventures with banks.

While banks are exempt from the registration requirements of federal and state securities laws, all banks and bank affiliates that engage in retail investment sales are subject to the anti-fraud provisions of the federal securities laws.

When a bank utilizes a third-party broker-dealer, the broker-dealer's activities are regulated by the SEC. Pursuant to the requirements set forth under federal securities laws, broker-dealers are also subject to the rules and regulations of securities self-regulatory organizations such as the National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE"). The provisions of ERISA may also regulate the sale of mutual funds that deal with benefit plans and other areas regulated by ERISA.

F. There have been many studies authorized recently by the SEC, GAO, trade groups, American Association of Retired Persons, and others that indicate there is some confusion on they part of many investors with respect to banks involvement in the mutual fund business. A recent SEC study showed that 66 percent of those surveyed thought that money market funds purchased through the banks were federally insured by he FDIC and 56 percent thought that all mutual funds sold by banks were backed by the assets of the bank or were federally insured. The existence of investor confusion in the sale of mutual funds has resulted in new guidelines being issued by each of the bank regulators and by trade associations. There has also been concern expressed by the SEC, and concern and new legislation proposed by members of Congress.

II. UPDATE ON BANKS SELLING INSURANCE PRODUCTS

A. Agent for General Insurance.

1. State Banks and Bank Holding Companies in Kentucky. Kentucky banking laws in KRS 287.030 appear to substantially limit banks and bank holding companies in Kentucky acting as insurance agent or broker except: (1) credit life; (2) credit health; and (3) insurance of the interest of a real property mortgagee in mortgaged property, other than title insurance. The relevant section reads:
(4) No person who after July 13, 1984, owns or acquires more than one-half (1/2) of the capital stock of a bank shall act as insurance agent or broker with respect to any insurance except credit life insurance, credit health insurance, insurance of the interest of a real property mortgagee in mortgaged property, other than title insurance. [KRS 287.030(4)].

With respect to bank holding companies owning banks in Kentucky, the attorney general in OAG 81-173 has said:

A bank holding company may not acquire 100% of the outstanding common stock of an insurance agency, since the language of this section expresses the clear intent of the legislature to limit the involvement of a bank's majority shareholders, including one-bank holding companies, in insurance-related activities; accordingly, any construction which would authorize ownership of an insurance agency as a wholly-owned subsidiary on the theory that it is a separate entity and is "acting" indirectly or independently of its controlling parent corporation would render that portion of the statute a nullity and lead to the absurd result that the statute can be avoided by mere organization as a bank holding company. (OAG 81-173).

The Commissioner of the Department of Financial Institutions may be limited in making a finding of permissible activities pursuant to KRS 287.020.3 [commonly referred to as "parity letters"]. The relevant restriction in KRS 287.020(3) states that "... This section shall not apply to activities prohibited under Subtitle 9 of KRS Chapter 304."


(a) 12 U.S.C. § 92. Federal banking laws permit national banks located in places the population of which does not exceed 5,000 inhabitants to engage as agents in general insurance. The law reads as follows:

§ 92 Action as insurance agent or broker; procuring loans on real estate
In addition to the powers now vested by law in national banking associations organized under the laws of the United States any such association located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census, may, under such rules and regulations as may be prescribed by the Comptroller of the Currency, act as the agent for any fire, life, or other insurance company authorized by the authorities of the State in which
such bank is located to do business in said State, by soliciting and selling insurance and collecting premiums on policies issued by such company; and may receive for services so rendered such fees or commissions as may be agreed upon between the said association and the insurance company for which it may act as agent: Provided, however, That no such bank shall in any case assume or guarantee the payment of any premium on insurance policies issued through its agency by its principal: and provided further, That the bank shall not guarantee truth of any statement made by an assured in filing his application for insurance. (12 U.S.C.§ 92).

The OCC has also issued the following regulations:

§ 7.7100 National banks acting as general insurance agents.
12 U.S.C. 92 provides that national banks may act as agents for any fire, life, or other insurance company in any place the population of which does not exceed 5,000 inhabitants. This provision is applicable to any office of a national bank when the office is located in a community having a population of less than 5,000 even though the principal office of such bank is located in a community whose population exceeds 5,000. (12 C.F.R. Part 7.7100).

§ 7.7495 Debt cancellation contracts.
A national bank may provide for losses arising from cancellation of outstanding loans upon the death of borrowers. The imposition of an additional charge and the establishment of necessary reserves in order to enable the bank to enter into such debt cancellation contracts are a lawful exercise of the powers of a national bank and necessary to the business of banking. (12 C.F.R. Par 7.7495).

(b) Recent Court Decisions.

On July 16, 1993, the U.S. Circuit Court of Appeals for the District of Columbia Circuit in Independent Insurance Agents of America v. Ludwig, 997 F.2d 958 (D.C. Cir. 1993) upheld a ruling by the OCC that national banks may sell any type of insurance nationwide from small towns of 5,000 people or less. The decision noted that no specific congressional intent could be found to restrict the geographical reach of insurance sales authorized by Section 92.

The Fifth Circuit in Saxon v. Georgia Association of Independent Insurance Agents, 399 F.2d 1010 (5th Cir. 1968) relied on Section 92 to declare unlawful Comptroller Saxon's ruling that permitted a national bank to sell its borrowers "broad forms of automobile, home, casualty and liability insurance." Saxon, 399 F.2d at 1012. The court applied the principle of expressio unius est exclusio alterius and reviewed the legislative history to conclude that national banks have no power to act as insurance agents in towns greater than 5,000 people.

The Second Circuit on June 15, 1992 in American Land Title Association v. Clarke, 968 F.2d 150 (2nd Cir. 1992), the court struck down the OCC's decision that Chase Manhattan Bank could sell title insurance as an incidental activity under 12 U.S.C. § 24(7). The court concluded that a power that had been withheld by Congress cannot be found to be incidental and necessary. This decision leaves in question the extent to which a national bank may use Section 24(7) to conduct any form of insurance activity. The court did distinguish Independent Bankers Association v. Heimann, 613 F.2d 1164 (D.C. Cir. 1979), which held that Section 92 did not bar a national bank from selling credit life insurance in a town with over 5,000 inhabitants, based largely on the nature of credit life insurance as being unique to banking.

On August 4, 1992, the United States District Court for the Eastern District of Kentucky, Frankfort Division, in The Owensboro National Bank v. Moore, 803 F. Supp. 24 (E.D. Ky. 1993), held that Section 92 preempts KRS 287.030(4) and, accordingly, the plaintiff banks may not be prevented from applying for insurance licenses. Judge Hood also noted that KRS 287.030(4) does not constitute insurance regulation and, accordingly, the McCarran-Ferguson Act, 15 U.S.C. § 1011, et. seq. ("McCarran Act") has no application. However, Judge Hood in conclusion noted:

The court specifically declines to determine whether the Commissioner is required to issue licenses once the completed
applications are received. Whether national banks are subject to Kentucky's criteria for the issuance of an insurance license is not properly before the court, and may well implicate McCarran-Ferguson in other respects. In any event, the court need not reach this issue in narrowly deciding that Ky. Rev. Stat. 287.030(4), as interpreted, is preempted by 12 U.S.C. § 92, and does not permit the Commissioner to refuse to provide the requested applications.

The decision has been appealed to the U.S. Court of Appeals for the Sixth Circuit and is presently awaiting oral argument which should occur in April.

(6) On December 2, 1993, the United States District Court in Barnett Banks of Marion County, N.A. v. Florida, 839 F. Supp. 835 (1993) ruled that Section 92 did not preempt a Florida insurance statute that limits bank subsidiaries of bank holding companies from insurance agency activities. The court concluded that the McCarran Act grants to the states the right to regulate the business of insurance.

The court distinguished the Owensboro National decision as follows:

Additionally, the outcome of that court's McCarran-Ferguson analysis differed from that in the present case, Judge Hood finding that the Kentucky statute did not constitute insurance regulation. Owensboro, however, is distinguishable for three important reasons. First, there was no state caselaw upon which Judge Hood could rely for the meaning and/or purpose of the state regulation. Second, the Kentucky provision was located within that chapter of the state statutes regulating banks and trust companies, not that portion which regulates insurance. Lastly, the court there applied the tripartite test announced in Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119, 73 L. Ed. 2d 647, 102 S. Ct. 3002 (1982) for determining whether a state law governs the "business of insurance." As the subsequently decided Fabe made clear, and as the instant Defendants have duly noted, the Pireno test applies to the second clause of McCarran-Ferguson (relating to the scope of antitrust
immunity), while the instant analysis--and that in Fabe--relates to the first clause of the Act. In this vein, it should also be noted that Fabe was a Sixth Circuit case, and was remanded to that court of appeals, before which an appeal from Owensboro presently lies. [803 F. Supp. at 35].

(7) While the courts have recently supported the ability of national banks that have offices in towns of 5,000 or less to act as agent for the sale of insurance as set forth above, the next test for national banks may be satisfying the requirements of the Department of Insurance to obtain an insurance license. The issue, as in Barnett Bank above, appears to be whether section 92 preempts state insurance laws that bar or limit the sale of insurance by certain parties. Since the McCarran Act clearly appears to give states the right to regulate the business of insurance, how do you reconcile limits that may be imposed under the McCarran Act and Section 92 insurance authority? As an example, KRS 304.9-100 deals with the situation where the granting of a license for engaging in the business of insurance is to be with respect to the general public and not for the purpose of permitting the licensee to write insurance for "controlled business." The commissioner may withhold any license "... if he finds that the license has been or is being, or will probably be used by the applicant or licensee principally for the purpose of writing 'controlled business'..." that is:

(b) Insurance or annuity contracts covering himself or members of his family, or the officers, directors, stockholders, partners, employees or debtors of a partnership, association, or corporation of which he or a member of his family is an officer, director, stockholder, partner, associate, or employee. [Emphasis added]. (KRS 304.9-100).

B. Credit Life and Credit Health Insurance.

1. Kentucky chartered banks pursuant to KRS 287.030(4) and national banks as an incidental power under 12 U.S.C. § 24(7) permit the bank to act as agent in the sale of credit life and credit health insurance.

2. The OCC in 12 C.F.R. Part 2.1 regulates the disposition of credit life insurance income. The OCC's position on credit life insurance was upheld in Independent Bankers Association of America v. Heimann, 613 F.2d 1164 [D.C. Cir. 1980].
3. Banks must comply with the rules and regulations of the Department of Insurance to sell credit life and credit health insurance.

C. Update on the Sale of Annuities by Banks. The direct sale of annuities by banks has become questionable based upon several recent court decisions. Annuities have been traditionally sold by insurance companies. There are variable and fixed rate annuities. The variable rate annuity is very similar to a mutual fund and the fixed rate annuity is more like an insurance product.

1. National Banks. The U.S. Court of Appeals for the Fifth Circuit on August 26, 1993, in Variable Annuity Life Insurance Company v. Clarke, 998 F.2d 1295 (5th Cir. 1993), held that national banks were barred from selling annuities in towns with more than 5,000 inhabitants and further determined that "annuities" are an "insurance product" and not financial investment instruments as the OCC had claimed. The court also rejected the OCC's argument that Section 24(7) of the National Bank Act provides independent authority for national banks to sell annuities. The OCC requested that the U.S. Court of Appeals for the Fifth Circuit rehear the case but the court declined on January 13, 1993, with a lengthy dissent from four judges; which sets the stage for a possible appeal to the U.S. Supreme Court.

2. State Banks in Kentucky. The Commissioner of the Kentucky Department of Financial Institutions has taken the position in a letter dated May 25, 1990 and has recently verbally confirmed his position with respect to variable and fixed annuities as follows:

We believe that KRS 287.210(2) permits state-chartered banks to act as compensated agents for their customers in purchasing or selling variable and fixed annuities. We infer from this section the incidental authority to enter into agreements with issuers or marketers of such contracts whereby the banks may for a fee promote the contracts and solicit their purchase by the banks' customers, subject to the following requirements:

1. The fee paid to the bank for each contract sold may not vary with the volume of contracts sold;

2. Prospectuses, promotional materials, advertising, and forms must clearly and conspicuously state that the contract is a product of the issuer, that it is not a product of the bank, and that it is not insured by the FDIC; and

3. The bank must obtain a signed statement prior to the sale of a contract in which its customer acknowledges that the annuity is an obligation of the issuer and not of the bank, that the bank is acting as a
compensated agent for the issuer, and that the obligation is not insured by the FDIC.

While your letter does not ask, I would add that state-chartered banks may implement an incentive program involving a pass-through of commissions to employees who sell the contracts so long as full disclosure of the compensation is made by the employee during the sale of the contract. In addition, the employee's percentage interest in commissions must not vary with the volume of contracts sold, and the bank must have written policies and adequate controls in place to prevent product tie-ins and unsound lending practices. (Letter from Commissioner of KDFI dated May 25, 1990 to M. Brooks Senn).

3. **Department of Insurance.** The Department of Insurance appears, based upon informal discussions with staff members, to take the position that an annuity in Kentucky is the sale of an insurance product and that any sale of an annuity must be in compliance with the rules and regulations of the Department of Insurance.

D. **Leasing Space in Banking Facilities to Third-Party Distributors.**

1. **National Banks.** The OCC has indicated that national banks may lease space in their lobbies to insurance agents and receive a percentage override on the gross income from the sales. For a discussion on this type of arrangement, see OCC Interpretive Letter No. 294, Fed. Banking L. Rep. (CCH) ¶ 85,438 (December 21, 1983). In 12 C.F.R. Part 7.7516, the OCC's regulation states:

   **§ 7.7516 Sharing of banking quarters.**
   
   The operations of a national bank and another financial institution should be separately identified and maintained within any banking quarters which may be shared by these institutions. Similarly, the assets and records of such institutions should be segregated. Where a national bank and another financial institution share banking quarters, an active officer or employee of one institution may engage in the performance of work for the other institution pursuant to an agency agreement and under such conditions as to insure that the agency relationship is readily known to the customers of either institution.

   The terms of any lease arrangement with a third party vendor should be reviewed with the staff of the OCC prior to implementation.

2. **State Banks in Kentucky.** The Commissioner of the KDFI has authorized state-chartered banks in Kentucky to lease space in its lobby to a third-party vendor and has previously not taken exception to the bank receiving compensation in the form of a rental payment of both fixed rent and a percentage rent based on the volume of sale.
Because no statute or regulation clearly authorizing such an arrangement exists under Kentucky law, I would suggest any state bank pursuing such an arrangement obtain a letter from the Commissioner authorizing such a lease.

3. **Department of Insurance.** The Department of Insurance may well object to a bank entering such an arrangement with a third-party vendor if the percentage rent based upon volume sold appears high and is the equivalent of commission sharing. (See KRS 304.9-421. Sharing of commissions prohibited.)

E. **OCC Insurance Guidelines.** The OCC has announced its intent to issue guidelines on the sale of insurance by national banks in the form of an advisory letter in the near future. At this time, these guidelines are not available.

### III. UPDATE ON THE SALE OF MUTUAL FUNDS BY STATE BANKS AND NATIONAL BANKS IN KENTUCKY.

A. **Overview.** Unlike the authority for banks to sell insurance products the permissibility of bank mutual fund activities under the Glass-Steagall Act basically remains unquestioned. While banks may not underwrite or distribute mutual funds, the real issue with respect to mutual funds has shifted to supervisory and compliance concerns dealing with protecting the consumer, providing adequate disclosure and insuring appropriate suitability standards are instituted, among other issues. Each of the banking regulators, the banking trade association, and others has set forth guidelines for banks that market, directly or indirectly, mutual funds and annuities to their customers.

B. **Bank Regulatory Guidelines.** The following bank regulators have issued guidelines on the marketing of non-insured products to a bank's customers:

1. The OCC in Section 413 for the *Comptroller's Handbook for National Bank Examiners* (OCC 94-13) on February 24, 1994 issued guidelines with respect to retail nondeposit investment sales. A copy of OCC 94-13 is attached to this outline. OCC 94-13 replaces Banking Circular 274, which is rescinded.


3. The FDIC issued a supervisory statement ("FIL-71-93") on October 8, 1993 on sales of nondeposit investments.

4. The Federal Reserve on June 25, 1993 issued a letter (SR 93-35) on the separation of mutual funds sales activities from insured deposit-taking activities.

5. Interagency Statement on Retail Sales of Nondeposit Investment Products (NR 94-21) was released on February 15, 1994 under the auspices of the four banking and thrift regulators. The guidelines oversee sale of annuities, mutual funds and securities products made by bank employees, sales made by employees of affiliated or unaffiliated...
entities occurring on bank premises and sales resulting from customer referrals when the bank receives a benefit for the referral. NR 94-21 supersedes guidelines previously issued by the four banking agencies. A copy of NR 94-21 is attached to this outline as a part of OCC 94-13.

C. SEC. The SEC has long lobbied for functional regulation of sale of securities by banks. In a recent speech to 1994 NASAA Winter Enforcement Conference, the SEC Commissioner, Richard Y. Roberts, stated that he would support the idea that banks should be permitted to engage in the business of dealing in, underwriting, and distributing the shares of investment companies and to organize, sponsor, manage or control investment companies by conducting these activities through separate non-bank affiliates.

D. Bank Trade Group Guidelines.

1. On February 1, 1994, the American Bankers Association, The Bankers Roundtable, Consumer Bankers Association, Independent Bankers Association, National Bankers Association and the Savings & Community Bankers of America released guidelines on Retail Investment Sales. These guidelines are intended to complement the guidelines set forth by bank regulators.

2. A discussion of some of the provisions follows:

(a) Purpose.

(1) Enhance Customer Protection.

(2) Complement Regulatory Policy.

(3) Help Banks Comply

(4) Encourage Training and Qualifications

(b) Summary.

(1) Oral and written disclosures. Oral and written disclosures should be provided to the customer stating that such products:

● are not bank deposits;

● are not obligations of or guaranteed by any bank;

● are not insured or guaranteed by the FDIC or any other government agency; and

● involve investment risk, including the possible loss of principal.
Signed disclosures. The customer should sign a disclosure form acknowledging that the customer has read and understands the written disclosure.

Advertising and promotion. All advertising should contain conspicuous and prominent notice of the uninsured nature of investment products.

Location. Sales of nondeposit investment products should take place in areas physically separate from deposit-taking activities.

Setting and circumstances. Tellers should not be permitted to sell nondeposit investment products and to offer investment products. Nondeposit investment products should only be sold by qualified personnel.

Employee qualifications and training. Bank management, sales representatives and audit and compliance personnel should demonstrate competence appropriate to the function or responsibilities assigned to them. When appropriate, and possible, sales representatives should obtain a NASD license, such as Series 6 or 7. A NASD license equivalency certificate may be appropriate. Background checks for all sales representatives are strongly recommended.

Employee compensation and referral fees. Suitability, not compensation, should guide in the sale of nondeposit investments products. Referral fees to tellers and other bank employees is permissible if not based upon the success of the referral generating a sale.

Bank management and board of director oversight. Banks should establish written policies and procedures regarding retail sales of non-deposit investments products. Policies should encompass third-party and affiliated vendor sales. Such policies should be designed to achieve compliance with applicable banking, securities and insurance laws and regulations. A compliance program should be established, which is independent of the sales program.

IV. MISCELLANEOUS AND CURRENT EVENTS.

A. The American Bankers Association announced in the American Banker on February 10, 1994 that it is developing a new series of training programs for banks that sell mutual funds. The programs range from basic overview to preparation for licensing.

B. On February 1, 1994, Treasury Secretary Lloyd Benson speaking before the American Association of Retired Persons called for mandatory disclosure.
requirements for bank mutual fund sales so the public will have sufficient awareness as they make decisions.


D. On October 19, 1993 Rep. Henry Gonzalez (D-Texas) and Rep. Charles Schumer (D-NY) introduced a bill (Depository Institution Retail Investment Sales and Disclosure Act (HR 3306)) to insure consumers investing in mutual funds through banks know their investments possess some risk and are not covered by federal deposit insurance. The bill, if adopted, requires the bank to physically separate the sale of uninsured products from the rest of the bank.

E. As most of you are aware, Mellon Bank Corp. and The Dreyfus Corp. on December 6, 1993 announced their intention to combine and form one financial services company. The transaction has created much congressional interest, as well as regulatory complexity as Mellon announced its intent to operate Dreyfus as a subsidiary of its lead bank. On February 24, 1994 the OCC took an unusual step of inviting public comments on the application.
COMPTROLLER ISSUES GUIDANCE TO EXAMINERS ON MUTUAL FUND SALES

The Office of the Comptroller of the Currency (OCC) today released procedures for examining the mutual fund or other retail nondeposit investment sales operations of national banks. The guidance implements the statement on nondeposit investment products issued by the federal bank and thrift regulators last week.

"Today’s action is the result of draft exam procedures that our examiners have been field testing for the past six months. All OCC examiners will now have detailed guidance about how to examine bank mutual fund sales," said Comptroller of the Currency Eugene A. Ludwig. "I’m instructing examiners to determine that bank management responds immediately to any matter that has the potential to confuse customers as to the uninsured nature of nondeposit investment products."

The examination procedures cover all aspects of a national bank’s retail sales activities, including sales made by bank employees and sales on bank premises made by employees of third party vendors. The procedures are more detailed than the OCC’s previous guidance and offer specific examples of what the OCC expects from national banks that engage in this business.

Among other things, the procedures instruct examiners to:

- Criticize sales programs with fund names so similar to the bank’s that even mitigating circumstances are unlikely to eliminate customer confusion. For example, a bank named First National Bank would be misleading customers if it operated an uninsured fund called First National Bank Fund.

- Increase scrutiny of ALL aspects of a bank’s sales program if the bank’s name is greatly similar to the fund’s name.
Assess the independence and thoroughness with which banks select the products they will offer. In particular, examiners should criticize bank managers who choose investment products simply because they generate the largest sales fees.

Verify that banks with investment sales programs have disclosed that mutual funds and other nondeposit investment products (1) are not FDIC insured, (2) are not deposits or other obligations or guarantees of the bank, and (3) involve investment risks, including possible loss of principal amount invested.

Determine whether these disclosures are featured conspicuously in all written or oral sales presentations, advertising and promotional materials, confirmations, and periodic statements that include the name or the logo of the bank or an affiliate. The procedures state that disclosures in advertisements and brochures should appear in text at least as large as that describing the product. The OCC will consider disclosures to be conspicuous if they are on brochure covers or at the front of descriptive text.

Determine whether products recommended for sale are suitable investments for customers. In particular, the procedures call for special attention for product recommendations made to first-time, risk averse, elderly, or surviving spouse customers.

Verify that a bank has assigned a bank officer to be responsible for resolving any customer complaints.

The procedures also include other examples of steps banks can take to minimize customer confusion. For example, they give advice about how banks can ensure that sales personnel are giving accurate disclosures to customers by using "testers." They also have guidance on oversight of third party vendors selling on bank premises and describe techniques used by well-managed banks to select mutual funds or other investment products, such as annuities, for sale to the bank's customers.

The OCC will send copies of the examination procedures to all national banks and all national bank examiners.

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TO: All Users of the Comptroller's Handbook for National Bank Examiners

PURPOSE

This issuance transmits a new section 413, Retail Nondeposit Investment Sales, for the Comptroller's Handbook for National Bank Examiners. This section should be inserted in the handbook at the end of the "Other Areas of Examination Interest" section, behind section 412, Discount Brokerage Activity.

REFERENCES

Banking Circular 274, Retail Nondeposit Investment Sales, is rescinded and replaced by new section 413 to the Comptroller's Handbook for National Bank Examiners, dated February 1994, attached.

BACKGROUND

On July 19, 1993, the Office of the Comptroller of the Currency issued Banking Circular 274, Retail Nondeposit Investment Sales, which provided guidelines for national banks involved in the sale to retail customers of mutual funds, annuities, and other nondeposit investments. Those guidelines were superseded on February 15, 1994, by the issuance of an Interagency Statement, developed by the OCC, the Federal Reserve Board, the FDIC, and the OTS. The Interagency Statement will apply uniform standards to federally insured financial institutions offering these services.

SCOPE

The Interagency Statement is incorporated in this insert, which provides national bank examiners with procedures for examining the nondeposit investment sales activities of national banks. The questions and procedures presented here check for compliance with the Interagency Statement as well as laws, rules, and regulations. They also provide national bank examiners with a basis for evaluating management and controls in this type of operation.
RESPONSIBLE OFFICE

Questions concerning the Interagency Statement or any part of the insert may be directed to the Office of the Chief National Bank Examiner, Capital Markets Group, in Washington, DC at (202) 874-5070.

Susan F. Krause
Senior Deputy Comptroller for Bank Supervision Policy

Enclosure
Retail Nondeposit Investment Sales

Introduction

This section sets forth guidance for examiners reviewing bank nondeposit investment product retail sales operations, including bank-related marketing and promotional activities. Examiners will review a bank's programs for consistency with the Interagency Statement on Retail Sales of Nondeposit Investment Products, dated February 15, 1994 (Interagency Statement). The evaluation will cover all bank-related activities including:

- Sales or recommendations made by bank employees;
- Sales or recommendations made by employees of affiliated or unaffiliated entities occurring on bank premises (including sales or recommendations initiated by telephone or by mail from bank premises); and
- Sales resulting from referrals of retail customers to a third party when the bank receives a benefit for the referral.

When reviewing a bank's nondeposit investment sales operation, examiners should determine that the bank views customers' interests as critical to all aspects of its sales programs. Examiners should evaluate a bank's policies and procedures from the customers' perspective and should ascertain that customers are provided with a high level of protection. If it becomes necessary to recommend remedial action, examiners should determine that bank management responds immediately to any matter that has the potential to confuse customers as to the uninsured nature of nondeposit investment products.

Banks that do not operate programs safely and soundly or that engage in violations of law or regulations will be subject to appropriate regulatory action. When determining the appropriate action, examiners should be mindful that some banks, especially banks relying on third parties for sales of nondeposit investment products, may need time to conform their programs to the Interagency Statement and to the guidance contained herein. At a minimum, however, examiners should determine whether bank management is making a good faith effort to comply with this regulatory guidance in a timely manner.

This section applies to sales to individual customers but does not apply to the wholesale sale of nondeposit investment products to non-retail customers, such as sales to institutional customers or to fiduciary accounts administered by an institution. As part of its general responsibilities, however, a national bank should take appropriate steps to avoid potential customer confusion when providing nondeposit investment products to institutional customers or to the bank's fiduciary customers. For additional information on restrictions on a national bank's use as fiduciary of the bank's brokerage service or other entity with which the bank has a conflict of interest, including purchases of the bank's proprietary and other products, see 12 CFR 9.12 and "Sales to Fiduciary Accounts," later in this section.

Scope

Examiner reviews of a bank's mutual fund or other nondeposit investment sales program will concentrate on the policies and procedures the bank adopts and on the effectiveness of their implementation.

When reviewing implementation of a bank's program, examiners will investigate whether senior bank management has:

1. Participated in planning the bank's investment sales program;
2. Adopted a framework to ensure compliance with all applicable laws, rules, regulations, regulatory conditions, and the Interagency Statement; and
3. Ensured effective supervision of individuals engaged in sales activities, including employees of the bank and any other entity involved in bank-related sales of investment products.

Where relevant, references in this handbook section to bank management or bank employees includes third party managers or third party employees.
Retail Nondeposit Investment Sales

Minimum Standards for Nondeposit Investment Programs
Antifraud provisions of the federal securities laws prohibit materially misleading or inaccurate representation in connection with offers and sales of securities. (See, for example, Section 10 of the Securities Exchange Act of 1934 and Rule 10b-5.) If customers are misled about the nature of nondeposit investment products, including their uninsured status, sellers could face potential liability under these antifraud provisions. Safe and sound banking also requires that bank-related retail sales activities be operated to avoid confusing customers about the products being offered. Use of nonbank employees to sell these products does not relieve bank management of the responsibility to take reasonable steps to ensure that the investment sales activities meet these requirements.

The Rules of Fair Practice of the National Association of Securities Dealers (NASD) expressly govern sales of securities by broker/dealers who are members of NASD. These rules apply to bank-related securities sales by banking subsidiaries registered as broker/dealers, affiliated broker/dealers, and unaffiliated broker/dealers operating under agreements with banks. These rules apply whether such sales are made on bank premises or at a separate location.

These rules do not expressly apply to sales or recommendations made directly by the bank. Even when these rules do not expressly apply, however, they are an appropriate reference for a bank compliance program designed to ensure that the bank’s retail sales of all nondeposit investment products are operated in a safe and sound manner.

Before beginning to operate a nondeposit investment sales program, banks may also consider notifying their blanket bond carriers of plans to engage in these activities. If applicable, this could permit the bank to obtain written assurances from the carrier that the bank’s insurance coverage for employees includes staff representing third party vendors.

Examiners also should encourage bank management to review Retail Investment Sales: Guidelines for Banks. The publication, prepared jointly by six banking industry trade associations, contains voluntary guidelines for bank sales of nondeposit investment products as well as common sense suggestions for putting many of the OCC’s recommendations into action.

Program Management
Banks must comply with all applicable laws, rules, regulations, and regulatory conditions, and operate consistently with the Interagency Statement for any of their bank-related retail sales of mutual funds, annuities, or other retail nondeposit investment products. Bank directors are responsible for evaluating the risks imposed by bank-related sales and are expected to adopt a program statement and self-regulatory policies and procedures to ensure compliance with all requirements. A bank’s policies and procedures must address bank-related retail sales made directly by a bank, through an operating subsidiary or affiliate, or by an unaffiliated entity.

Examiners should expect that banks will tailor their policies and procedures to the scope of the bank’s sales activities. The level of detail contained in a bank’s policies and procedures will depend on the structure and complexity of the bank’s program.

Examiners will review the bank’s securities sales activities to determine that the bank has adopted a statement that addresses the risks associated with the sales program and describes the features of the sales program, the roles of bank employees, and the roles of third party entities. The statement should set forth the strategies the bank will employ to achieve its objectives. It also should outline the self-regulatory procedures bank management will implement to ensure that the program’s objectives are met without compromising the customers’ best interests.
Retail Nondeposit Investment Sales

Introduction

At a minimum, examiners should expect bank policies and procedures to address:

Supervision of personnel involved in nondeposit investment sales programs — Senior bank managers will be expected to ensure that specific individuals employed by the bank, an affiliated broker/dealer, or a third party vendor are responsible for each activity outlined in the bank’s policies and procedures. Managers of the bank’s securities sales activities will be accountable for understanding the investment products offered and the sales process, as well as for assuring compliance with securities and banking laws, rules, and regulations.

Designation of employees authorized to sell investment products — This should serve as a guide for all bank-related employees dealing with retail nondeposit investment product customers. The program statement should specify that only properly trained and supervised employees are permitted to make investment sales or recommendations. It should describe the responsibilities of personnel authorized to sell or recommend nondeposit investment products and of other personnel who may have contact with retail customers concerning the sales program. It also should include a description of appropriate and inappropriate referral activities and the training requirements and compensation arrangements for each category of personnel.

The roles of other entities selling on bank premises, including supervision of selling employees — Bank management must plan to monitor compliance by other entities on an ongoing basis. The degree of bank management’s involvement should be dictated by the nature and extent of nondeposit investment product sales, the effectiveness of customer protection systems, and customer responses. (See "Third Party Vendors," later in this section for more details on programs operated by third parties.)

The types of products sold — Policies and procedures should include the criteria the bank will use to select and review each type of product sold or recommended.

For each type of product sold by bank employees, the bank should identify specific laws, regulations, regulatory conditions, and any other limitation or requirements, including qualitative considerations, that will expressly govern the selection and marketing of products the bank will offer. (See "Product Selection," later in this section for further discussion of these issues.)

Examiners should review:

- The process the bank uses to select the products it will offer,
- What the bank did to ensure the products meet its customers’ needs and expectations, and
- How well the bank is performing an ongoing analysis of the appropriateness of the products offered for sale.

Examiners will also assess the independence and thoroughness of the analysis and the degree to which the bank relies on ratings services. Examiners should be critical of bank managers who simply choose products that generate the largest sales fees or accept what a third party has to offer without performing an independent analysis of the suitability of the products to the bank’s strategy and customer mix.

Examiners should not give the impression that the agency expects bank managers to be "stock pickers" or that it intends to expand or limit the types of products banks offer. Instead, examiners should determine that bankers are selecting products that generally meet their customers’ needs. (See "Third Party Vendors," later in this section, for more details on the bank’s oversight roles when it relies on its third party vendor to select products.)

Policies governing the permissible uses of bank customer information — Examiners should determine that bank customer information policies address the permissible uses of such information for any purpose
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associated with bank-related retail investment sales activity. In particular, if the bank intends to use customer lists to telephone depositors whose certificates of deposit are due to mature to inform them about alternative investment products, the policies should outline steps the bank will take to avoid confusing customers as to the risks associated with nondeposit investment products, including their uninsured nature.

Banks may also supply customer information lists to a third party vendor. Supplying such information should only occur, however, after bank management has evaluated steps the third party is taking to avoid confusing customers and after determining such steps are consistent with bank policy.

Bank management also may wish to consider obtaining a legal opinion concerning the bank’s authority to share customer information with third parties.

Communications with customers — Examiners should determine whether the bank’s policies consider the need for periodic and ongoing communications with customers to help them understand their investments and to remind customers periodically that the products they have purchased are not insured deposits. Policies should outline customer communications for the bank during periods of market stress and assign responsibilities for such communications.

Setting and Circumstances of Nondeposit Investment Product Sales

Banks should market nondeposit products in a manner that does not mislead or confuse customers as to the nature of the products or their risks. The setting and circumstances surrounding sales of investment products is fundamental to ensuring that customers can readily distinguish between nondeposit investment products and insured deposits. Examiners will determine that bank management has established controls to distinguish retail deposit-taking activities from the promotion, sale, and subsequent customer relationships related to retail nondeposit investment sales.

To minimize customer confusion, sales of, or recommendations for, nondeposit investment products on the bank’s premises should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution.

In the limited situation in which physical considerations prevent nondeposit investment product operations from being conducted in a distinct area of the bank, a bank has a heightened responsibility to ensure that measures are in place to minimize customer confusion. To minimize customer confusion, the bank should make an officer responsible for each of the locations at which the investment product sales will take place.

The bank also should employ signs and, where possible, separate desks and personnel for deposit-taking and investment product sales. Investment product salespeople should clearly identify themselves by the use of appropriate methods such as name tags or separate business cards. In banks where the investment program is likely to be less elaborate, the examiner should determine, at a minimum, that the bank utilizes the written and oral disclosures described below.

In no case should any employee, while located in the routine deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products, or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may only refer customers to individuals who are specifically designated and trained to assist customers interested in the purchase of such products.

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Product names — Banks may not offer nondeposit investment products with a product name identical to the bank’s name. Names that imply that mutual funds are U.S. government guaranteed also are prohibited.

Banks also should recognize that the potential for customer confusion may be increased if the bank offers nondeposit product names that are similar to the bank’s name. If the bank offers such nondeposit products with names similar to the bank’s, it should design sales training programs to minimize the risk of confusing customers.

In addition, Securities and Exchange Commission (SEC) staff have issued an opinion that common names between a bank and a mutual fund sold or marketed by or through that bank are presumed to be misleading and a violation of the Investment Company Act of 1940. SEC staff contends, however, that a common name fund can rebut the presumption that a fund’s name is misleading by ensuring that the cover page of the prospectus prominently discloses that the fund’s shares are not deposits or obligations of the bank and are not federally insured.

When examining investment sales programs in a bank that is selling funds with names similar to the bank’s, examiners will evaluate the steps that bank management has taken to avoid confusing customers. The greater the similarity between bank and fund names, the more closely examiners will scrutinize all aspects of a bank’s sales program.

Examiners should criticize sales programs in which fund names are so similar to the bank’s that even mitigating circumstances are unlikely to eliminate customer confusion. For example, it may be acceptable for "First National Bank" to offer a nondeposit investment product named "First Fund" as long as the bank has implemented sufficient disclosures, training, and other measures to mitigate customer confusion. Other names, however, such as "First Bank Fund" or "First National Fund" are so similar to a bank’s name that they are inappropriate because they are inherently confusing.

Examiners and bank management should also be aware that the potential for customer confusion can depend on the context in which the sales are taking place. For example, it may be inappropriate for the First National Bank to offer a mutual fund product named "FNB Money Market Fund" if First National Bank were also offering an insured deposit product named "FNB Money Market Account."

Overall setting and circumstances — When reviewing nondeposit investment product sales operations, examiners should not place undue weight on a single aspect of the setting and circumstances of the sale. Each bank’s sales program is different, and one set of rules may not cover all circumstances or provide all customers with the necessary level of protection. Before judging a particular bank’s operations, examiners should consider how the various elements of the program interact and whether the elements combined mislead or avoid misleading customers.

The following example illustrates how the combination of certain elements can potentially mislead customers:

An employee of the First National Bank sits at a desk in the lobby. This employee sells money market mutual funds and renews CDs. The employee tells customers about two products the bank is offering: the FNB Money Market Fund, an uninsured retail nondeposit investment product, and the FNB Money Market Account, an insured deposit. This employee may have an incentive to market the uninsured product because the employee gets a commission for selling a mutual fund but receives nothing for selling or renewing a deposit.

This situation could confuse customers. To mitigate customer confusion, the bank should ensure that the employee has extensive knowledge of the products being sold and that the employee is thoroughly aware...
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of customer protection issues. When selling noninsured products, the employee should also require customers to sign a new account form acknowledging that the product is not insured.

If space and personnel limitations appear to increase the potential for customer confusion, examiners should encourage bank management to require additional training and disclosures, to develop signs and product names that clearly distinguish among the products being sold, and to assure that compensation for selling uninsured and insured products is equalized. Examiners should expect banks with nondeposit investment sales programs already in operation when this section is issued to initiate actions immediately to conform all aspects of the setting and circumstances of the bank's program to these requirements. In particular, banks should take immediate steps to correct any elements that could confuse customers.

Disclosures and Advertising

Disclosures

Complete and accurate disclosure must be provided to avoid customer confusion as to whether a bank-related product is an investment product or an insured bank deposit. Examiners should determine that banks selling, advertising, or otherwise marketing nondeposit investment products to retail customers provide the following product disclosures conspicuously: The products offered (1) are not FDIC insured, (2) are not deposits or other obligations or guarantees of the bank, and (3) involve investment risks, including possible loss of principal amount invested.

The minimum disclosures should be provided to the customer:

- Orally during any sales presentation.
- Orally when investment advice concerning nondeposit investment products is provided.
- Orally and in writing prior to or at the time an investment account is opened to purchase these products.

- In advertisements and other promotional materials, as described below.

Examiners will determine whether these disclosures are featured conspicuously in all written or oral sales presentations, advertising and promotional materials, prospectuses, confirmations, and periodic statements that include the name or the logo of the bank or an affiliate.

Advertisements and brochures also should feature these disclosures at least as large as the text describing the bank's nondeposit investment products. The OCC believes that these disclosures are conspicuous when they appear on the cover of a brochure or on the first part of relevant written text. A bank's disclosures could also be considered conspicuous if it prints the required disclosures in a box or by displaying them in bold type or with bullet points.

The bank should obtain a signed statement acknowledging such disclosures from customers at the time a retail nondeposit investment account is opened. For accounts established before issuance of this section, the bank should consider obtaining such a signed statement prior to the next sale. If the bank solicits customers by telephone or mail, it should be assured that customers agreeing to purchase nondeposit investment products receive the disclosure acknowledgement form when they open a new account. A bank should also request all customers who previously opened investment accounts by mail without receiving these written disclosures to sign and return a disclosure acknowledgement to the bank.

Confirmations and account statements for nondeposit investment products should contain at least the minimum disclosures if the confirmation or account statement contains the name or logo of the bank or its affiliate. If a customer's periodic deposit account statement includes account information about nondeposit investment products, the bank should clearly separate that information from information about the deposit account. The material on the cus-
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By any other entity apart from FDIC, e.g., the Securities Investor Protection Corporation (SIPC), a state insurance fund, or an insurance company. If these types of representations are made, examiners should determine whether training concerning differences in insurance coverage is provided to appropriate personnel. Appropriate personnel includes anyone who is likely to respond to customer inquiries or individuals designated to sell such products. Examiners should also determine if written or oral explanations of the differences in coverage are provided to all customers.

Advertising
Examiners should assess the procedures the bank uses to ensure that bank-related sales advertisements are accurate, do not mislead customers about the nature of the product, and include required disclosures. For example, claims about "no fees" or "no charges" are not accurate if the selling bank collects fees for investment advisory services or collects fees for shareholder accounting on the product or service being advertised. In this case a bank could claim that there are no "sales" charges and inform readers that a description of other charges is contained in the prospectus.

Examiners should determine that the bank does not imply in advertising or in written and oral presentations that the bank stands behind an investment product.

The bank’s marketing department should not be solely responsible for bank-related investment sales advertisements. The issuer, or, if a mutual fund, the distributor, may prepare advertisements of specific investment products that conform to standards developed by self-regulatory organizations such as NASD. Senior bank management should appoint an officer responsible for ensuring that bank investment advertisements as well as advertisements prepared by another party that make reference to the bank, or any advertisement used in bank-related sales, are accurate, not misleading, and include all required

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disclosures.

Suitability
Consistent with the Rules of Fair Practice, the OCC expects banks to determine whether a product being recommended is an appropriate investment for the customer. Banks should ensure that any salespeople involved in bank-related sales obtain sufficient information from customers to enable the salesperson to make a judgment about the suitability of recommendations for particular customers. At a minimum, suitability inquiries should be made consistent with the Rules of Fair Practice concerning the customer’s financial and tax status, investment objectives, and other factors that may be relevant, prior to making recommendations to the customer. This information should be documented and updated periodically.

A well-documented suitability inquiry can protect a bank from dissatisfied customers who threaten litigation. Such litigation could introduce risk to the bank’s capital. Accordingly, the OCC may view banks operating a retail securities business without appropriate suitability procedures to be engaging in an unsafe and unsound practice.

Many banks use software programs that document investor profiles to assist in making suitability judgments. Each profile is based on a customer’s responses to inquiries as to his or her financial and relevant personal history. The software program subsequently matches the customer’s investment needs and objectives to the bank’s available products. This type of software is a tool, not a substitute for professional judgement; it should not weight bank proprietary products too heavily or bank deposits too lightly.

One example of a critical suitability determination involves sales to elderly bank customers. Many of these customers rely upon investments or savings for retirement income and may consequently demand high yields. They may not, however, have the ability to absorb or recover losses. A nondeposit investment salesperson should also be aware that it is especially important to make a careful suitability recommendation when dealing with a surviving spouse who is not experienced in investment matters.

Examiners should investigate potential suitability problems in mutual fund sales when reviewing “breakpoints” and “letters of intent.” Breakpoints are discounts that are available to investors who purchase a large amount of mutual fund shares in a lump sum or as part of a cumulative investment program (e.g. under a “letter of intent”). The potential for abuse usually occurs when the sale of several different mutual fund shares takes place in quantities just below the level at which the purchaser would qualify for reduced sales charges on any one of the funds.

Examiners should determine whether a bank officer has been assigned responsibility for implementing and/or monitoring the suitability system. The examination approach should focus on the system the bank has in place to make suitability inquiries, suitability judgements, and periodic account reviews. Examiners generally should review sales patterns rather than individual sales for suitability issues. To determine the types of sales to test for suitability, examiners should investigate marketing programs that target a class of customers, customer complaints, sales to first-time and risk-averse investors, sales made by high- or low-volume salespersons, volatile and new products, and the existence of mutual fund redemptions after relatively short holding periods.

Qualifications and Training
Banks should implement detailed training programs to ensure that sales personnel have thorough product knowledge (as opposed to simple sales training for a product) and understand customer protection requirements. Examiners should assess the process the bank uses to ensure that sales personnel are properly qualified...
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and adequately trained to sell all bank-related nondeposit investment products. If bank personnel sell or recommend securities, the training should be substantively equivalent to that required for personnel qualified to sell securities as registered representatives. Securities industry training is available in most metropolitan areas.

Examiners also should determine that the bank’s audit and compliance personnel and persons with supervisory responsibilities are properly trained and knowledgeable.

A bank’s hiring practices and training plan should be designed around the complexity and risks of the particular investment products being offered. While it may be appropriate to have a banking generalist with no securities industry background sell money market mutual funds, it could be inappropriate to allow this individual to sell fixed-rate annuities without extensive training.

If individuals with securities industry experience are hired to sell investment products for banks, they should have an understanding of securities industry customer protection and control systems and have an adequate knowledge of the products being offered. Since they may not be familiar with general banking regulations and may not understand the needs of bank customers, banks should also ensure that these individuals are instructed as to the specialized obligations of selling investment products in a retail banking environment. Examiners should expect management to check with securities regulators to determine if potential bank sales employees with previous securities industry experience have a disciplinary history.

Banks engaging in lower volume mutual fund and annuity sales frequently train existing bank employees to sell investment products. Examiners should determine that bank management is satisfied that these individuals have acquired "product knowledge," and thoroughly understand the need to safeguard the customers’ interests. More specialized "product knowledge" training is generally provided by the marketing division of a mutual fund sponsor or another third party vendor. Bank staff should also receive customer protection and compliance training.

Examiners should determine whether a bank officer has been assigned responsibility for ensuring that adequate training is provided to bank staff, and for reviewing the hiring and training practices of a third party vendor.

Compensation

Incentive compensation systems, which are standard in the securities and insurance businesses, are becoming increasingly common in commercial banking. Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by customers. However, incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to customers.

An improperly designed compensation system can provide a bank employee with the incentive to place his or her own compensation interests above the interests of bank customers. Examiners should assess the steps management has taken to ensure that compensation programs do not operate as an incentive for salespeople to make unsuitable recommendations or sales to customers.

One way to avoid having the compensation system drive the recommendation toward mutual funds and away from certificate of deposit renewals would be to separate the nondeposit investment product sales and CD renewal functions. Alternatively, if employees are permitted to offer both deposits and nondeposit investment products, a bank could reduce the temptation by compensating the employee for renewing maturing deposits as well as for selling nondeposit investment products. Examiners should discuss with bank management where appropriate the methods used to avoid possible conflicts of interest poten-
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To investigate whether incentive compensation schemes could induce salespersons to recommend products with higher commissions over a more suitable option, examiners should look to customer complaints and to sales patterns rather than to individual sales. For example, an examiner can look for instances in which sales for a particular product increased after changes to an incentive compensation system.

Examiners also should expect a bank to increase its supervision of sales programs as it increases its incentive compensation. Examiners should be critical of supervision that does not take into account the possibility that recommendations for purchases of nondeposit investment products could be influenced by the incentive compensation scheme.

If the overall setting and circumstances of a bank’s investment sales program appears to be only marginally satisfactory, examiners should regard higher incentive compensation on certain investment products and lower compensation on deposits and other investment products as having the potential for causing serious problems. In this case the compensation system itself should justify an increase in the level of bank management supervision. If supervision is not adequate, the examiner should criticize the compensation system and other objectionable factors in the setting and circumstance of the sale.

Bank supervisory employees who review and approve individual sales, accept new accounts, and review established customer accounts should not receive incentive compensation based on the profitability of individual trades or accounts that are subject to their review. Similarly, department auditors or compliance personnel should not participate in incentive compensation programs that are based directly on the success of sales efforts nor should they report to a manager who receives this type of incentive compensation. In addition, bank management should not rely on third party audit and control systems if that vendor’s control personnel receive transaction-based incentive compensation.

Bank employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referred for nondeposit investment products. The payment of this referral fee should not depend on whether the referral results in a transaction.

Fiduciary Accounts

Pursuant to 12 CFR 9.11(d), examiners will review the investments held by national banks as fiduciary to determine whether such investments are in accordance with law, 12 CFR 9, and sound fiduciary principles. In so doing, they will ensure that the bank has complied with all applicable state and federal restrictions on investment transactions involving the bank’s fiduciary accounts.

Under 12 CFR 9.12, national bank fiduciaries may not invest funds held as fiduciary in the stock of organizations with which there exists such a connection as may affect the exercise of the best judgment of the bank in acquiring the stock, unless there exists specific authority for such an investment in the governing instrument, local law, a court order or through consents from all beneficiaries. As to accounts subject to the Employee Retirement Income Security Act of 1974, such investments must be within the authority of that Act. These principles govern purchases of a bank’s proprietary products, such as bank-advised mutual funds and private label mutual funds for fiduciary accounts.

In addition, pursuant to 12 CFR 9.11(d), examiners will determine that fiduciary purchases and retention of bank proprietary products for fiduciary accounts are in accord with sound fiduciary principles. This requires that even if specific authority exists for fiduciary accounts to purchase or retain bank-advised or bank private label mutual funds, the assets must be appropri-
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The investment must be consistent with the purpose for which each account was created, and suitable for the beneficial interest holders of each account. This requirement exists as to purchases for individual accounts, and for conversions of collective investment funds to bank-advised mutual funds.

Twelve CFR 9.7 requires banks to conduct initial and annual reviews of each fiduciary account as well as a separate review of all securities by issuer to ensure compliance with these requirements. These reviews include:

- A documented review of each account to determine that the assets of that account, including any proprietary products, meet the investment objectives of the account. In structuring the account portfolio, the fiduciary must consider the provisions of the document establishing the account. The review must also take into account the needs of the beneficial interest holders. This review should address the issues set forth in the Comptroller's Handbook for Fiduciary Activities, "Portfolio Management."

- A documented annual review of all assets by issuer, including proprietary products. This review should consider the quality of fund management, fee structure, risk diversification and anticipated rates of return. It should also address the considerations set forth in the Comptroller's Handbook for Fiduciary Activities, "Investments."

Compliance Program

Banks must maintain compliance programs capable of verifying compliance with the guidelines specified in the Interagency Statement and with any other applicable requirements. Banks should perform nondeposit investment compliance programs independently of investment product sales and management. At a minimum, the compliance function should include a system to monitor customer complaints and to review customer accounts periodically to detect and prevent abusive practices.

Examiners reviewing the compliance operations of a bank offering a variety of retail investment products should ensure that the bank has comprehensive self-regulatory policies and that it is conducting an ongoing comparison of the bank’s investment sales practices with its stated investment policy. In banks with a less elaborate investment sales program, where an internal auditing group may perform all of the bank’s compliance functions, the examiner should ensure that these auditors are periodically comparing sales practices with policy.

Individuals performing the audit or compliance of the bank’s investment program should be qualified and should have the necessary experience to perform the assigned tasks. Compliance personnel should also engage in ongoing training to keep abreast of emerging developments in banking and securities laws and regulations.

Banks can establish independence of audit or compliance personnel if such personnel determine the scope, frequency, and depth of their own reviews; report their findings directly to the board of directors or an appropriate committee of the board; have their performance evaluated by persons independent of the investment product sales function; and receive compensation that is not connected to the success of investment product sales.

Bank compliance programs should be modeled after those in the securities business where it is customary for compliance personnel to conduct regular and frequent customer account reviews in order to detect and prevent abuses. The extent and frequency of customer account supervision should be dictated by the aggressiveness of the sales program and the riskiness of products being offered.

Examiners should expect the bank to assign individuals independent of the sales
force to review periodically customer responses to suitability inquiries and to compare these responses to the type and volume of account activity to determine whether the activity in an account is appropriate. If account activity is unusual relative to the customer’s stated objectives and risk tolerance, or if account activity is brisk relative to the size of a customer’s investment or past practices, management should make follow-up inquiries to determine if the activity serves the best interests of the customer.

If examinations or routine oversight by bank management indicates that suitability problems may exist, bank management is expected to conduct its own review of all affected accounts and to institute corrective actions. If it is determined that customers may have been disadvantaged, corrective actions should be designed on a case-by-case basis and may include full explanations to customers and, where appropriate, offers to rescind trades.

Customer complaints are an indication of potential problems that warrant a prompt account review. Examiners should expect the bank to assign a bank officer who is independent of the sales force the responsibility for approving the resolution of complaints or reviewing the resolution of complaints by a third party vendor. The examiner should evaluate the system for assuring that all complaints (written and oral) receive management’s attention by reviewing the bank’s audit of the complaint resolution system.

Managers of high-volume investment sales programs also often use automated exception reporting systems to flag potential problems before customers complain. Such systems monitor product sales and the performance of salespersons. If the bank has such systems in place, and if the reports show significant volumes of mutual fund redemptions after short holding periods, examiners should review the steps management has taken to investigate whether the product is being sold properly.

If early redemptions are restricted to one salesperson or one branch, management can reasonably conclude that the problem is localized. However, early redemptions occurring throughout the sales network may indicate that something is wrong with the product itself or with the training provided to salespeople. Similarly, if reports indicate that a salesperson is selling one type of product almost exclusively, management may need to review that individual’s performance or training.

Ultimately, the way for bank management to assure itself that the securities salespersons are providing the required disclosures and making suitable recommendations to customers is to “test” the sales program. Effective “tests” can be conducted in several ways. Larger banks sometimes employ “testers” who pose as prospective customers and test the sales presentations for a variety of issues including adherence to customer protection standards. Many other well-managed banks (of all sizes) have instituted follow-up programs to verify that their customers understood their investment transactions. A bank manager, who is independent of the sales force, may telephone customers a few days after an investment account is opened or an unusual transaction has taken place. The manager will determine if the customer understands what he or she has purchased; understands the risks, including the uninsured nature of the product; understands the bank’s role in the transaction; and can generally confirm responses to a suitability inquiry previously provided.

A bank officer usually can determine if a customer understands an investment by asking the customer to describe its general features. The customer should be able to describe how the product works and its risks rather than simply recite what he or she hopes to gain from the particular investment. Managers usually also determine if the customer is satisfied with the product and service or has any problems or suggestions for improving service. If a bank institutes a telephone follow-up program, it should maintain a record of con-
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The written agreement with a third party vendor that has been approved by the bank’s board of directors before the vendor is permitted to offer nondeposit investment products to the bank’s customers. The agreement should outline the duties and responsibilities of each party and should include a description of all of the activities the third party is permitted to engage in on the bank’s premises. The agreement also should set forth terms for the use of the bank’s space, personnel, and equipment as well as compensation arrangements for personnel of the bank and the third party. The agreement also should:

- Specify that the third party will comply with all applicable laws and regulations and will act consistently with the provisions of this temporary insert, especially the provisions relating to customer disclosures,
- Authorize the bank to monitor the third party by periodically reviewing and verifying that the third party and its sales representatives are complying with its agreement with the bank, with all applicable laws and regulations, and with the provisions of this temporary insert,
- Specify the type, scope, and frequency of reports the third party is to furnish to bank management to permit bank management to fulfill its oversight responsibilities,
- Authorize the institution and the OCC to have access to appropriate records of the third party,
- Require the third party to agree to indemnify the bank for any liability that resulted from third party investment product sales program actions, and
- Set forth the training which the bank expects its employees and third party personnel to possess, and
- Provide for written employment contracts between the bank and the third party vendor’s employees.

Examiners will review the agreement to determine that it specifies that the third party vendor will comply with all applicable requirements contained in the Interagency Statement. Examiners also will review the
agreement to determine if it includes provisions regarding bank oversight and examiner access to appropriate records. It is expected that compliance with the agreement will be periodically monitored by the institution’s senior management.

Before entering into an agreement with a third party vendor, bank management also should be satisfied that the vendor uses a product selection process similar to the one outlined below. Banks relying on a third party vendor to select products also should understand and agree with the vendor’s method of analysis and document its concurrence with that method. Examiners should determine whether management has understood and concurred. Bank management should periodically investigate the vendor’s product selection process to ensure that it continues to be appropriate to the bank’s customer mix. Examiners also should determine whether bank management understands and agrees with contingency plans developed by the third party vendor and the product issuer to respond to customer orders during unusual surges in redemptions.

To fulfill its oversight responsibilities, it is expected that bank management will receive various reports from the third party vendor and have access to the vendor’s appropriate records. The reports received will vary with the scope of the sales program and should be tailored to the needs of the institution. The reports should always include a list of all customer complaints and their resolution. Other reports that may facilitate bank management’s oversight role, could include:

- A periodic listing of all new account openings and descriptions of the initial trades;
- A list of significant or unusual (for the customer) individual sales during a reporting period;
- Sales reports by product, salesperson, and location during a reporting period; and
- Reports of internal compliance reviews of customer accounts originated at the bank and reports furnished to the third party vendor by its regulator(s) on at least an annual basis.

Bank management must monitor compliance by third party vendors on an ongoing basis. Senior bank managers will be expected to ensure that specific individuals employed by the bank and by the third party vendor are responsible for each activity outlined in the bank’s investment sales policy. The degree of bank management’s involvement should be dictated by the types of products being offered, the volume of sales, the nature of customers’ complaints, and the effectiveness of the third party vendor’s customer protection systems.

Senior bank management also should appoint an officer responsible for ensuring that bank investment advertisements as well as advertisements prepared by another party that refer to the bank, or any advertisement used in bank-related sales, are accurate, not misleading, and include all required disclosures. In addition, any advertising or promotional material — prepared by or on behalf of a third party vendor — should clearly identify the company selling the nondeposit investment product and should not suggest that the depository institution is the seller.

Examiner access to the records of third party vendors should be governed by preliminary examination findings. When such findings make it clear that bank management has discharged its oversight responsibility by reviewing and responding appropriately to third party reports, only a few customer complaints have been filed against the vendor, and the vendor’s reports are timely, sufficiently detailed, and prepared by someone independent of the vendor’s sales force, examiner access to third party records should generally be limited to the reports furnished to management by the vendor.

**Product Selection**

This section describes in general terms the methods that well-managed banks use to
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select specific nondeposit investment products and to determine that such products continue to be acceptable to the bank's customer mix. This information is provided to help examiners understand and review the process used by well-managed banks to make this determination.

Bank management should determine the specific laws, regulations, regulatory conditions or other limitations or requirements, including qualitative considerations, that will govern the sale of products to be offered. Although not required, most well-run bank investment sales programs limit the number of products offered so that customers and salespersons will not be presented with an overwhelming number of choices. Limitations based on product quality may also make it easier for sales managers to shield certain classes of customers from inappropriate products.

As a general practice, bank investment programs offer at least one type of money market mutual fund for customers who are interested in liquidity. In addition, most banks offer a U.S. government bond fund for customers who stress safety and steady income, an equity fund for customers interested in capital growth, and a tax-exempt bond fund for customers who wish to avoid taxes on investment earnings.

When deciding which funds to offer, managers should review the fund's performance over an extended period of time. Most bank managers prefer to avoid mutual funds with volatile records. Management's selection of a family of funds should not be based on the performance of one particular fund; each fund selection should stand on its own merits.

Management's selection of investment products usually begins with an evaluation of the stability of asset values over time and an assessment of yields to investors. Management also compares the performance of other funds with similar objectives over the same period(s). Specialized ratings services (such as Morningstar or Lipper) or rankings by analytical services are usually regarded as necessary but secondary considerations.

Management also considers the fund's track record in terms of both risk and reward. Management analyzes the fund's net asset value versus total return, its management or operating expenses, the turnover within the fund's portfolio, and capital gains and other sources of income. Other key considerations include the composition of the portfolio and concentrations in types of holdings, sector weights, and, in the case of equity funds, the percentage of ownership represented by individual issues.

Management also evaluates important non-statistical factors such as the continuity, tenure, and demonstrated talent of the fund's management. They also may consider factors such as the quality of a mutual fund's operational and marketing support.

The bank itself, and not another entity's marketing department, should select the funds to be offered. Independent committees and qualified analysts should make the final selections, not a sales manager whose view of the commission structure may affect this judgment.

If the bank uses outside consultants to help select a mutual fund, bank management should determine whether the consultant receives compensation from mutual funds or mutual fund wholesalers. If the analysis is performed by another party, such as a clearing broker or third party vendor, bank management should understand and agree with the method of analysis and should document the bank's concurrence.

Regardless of who selects the mutual fund products, bank management will be expected to consider the issuer's contingency plans for handling unusual surges in redemptions at the time such products are being considered. Such contingency plans normally include emergency staffing, communications, and operational programs that are based on various market scenarios.
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Bank management should compare these contingency plans to the expected needs of bank customers during periods of stress.

Finally, once the initial selection process is complete, bank management should conduct ongoing reviews to assure that the products remain acceptable in light of the bank’s objectives and customer’s needs.

Selection of annuity products is conducted in the same manner. A variable-rate annuity, a hybrid form of investment that contains elements of mutual funds and insurance, could be characterized as a mutual fund operated by an insurance company. During product selection, bank management should consider the performance and composition of the portfolio that is dedicated to the annuity holders.

Selection analysis for fixed-rate annuities differs from variable-rate annuities. Since fixed-rate annuities are obligations of insurance companies, the risks associated with them relate to the issuer’s ability to honor the terms of the annuity contract. Accordingly, the safety of an annuity depends upon the financial standing of the firm that issues it and the selection analysis involves an assessment of the quality and diversification of the company’s assets, its holdings of junk bonds, mortgage-backed securities, and problem real estate loans, as well as the continuity of management.

Because it is difficult to independently analyze insurance companies, ratings provided by rating agencies such as A.M. Best, Standard & Poor’s, Duff & Phelps, Moody’s and Weiss Research play a part in annuity analysis. If bank management relies significantly on such ratings rather than on its own analysis, however, examiners should expect that the issuer selected by the bank has received top ratings from most of the ratings services.

When analyzing annuities, management also should recognize that an issuing insurance company can, in certain circumstances, sell or simply transfer the annuity contract to another insurance company, thereby extinguishing its obligation to the purchaser of the annuity. Annuity owners are generally, but not always, asked to consent to this transfer. A bank selling annuities should consider the possibility of such a transfer in its product selection analysis. At a minimum, the bank should disclose this possibility to prospective customers.

Interagency Statement on Retail Sales on Nondeposit Investment Products

The full text of the interagency statement begins on the next page.
Retail Nondeposit Investment Sales

Introduction

Recently many insured depository institutions have expanded their activities in recommending or selling to retail customers nondeposit investment products, such as mutual funds and annuities. Many depository institutions are providing these services at the retail level, directly or through various types of arrangements with third parties.

Sales activities for nondeposit investment products should ensure that customers for these products are clearly and fully informed of the nature and risks associated with these products. In particular, where nondeposit investment products are recommended or sold to retail customers, depository institutions should ensure that customers are fully informed that the products:

- Are not insured by the FDIC;
- Are not deposits or other obligations of the institution and are not guaranteed by the institution; and,
- Are subject to investment risks, including possible loss of principal invested.

Moreover, sales activities involving these investment products should be designed to minimize the possibility of customer confusion and to safeguard the institution from liability under the applicable anti-fraud provisions of the federal securities laws, which, among other things, prohibit materially misleading or inaccurate representations in connection with the sale of securities.

The four federal banking agencies — the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision — are issuing this Statement to provide uniform guidance to depository institutions engaging in these activities.

(Note: Each of the four banking agencies has in the past issued guidelines addressing various aspects of the retail sale of nondeposit investment products. OCC Banking Circular 274 (July 19, 1993); FDIC Supervisory Statement FIL-71-93 (October 8, 1993); Federal Reserve Letters SR 93-35 (June 17, 1993), and SR 91-14 (June 6, 1991); OTS Thrift Bulletin 23-1 (September 7, 1993). This Statement is intended to consolidate and make uniform the guidance contained in the various existing statements of each of the agencies, all of which are superseded by this Statement. Some of the banking agencies have adopted additional guidelines covering the sale of certain specific types of instruments by depository institutions, i.e., obligations of the institution itself or of an affiliate of the institution. These guidelines remain in effect except where clearly inapplicable.)

Scope

This Statement applies when retail recommendations or sales of nondeposit investment products are made by:

- Employees of the depository institution;
- Employees of a third party, which may or may not be affiliated with the institution (see Note, below, addressing which institutions are covered), occurring on the premises of the institution (including telephone sales or recommendations by employees or from the institution's premises and sales or recommendations initiated by mail from its premises); and
- Sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

(Note: This Statement does not apply to the subsidiaries of insured state nonmember banks, which are subject to separate provisions, contained in 12 CFR 337.4, relating to securities activities. For OTS-regulated institutions that conduct sales of nondeposit investment products through a subsidiary, these guidelines apply to the subsidiary. 12 CFR 545.74 also applies to such sales. Branches and agencies of U.S.
Retail Nondeposit Investment Sales

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Foreign banks should follow these guidelines with respect to their nondeposit investment sales programs.

These guidelines generally do not apply to the sale of nondeposit investment products to non-retail customers, such as sales to fiduciary accounts administered by an institution. (Note: Restrictions on a national bank's use as fiduciary of the bank's brokerage service or other entity with which the bank has a conflict of interest, including purchases of the bank's proprietary and other products, are set out in 12 CFR 9.12. Similar restrictions on transactions between funds held by a federal savings association as fiduciary and any person or organization with whom there exists an interest that might affect the best judgment of the association acting in its fiduciary capacity are set out in 12 CFR 550.10. However, as part of its fiduciary responsibility, an institution should take appropriate steps to avoid potential customer confusion when providing nondeposit investment products to the institution's fiduciary customers.)

Adoption of Policies and Procedures

Program Management. A depository institution involved in the activities described above for the sale of nondeposit investment products to its retail customers should adopt a written statement that addresses the risks associated with the sales program and contains a summary of policies and procedures outlining the features of the institution's program and addressing, at a minimum, the concerns described in this Statement. The written statement should address the scope of activities of any third party involved, as well as the procedures for monitoring compliance by third parties in accordance with the guidelines below. The scope and level of detail of the statement should appropriately reflect the level of the institution's involvement in the sale or recommendation of nondeposit investment products. The institution's statement should be adopted and reviewed periodically by its board of directors. Depository institutions are encouraged to consult with legal counsel with regard to the implementation of a nondeposit investment product sales program.

The institution's policies and procedures should include the following:

- **Compliance procedures.** The procedures for ensuring compliance with applicable laws and regulations and consistency with the provisions of this Statement.
- **Supervision of personnel involved in sales.** A designation by senior managers of specific individuals to exercise supervisory responsibility for each activity outlined in the institution's policies and procedures.
- **Types of products sold.** The criteria governing the selection and review of each type of product sold or recommended.
- **Permissible use of customer information.** The procedures for the use of information regarding the institution's customers for any purpose in connection with the retail sale of nondeposit investment products.
- **Designation of employees to sell investment products.** A description of the responsibilities of those personnel authorized to sell nondeposit investment products and of other personnel who may have contact with retail customers concerning the sales program, and a description of any appropriate and inappropriate referral activities and the training requirements and compensation arrangements for each class of personnel.

Arrangements with Third Parties. If a depository institution directly or indirectly, including through a subsidiary or service corporation, engages in activities as described above under which a third party sells or recommends nondeposit investment products, the institution should, prior to entering into the arrangement, conduct an appropriate review of the third party. The institution should have a written agreement with the third party that is approved...
Retail Nondeposit Investment Sales
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by the institution’s board of directors. Compliance with the agreement should be periodically monitored by the institution’s senior management. At a minimum, the written agreement should:
- Describe the duties and responsibilities of each party, including a description of permissible activities by the third party on the institution’s premises, terms as to the use of the institution’s space, personnel, and equipment, and compensation arrangements for personnel of the institution and the third party.
- Specify that the third party will comply with all applicable laws and regulations, and will act consistently with the provisions of this Statement and, in particular, with the provisions relating to customer disclosures.
- Authorize the institution to monitor the third party and periodically review and verify that the third party and its sales representatives are complying with its agreement with the institution.
- Authorize the institution and the appropriate banking agency to have access to such records of the third party as are necessary or appropriate to evaluate such compliance.
- Require the third party to indemnify the institution for potential liability resulting from actions of the third party with regard to the investment product sales program.
- Provide for written employment contracts, satisfactory to the institution, for personnel who are employees of both the institution and the third party.

General Guidelines

1. Disclosures and Advertising
The banking agencies believe that recommending or selling nondeposit investment products to retail customers should occur in a manner that assures that the products are clearly differentiated from insured deposits. Conspicuous and easy to comprehend disclosures concerning the nature of nondeposit investment products and the risk inherent in investing in these products are one of the most important ways of ensuring that the differences between nondeposit products and insured deposits are understood.

Content and Form of Disclosure. Disclosures with respect to the sale or recommendation of these products should, at a minimum, specify that the product is:
- Not insured by the FDIC;
- Not a deposit or other obligation of, or guaranteed by, the depository institution;
- Subject to investment risks, including possible loss of the principal amount invested.

The written disclosures described above should be conspicuous and presented in a clear and concise manner. Depository institutions may provide any additional disclosures that further clarify the risks involved with particular nondeposit investment products.

Timing of Disclosure. The minimum disclosures should be provided to the customer:
- Orally during any sales presentation,
- Orally when investment advice concerning nondeposit investment products is provided,
- Orally and in writing prior to or at the time an investment account is opened to purchase these products, and
- In advertisements and other promotional materials, as described below.

A statement, signed by the customer, should be obtained at the time such an account is opened, acknowledging that the customer has received and understands the disclosures. For investment accounts established prior to the issuance of these guidelines, the institution should consider obtaining such a signed statement at the time of the next transaction.

Confirmations and account statements for such products should contain at least the minimum disclosures if the confirmations or account statements contain the name or the logo of the depository institution or an affiliate. (Note: These disclosures should be made in addition to any other confirma-
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 tion disclosures that are required by law or regulation, e.g., 12 CFR 12, 208.8(k)(3), and 344.) If a customer's periodic deposit account statement includes account information concerning the customer's nondeposit investment products, the information concerning these products should be clearly separate from the information concerning the deposit account, and should be introduced with the minimum disclosures and the identity of the entity conducting the nondeposit transaction.

Advertisements and Other Promotional Material. Advertisements and other promotional and sales material, written or otherwise, about nondeposit investment products sold to retail customers should conspicuously include at least the minimum disclosures discussed above and must not suggest or convey any inaccurate or misleading impression about the nature of the product or its lack of FDIC insurance. The minimum disclosures should also be emphasized in telemarketing contacts. Any third party advertising or promotional material should clearly identify the company selling the nondeposit investment product and should not suggest that the depository institution is the seller. If brochures, signs, or other written material contain information about both FDIC-insured deposits and nondeposit investment products, these materials should clearly segregate information about nondeposit investment products from the information about deposits.

Additional Disclosures. Where applicable, the depository institution should disclose the existence of an advisory or other material relationship between the institution or an affiliate of the institution and an investment company whose shares are sold by the institution and any material relationship between the institution and an affiliate involved in providing nondeposit investment products. In addition, where applicable, the existence of any fees, penalties, or surrender charges should be disclosed. These additional disclosures should be made prior to or at the time an investment account is opened to purchase these products.

If sales activities include any written or oral representations concerning insurance coverage provided by any entity other than the FDIC, e.g., the Securities Investor Protection Corporation (SIPC), a state insurance fund, or a private insurance company, then clear and accurate written or oral explanations of the coverage must also be provided to customers when the representations concerning insurance coverage are made, in order to minimize possible confusion with FDIC insurance. Such representations should not suggest or imply that any alternative insurance coverage is the same as or similar to FDIC insurance.

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the depository institution. Recommending or selling a nondeposit investment product with a name similar to that of the depository institution should only occur pursuant to a sales program designed to minimize the risk of customer confusion. The institution should take appropriate steps to assure that the issuer of the product has complied with any applicable requirements established by the Securities and Exchange Commission regarding the use of similar names.

2. Setting and Circumstances
Selling or recommending nondeposit investment products on the premises of a depository institution may give the impression that the products are FDIC-insured or are obligations of the depository institution. To minimize customer confusion with deposit products, sales or recommendations of nondeposit investment products on the premises of a depository institution should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution. However, in the limited situation where physical considerations prevent sales of nondeposit products from being conducted in a distinct area, the institution has a heightened responsibility to ensure appropriate measures are in place.
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to minimize customer confusion.

In no case, however, should tellers and other employees, while located in the routine deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products, qualify a customer as eligible to purchase such products, or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may refer customers to individuals who are specifically designated and trained to assist customers interested in the purchase of such products.

3. Qualifications and Training

The depository institution should ensure that its personnel who are authorized to sell nondeposit investment products or to provide investment advice with respect to such products are adequately trained with regard to the specific products being sold or recommended. Training should not be limited to sales methods, but should impart a thorough knowledge of the products involved, of applicable legal restrictions, and of customer protection requirements. If depository institution personnel sell or recommend securities, the training should be the substantive equivalent of that required for personnel qualified to sell securities as registered representatives. (Note: Savings associations are not exempt from the definitions of "broker" and "dealer" in Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934; therefore, all securities sales personnel in savings associations must be registered representatives.)

Depository institution personnel with supervisory responsibilities should receive training appropriate to that position. Training should also be provided to employees of the depository institution who have direct contact with customers to ensure a basic understanding of the institution's sales activities and the policy of limiting the involvement of employees who are not authorized to sell investment products to customer referrals. Training should be updated periodically and should occur on an ongoing basis.

Depository institutions should investigate the backgrounds of employees hired for their nondeposit investment products sales programs, including checking for possible disciplinary actions by securities and other regulators if the employees have previous investment industry experience.

4. Suitability and Sales Practices

Depository institution personnel involved in selling nondeposit investment products must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices. In this regard, if depository institution personnel recommend nondeposit investment products to customers, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer on the basis of information disclosed by the customer. Personnel should make reasonable efforts to obtain information directly from the customer regarding, at a minimum, the customer's financial and tax status, investment objectives, and other information that may be useful or reasonable in making investment recommendations to that customer. This information should be documented and updated periodically.

5. Compensation

Depository institution employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referral for nondeposit investment products. The payment of this referral fee should not depend on whether the referral results in a transaction.

Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by customers. However, incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to customers.
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Depository institution compliance and audit personnel should not receive incentive compensation directly related to results of the nondeposit investment sales program.

6. Compliance
Depository institutions should develop and implement policies and procedures to ensure that nondeposit investment product sales activities are conducted in compliance with applicable laws and regulations, the institution’s internal policies and procedures, and in a manner consistent with this Statement. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third party sales are being conducted in a manner consistent with the governing agreement with the depository institution.

The compliance function should be conducted independently of nondeposit investment product sales and management activities. Compliance personnel should determine the scope and frequency of their own review, and findings of compliance reviews should be periodically reported directly to the institution’s board of directors, or to a designated committee of the board. Appropriate procedures for the nondeposit investment product programs should also be incorporated into the institution’s audit program.

Supervision by Banking Agencies

The federal banking agencies will continue to review a depository institution’s policies and procedures governing recommendations and sales of nondeposit investment products, as well as management’s implementation and compliance with such policies and all other applicable requirements. The banking agencies will monitor compliance with the institution’s policies and procedures by third parties that participate in the sale of these products. The failure of a depository institution to establish and observe appropriate policies and procedures consistent with this Statement in connection with sales activities involving nondeposit investment products will be subject to criticism and appropriate corrective action.

Questions on the Statement may be submitted to:

FRB — Division of Banking Supervision and Regulation, Securities Regulation Section, (202) 452-2781; Legal Division, (202) 452-2246.

FDIC — Office of Policy, Division of Supervision, (202) 898-6759; Regulation and Legislation Section, Legal Division (202) 898-3796.


OTS — Office of Supervision Policy, (202) 906-5740; Corporate and Securities Division, (202) 906-7289.

Effective date: February 15, 1994
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<th><strong>Examination Objectives</strong></th>
<th><strong>Section 413.2</strong></th>
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<tr>
<td>1. To determine if the bank has taken reasonable steps to ensure that retail customers can distinguish between insured deposits and uninsured nondeposit investment products.</td>
<td>3. To ensure that bank management operates the bank's nondeposit investment sales program in a safe and sound manner and complies with OCC guidelines, interagency statements, and all applicable laws and regulations.</td>
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<td>2. To determine if the banks' policies, procedures, and practices provide for an adequate self-regulatory system that is designed to ensure customer protections in all aspects of the sales programs.</td>
<td>4. To initiate corrective action when the bank's policies, practices, procedures, or managerial controls are deficient or when the bank has failed to comply with laws, rules, regulations or OCC guidelines.</td>
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Retail Nondeposit Investment Sales
Examination Procedures

Section 413.3

All examiners should be familiar with all examination procedures, and should complete any steps they think are necessary. However, there are some reasonable standards for which procedures form the basis of review of certain types of operations:

For a community bank that uses an independent third party vendor to operate its retail sales program, examiners may find it adequate to complete only the Third Party Vendor section of the ICQs and the related examination procedures.

For a bank that operates its own sales program or operates through a joint venture or an affiliated broker/dealer, an examiner will usually find it necessary to complete all sections at the first examination. At subsequent examinations of sales programs with no apparent weaknesses, completion of only the core examination procedures (indicated in bold type) may be adequate. Any concern that surfaces when applying the core procedures may be addressed by expanding the examination.

1. Complete the Internal Control Questionnaire (ICQ). Note explanations for any negative answers and changes since the last examination.

Scope of the Examination

2. To determine the scope of the examination:
   a. Meet with senior management of the bank or department to discuss the scope and direction of the retail nondeposit investment sales program.
   b. Review the business plan and policy and procedure manual to gain perspective on the nature of the bank’s program. Note any significant changes since the last examination.
   c. Review compliance and/or audit coverage and reports since the last examination. Note:
      — Previously identified strengths and weaknesses, and

Program Management

3. Determine the extent of management involvement in the operation, and the quality of management of the retail nondeposit investment sales program. Review:
   - Responses to the Program Management section of the ICQ.
   - Resumes of key officials involved in the management of the sales program to determine their experience and tenure with the bank.
   - Written performance objectives and performance appraisals of key management personnel to determine whether objectives and appraisals incorporate compliance issues, particularly compliance with disclosure and customer protection standards.
   - Reports furnished to senior management and the board of directors to determine whether they are sufficiently timely, accurate and meaningful to permit effective oversight.

4. Review senior management’s actions in implementing the retail nondeposit investment sales program and in offering any new products. Specifically determine whether bank management:
   - Participated in the development of the bank’s investment sales program strategic plan.
   - Conducted a risk and regulatory assessment and adopted a compliance program directed at ensuring compliance with all applicable laws, rules, regulations, regulatory conditions, and the Interagency Statement’s guidelines.
   - Provided for internal audit/compliance participation in the development of the program.
   - Adopted a program management statement aimed at ensuring effec-
5. Determine how the retail nondeposit investment sales program is managed.
   a. Analyze sales program growth and earnings performance and determine why certain products have high levels of performance. Consider how this performance relates to incentive compensation and the suitability of recommendations to customers.
   b. Review the customer mix and market surveys. Look at trends in identifiable classes of customers and be alert for concentrations by types of customers. Also, try to determine whether customers are viewed as one-time buyers or are being cultivated to establish longer term relationships.
   c. Review the products offered and any market surveys and determine the risk inherent in different products. Consider whether management has attempted to match products to investors' needs in general.
   d. Review projections for the sales program and for different products and determine whether they:
      — Are realistic in light of the bank's customer mix;
      — Relate to bank staffing and training plans for the sales, supervision, and compliance functions; and
      — Are consistent with the bank's overall strategic plan.
   e. Determine the effectiveness of the bank's self-regulatory policies and procedures as measured by the number and type of customer complaints and by responses to the ICQ.

Product Selection

6. Assess the adequacy of management processes to select and review products sold. Review:
   • Responses to the Product Selection section of the ICQ.
   • Methods bank management uses to select products to meet customer needs.
   • Management's comparison of the performance of the products they offer to general market products with similar objectives.

7. Discuss your findings from the product selection review with senior management and make a judgement about the appropriateness of management's decision to continue to offer these products.

Use of Customer Information

8. Determine whether policies governing the permissible uses of bank customer information address the steps to be taken to reduce possible confusion among depositors who are being solicited to purchase nondeposit investment products.

Setting and Circumstances of Sales

9. Determine whether bank management has established effective controls to distinguish retail deposit-taking activities from retail nondeposit investment sales. Consider how the various elements of the setting and circumstances may interact to influence the customers' perception.

10. Where the deposit-taking and securities sale functions are performed by the same personnel, determine if the bank uses appropriate written and oral disclosures to guard against customer confusion, and the extent to which bank staff is trained to use, and does use, such disclosures.
Disclosures and Advertising

11. Review responses to the Disclosures and Advertising section of the ICQ and a representative sample of each type of advertising and promotional material.
   a. Determine whether all of the required disclosures are featured conspicuously in:
      - All written or oral sales presentations,
      - Advertising and promotional materials,
      - Confirmations and account statements that contain the name or the logo of the bank or an affiliate, and
      - Periodic statements that include information on both deposit and nondeposit products.
   b. Determine, where applicable, if the bank has disclosed the existence of:
      - An advisory or other relationship between the bank and any affiliate involved in providing nondeposit investment products, and
      - Any early withdrawal penalties, surrender charge penalties, and deferred sales charges.
   c. Determine whether bank-related sales advertisements are:
      - Accurate, and
      - Not likely to mislead customers about the nature of the product.
   d. Review product brochures and advertising to ensure that they do not imply that the bank stands behind an investment product. Also determine whether public statements concerning the selection of the products a bank offers are reasonable.
   e. Determine whether personnel make any written or oral representations concerning insurance coverage by any entity other than the FDIC, e.g., Securities Investor Protection Corporation (SIPC); a state insurance fund; or an insurance company.

If representations about non-FDIC insurance coverage are made, determine whether:
   - Each appropriate person who has contact with customers is trained concerning the differences among those coverages, and
   - Written or oral explanations of the differences in coverage are provided to all customers.

Suitability

12. Judge whether systems in place are adequate to ensure that sales personnel make suitable recommendations and whether management is discharging its responsibilities under these systems by reviewing:
   - Responses to the Suitability section of the ICQ,
   - Customer complaints and resolutions,
   - Sales patterns,
   - Compensation differentials that may influence recommendations, and
   - Compliance and/or audit reports.

13. If your findings in 12, above, are negative or uncertain, review a sample of sales to determine if transactions appear unsuitable for a customer, based on responses to the suitability inquiries. The sample should include transactions involving:
   - Customer complaints,
   - Marketing programs that target a class of customers,
   - First-time and risk-averse investors,
   - High or low volume salespersons,
   - More volatile and newer products, and
   - Redemptions of annuities or mutual funds after relatively short holding periods.

14. If, after the review in 13, above, you are still not certain that recommenda-
Retail Nondeposit Investment Sales
Examination Procedures

15. If you determine that customers may have been disadvantaged, discuss appropriate corrective action with senior management. Such action should be designed on a case by case basis and may include:
   - Full explanations to customers and, where appropriate, offers to rescind trade.
   - A recommendation to bring in an independent audit or special counsel to perform further review of customer transactions.
   - Other action agreed upon between bank management and the EIC.

Qualifications and Training

16. Assess the bank’s process for ensuring that supervisory, investment sales, audit, and compliance personnel are properly qualified and adequately trained by reviewing hiring and training practices and future plans and determining whether they are:
   - Designed around the complexity and risks of the investment products being offered, and
   - Consistent with the organization’s projections for growth and product line expansion.

Compensation

17. Review the compensation plan and assess the steps management has taken to ensure that compensation programs are not structured in a way that result in unsuitable recommendations or sales being made to customers.
   a. Be alert to increases in the sales volume of a particular product, to customer complaints, and to suitability problems that may relate to the incentive compensation system and/or changes in compensation.
   b. Determine whether supervision of sales programs or of individual product offerings increases as incentive compensation increases.
   c. Determine whether referral fees are, in any way, based on a sale being made.
   d. Review written performance objectives and a sample of performance appraisals for salespersons and determine if the system for motivating and rewarding salespersons strikes a reasonable balance between profitability and the need to protect customer interests.

Sales to Fiduciary Accounts

18. Determine whether, on retail nondeposit investment transactions involving the bank’s fiduciary accounts, the bank has complied with all applicable state and federal restrictions, including the Employee Retirement Income Security Act of 1974.
   a. If proprietary or private label sales to trust accounts were executed through the bank’s nondeposit investment sales program, determine if the transactions were expressly authorized under state law or if authorization were obtained by the bank.
   b. Determine whether management’s justification of any transfer of trust account investments to investments acquired through the bank’s nondeposit investment sales program has taken into account all relevant circumstances, account by account. Relevant circumstances include:
      - The provisions of the trust account,
      - The beneficiaries’ needs,
      - The quality of fund management,
      - The fee structure,
      - Risk diversification, and
      - Rates of return.
   c. Determine whether the trust department conducts periodic re-
views of the ongoing prudence of the investment. Such reviews should cover:
- The quality of the holdings,
- The compatibility of investment objectives, and
- The availability of competing investments, including non-proprietary products, which might better meet the fiduciary account’s investment objectives.

Compliance Program

19. Determine how effective the bank’s compliance program is by reviewing:
   - Responses to the Compliance Program section of the ICQ,
   - The independence of compliance personnel,
   - Training provided to compliance personnel,
   - Automated exception reporting systems, and
   - The scope, frequency, and findings of compliance reviews, and responses to findings.

20. Determine whether results of periodic reviews are formally communicated to senior managers independent of the sales function, and whether a follow-up system tracks management responses to noted exceptions.

21. If prior examination findings, compliance reports, a pattern of customer complaints, or routine oversight by bank management identifies the possibility that suitability problems may exist, determine if bank management has conducted a thorough review of all affected accounts and instituted appropriate corrective actions.

Third Party Vendors

22. Determine the effectiveness of the bank’s oversight program and whether bank management has discharged its responsibilities under the program.

a. Review responses under the Third Party Vendor section of the ICQ and the text of the bank’s oversight program.

b. Review the scope and frequency of completed and scheduled oversight reviews and reviews of customer complaints and their resolution.

c. Review bank management’s response to recommendations made during past examinations.

d. Review the third party vendor agreement and determine:
   - Whether it specifies that such entities will comply with all applicable requirements, including those in the Interagency Statement.
   - How bank management assures itself that third party vendors comply with the terms of the agreement.

e. Review how bank management determined the adequacy of the steps a third party vendor takes to avoid customer confusion about the nature of the product and the bank’s role in the sales process.

f. Determine whether bank management understands and agrees with the way the third party vendor selects products.

23. After making a judgment about the effectiveness of the oversight of third party vendor sales, complete any other examination procedures that appear appropriate.

Summary

24. Determine if bank management has demonstrated by its actions whether it believes customers’ interests are critical to all aspects of its nondeposit investment product sales programs.

25. Discuss significant findings with the EIC and bank management and prepare written comments.
Retail Nondeposit Investment Sales
Internal Control Questionnaire

Section 413.4

Program Management

1. Has the bank's board of directors adopted a program management statement that addresses:
   • The features of the sales program?
   • The associated risks?
   • The roles of bank employees?
   • The roles of third party entities?

2. Do the bank's policies address the following issues:
   • Program objectives?
   • Strategies to be employed to achieve objectives?
   • Supervision of personnel involved in nondeposit investment sales programs?
   • Supervisory responsibilities of third party vendors who are selling on bank premises?
   • Selection of the products the bank will sell?
   • Permissible uses of bank customer information?
   • Communications with customers?
   • The setting and circumstances of nondeposit product sales?
   • Disclosures and advertising?
   • Suitability of recommendations?
   • Employee qualifications and training?
   • Employee compensation systems?
   • A compliance program?

3. Do written supervisory procedures assign a manager the responsibility for:
   • Reviewing and authorizing each sale?
   • Accepting each new account?
   • Reviewing and authorizing all sales- or account-related correspondence with customers?
   • Reviewing and authorizing all advertising and promotional materials prior to use?

4. Does the bank use written job descriptions to assign management responsibilities?

5. Do policies and procedures for personnel who are not directly involved in nondeposit investment product sales detail what the employees may say and not say about investment products?

Product Selection

6. Does the bank select the products to be offered?

7. If so, does the selection process make use of predetermined criteria that consider the customers' needs?

8. Does a qualified committee or an analyst who is independent of the sales function make the product selections?

9. If the bank uses outside consultants to help select products, does bank management determine if the consultant receives compensation from product issuers or wholesalers?

10. If the product selection analysis is performed by another party, such as a clearing broker or third party vendor, does bank management understand and agree with the analysis method?

11. Does the bank conduct continuing reviews of product offerings to assure that they remain acceptable and are such reviews done at least annually?

12. Does bank management consider, as part of the selection process, the product issuer's contingency plans for dealing with unusual surges in redemptions?

13. Are these contingency plans based on various market scenarios?

14. Do the contingency plans include:
   • Emergency staffing?
   • Additional communications capabilities?
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- Enhanced operational support?

15. Does the analysis of fixed and variable rate annuities include a determination of the credit quality of the issuing insurance company?

16. Does the analysis of fixed and variable rate annuities include determining whether the issuing insurance company can sell or simply transfer the annuity contract to another insurance company?

Use of Customer Information

17. Do written policies concerning the use of information about bank customers address:
   - The minimum standards or criteria for identifying a customer for solicitation?
   - Acceptable calling times?
   - The number of times a customer may be called?
   - The steps to be taken to avoid confusing depositors about the nature of the products being offered?

Setting and Circumstances of Nondeposit Sales

18. Has a bank officer been assigned responsibility for reviewing all current and planned nondeposit investment sales locations to determine whether appropriate measures are in place to minimize customer confusion?

19. Are nondeposit investment products sold only at locations distinct from where deposits are accepted?

20. Are sales locations distinguished by use of:
   - Separate desks?
   - Distinguishing partitions, railings, or planters?
   - Signs?

21. If personnel both accept deposits and sell nondeposit investment products, do operating procedures address safeguards to prevent possible customer confusion?

22. Are the people who sell nondeposit investment products distinguished from people who accept deposits by such means as:
   - Name tags or badges?
   - Business cards?

23. Do operating procedures prohibit tellers from offering investment advice, making sales recommendations, or discussing the merits of any nondeposit investment product with customers?

24. Does the bank offer nondeposit investment products with product names that are not:
   - Identical to the bank's name?
   - Similar to a deposit product?
   (Example: XYZ Money Market Fund vs. XYZ Money Market Account.)

25. Does the bank avoid using the words "insured," "bank," or "national" in product names?

Disclosures and Advertising

26. Has bank management designated an officer to be responsible for ensuring that bank-prepared investment advertisements and advertisements prepared by any other party are accurate and include all required disclosures?

27. Is a signed statement acknowledging disclosures obtained from each customer at the time that a retail nondeposit investment account is opened?

28. For accounts established prior to the issuance of the Interagency Statement, are procedures in place to ensure that such a signed statement is obtained prior to, or at the time of, the next transaction?
29. Is there a tracking system designed to monitor and obtain missing acknowledgments?

30. Are all salespeople provided written disclosure guidelines for oral presentations?

31. Do the guidelines for oral presentations clearly direct the speaker to:
   • State the required disclosures?
   • Clarify the bank's role in the sales process?

32. If ratings are used in promoting certain products, does bank policy indicate whether the bank will disclose ratings changes?

33. If so, does policy indicate how such disclosures will occur?

34. If the bank is selling annuities which can be transferred to another obligor, is this possibility disclosed to prospective customers?

Suitability

35. Has a bank officer been assigned responsibility for implementing and monitoring the suitability system?

36. Are systems in place to ensure that any salespeople involved in bank-related sales obtain sufficient information from customers to enable them to make a judgment about the suitability of recommendations for particular customers?

37. Do suitability inquiries include information concerning the customer's:
   • Financial and tax status?
   • Investment objectives?
   • Other information such as date of birth, employment, net worth (net of residential real estate), income, current investments, or risk tolerance?

38. Are customer responses to suitability inquiries documented on a standard form or any other method that permits ready review?

39. Is there a tracking system designed to monitor and obtain missing suitability information?

40. Are new accounts reviewed and formally accepted by a manager before the first transfer is finalized?

41. Does the new account acceptance process include a review of the suitability inquiry and customer responses?

42. Is each sale approved in writing by a designated manager?

43. Are breakpoints considered in both the initial recommendation and in the review of the suitability of those recommendations?

44. Is suitability information for active accounts updated periodically?

45. If the bank uses software programs to assist salespersons in making suitability judgments, does the program:
   • Weight bank proprietary products and bank deposits similarly to other products?
   • Consider breakpoints?

46. If a software program is not used, has management identified which products meet certain investment objectives, or has management generally categorized products as suitable for either unsophisticated, sophisticated, or risk-averse customers?

47. Does the bank use suitability guidelines that would limit certain transactions with first time or risk-averse investors, or would require a higher level of approval?

48. Is a bank officer who is independent of the sales force assigned responsibility for reviewing complaints and
Retail Nondeposit Investment Sales
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their resolution?

Qualifications and Training

49. Does the bank's staffing plan consider its nondeposit investment sales program?

50. Does the bank seek to employ dedicated investment specialists and not platform generalists as sales representatives?

51. Does management have written qualification requirements for outside hires of salespeople and sales program managers?

52. Is a system in place to document background inquiries made about new bank sales employees who have previous securities industry experience to check for a possible disciplinary history?

53. Has a bank officer been assigned responsibility for ensuring that adequate training is provided to bank staff?

54. Does the bank have a formal training program for individuals who:
   - Make customer referrals for nondeposit products?
   - Are engaged in retail sales of nondeposit investment products?
   - Are responsible for supervising people who make referrals and/or who engage in selling?

55. Is this training offered as part of:
   - Initial training?
   - Continuing training?

56. Is there a training manual showing the objectives of each initial and subsequent training session?

57. Have lesson plans been developed for in-house programs?

58. Are tellers trained:
   - To not accept orders or sell nondeposit investment products?
   - To avoid offering investment advice?
   - To not make recommendations?
   - To not discuss the merits of any securities with customers?

59. Does the bank provide training that addresses suitability issues?

60. Does suitability training specifically address customer protection issues associated with the most vulnerable classes of investors who may actually prefer the "no investment risk" aspect of insured bank deposits?

61. Is product training provided to:
   - Compliance staff?
   - Audit staff?

62. Does the bank have a formal plan to meet future retail nondeposit investment product sales training needs?

Compensation

63. Are compensation systems set up to avoid paying the same people incentive compensation for the sale of nondeposit investment products when no incentives are paid for renewing certificates of deposit?

64. Do supervisory policies control incentive compensation increases associated with sales contests or the introduction of new products?

65. Are referral programs designed so that employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referred, without regard for whether the sale is made?

66. Do policies prohibit tellers from participating in contests or other promotional programs in which prizes are based on successful sales to customers referred?
67. Do policies and procedures preclude incentive compensation based on the profitability of individual trades by, or accounts subject to the review of, bank employees who:

- Review and approve individual sales?
- Accept new accounts?
- Review established customer accounts?

68. Do policies and procedures preclude payment of incentive compensation to department auditors or compliance personnel?

69. Does the management structure preclude control, audit or compliance personnel from reporting to managers whose compensation is based on profits from nondeposit investment products sales?

70. Does the compensation program reduce remuneration to sales program managers whose accounts show:

- Missing documents?
- Unreported customer complaints?
- Reversed or "bad" sales?
- Compliance problems?

71. Do audit or compliance personnel:

- Determine the scope and frequency of their own nondeposit investment sales program reviews?
- Report their findings directly to the board of directors or an appropriate committee of the board?
- Have their performance evaluated by persons independent of the investment product sales function?
- Receive compensation that in no way is connected to the success of investment product sales?
- Receive training in products and customer protection issues?
- Keep abreast of emerging developments in banking and securities laws and regulations through ongoing training?

72. Does the bank’s written compliance program call for periodic reviews to determine compliance with policies, procedures, applicable laws and regulations, and the Interagency Statement? Do those reviews cover:

- Customer complaints and their resolution?
- Customer correspondence?
- Transactions with employees and directors or their business interests?
- All advertising and promotional materials?
- Scripts or written guidelines for oral presentations?
- Training materials?
- Regular and frequent reviews of active customer accounts?
- Customer responses to suitability inquiries and a periodic comparison of those responses to the type and volume of account activity, with the goal of determining whether the activity in an account is appropriate?

73. Does the compliance program call for compliance personnel to perform continuing reviews of:

- Changes in the system for reporting customer complaints and resolutions?
- Changes in previously approved standard correspondence with customers?
- New advertising and promotional materials prior to use?
- Changes in existing training programs or new training programs?
- Changes in incentive compensation systems?
- New products under development?

74. Does the timing, scope, and frequency of compliance reviews consider factors such as:

- Changes or differences in incentive compensation paid on different or new products?
- Sales or referral contests?
- Patterns of sales for specific, espe-
Retail Nondeposit Investment Sales
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81. Has the bank instituted a follow-up contact program to verify whether customers understand their investment transactions?

82. Do inquiries in the follow-up contact program include discussion of the customer's:
   • Understanding of what he or she has purchased?
   • Understanding of the investment risks and the absence of deposit insurance coverage?
   • Initial responses to the salesperson's suitability inquiry?
   • Understanding of fees?
   • Problems or complaints?
   • Understanding of the bank's role in the transaction?

83. If the bank operates a follow-up contact program, are records of customers responses maintained?

Third Party Vendors

84. Has a bank officer been assigned responsibility for ensuring that the bank adequately monitors the effectiveness of customer protection systems?

85. Has the bank developed a written oversight program to monitor the activities of outside vendors operating bank-related sales programs?

86. Does the governing agreement with third party vendors include provisions regarding:
   • Training for bank employees?
   • Methods of implementing the customer protection standards contained in the bank's policy?
   • Permission for the OCC and the bank to have access to appropriate records involved in bank-related sales?
   • The scope and frequency of reports to be furnished?

87. Do reports furnished by third party...
vendors include:
- A list of all new account openings and initial trades?
- A list of significant or unusual (for the customer) individual sales?
- A list of all written and oral customer complaints and their resolution?
- Sales reports by product, salesperson, and location?
- Internal compliance reviews of accounts originated at the bank?
- Copies of reports furnished to the third party vendor by their regulator?

88. Are reports furnished by a third party vendor:
- Prepared by someone independent of the vendor’s sales force?
- Timely and sufficiently detailed?

89. Does bank management have procedures in place to avoid reliance on third party audit and control systems if the vendor’s control personnel receive transaction-based incentive compensation?

90. If the product selection analysis is performed by another party, such as a clearing broker or third party vendor, does bank management understand and agree with the analysis method?

91. If customer information is provided to the third party vendor, has a legal opinion concerning the bank’s authority to share customer information with third parties been obtained?

92. Has a bank officer been assigned responsibility for ensuring that adequate training is provided to bank staff, and for reviewing the hiring and training practices of any third party vendor?
| Customer disclosure requirements | 15 USC 77a, 78a, and 80a | 17 CFR 240 (Rule 10b-5) | Interagency Statement on Retail Sales of Nondeposit Products (February 15, 1994) |
| Use of common names | 15 USC 80a | | Interagency Statement |
| Investments in trust accounts | 29 USC 1001 (ERISA) | 9 | Interagency Statement |
| Recordkeeping and confirmation requirements for securities transactions | | 12 | Interagency Statement |
| Antifraud restrictions | 15 USC 77a and 78a | 17 CFR 240 (Rule 10b-5) | |
| Uniform guidelines | | | AL 93-11 and Interagency Statement |
| Customer protection rules | 15 USC 77a, 78a, and 80a | 17 CFR 240 (Rule 10b-5) | NASD Rules of Fair Practice and Interagency Statement |

* 12 USC, unless specifically stated otherwise.
+ 12 CFR, unless specifically stated otherwise.
** BC = Banking Circular, EC = Examining Circular, AL = Advisory Letter.
AREAS PROMPTING THE MOST FREQUENT INQUIRIES TO THE DEPARTMENT OF FINANCIAL INSTITUTIONS

J. Rick Jones
Kentucky Department of Financial Institutions
Frankfort, Kentucky

SECTION F
Areas Prompting The Most Frequent Inquiries
To The Department of Financial Institutions

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

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

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

(4) All amendments to the articles of incorporation of any financial institution mentioned in KRS 287.040 shall be approved by the commissioner before filing with the secretary of state. (165a-20: amend. Acts 1946, ch. 141, § 29; 1982, ch. 251, § 4, effective April 1, 1982; 1984, ch. 324, § 7, effective July 13, 1984; 1986, ch. 444, § 3, effective July 15, 1986.)


Opinions of Attorney General. If the identity of the chief executive officer of a proposed bank is material to the department of banking in passing on an application to organize a bank, it is also material to any person having standing to protest the application, therefore if the commissioner of banking (now financial institutions) elicits the identity of the executive officers from the applicants and has that information on file in a public record, it should be made available for public inspection. OAG 80-444.

1. Discretion of commissioner.
   In approving the organization of banks, the commissioner has only such discretion as is given him by statute. Beyond this his duties are ministerial and enforceable by mandamus. Speer v. Dossey, 177 Ky. 761, 198 S.W. 19 (1917).

   Although the commissioner was not required to conduct a hearing to afford protesting banks an opportunity to protest the approval of the articles of incorporation of a proposed bank, the fact that the hearing was not conducted could be considered as evidence bearing upon the question of the arbitrariness of the commissioner's order. Phelps v. Sallee, 529 S.W.2d 361 (Ky. Ct. App. 1975).

2. Sufficient Evidence.
   Where the reports of the commissioner of banking favorably showed the financial standing, the moral character and the capability of each of the prospective incorporators coupled with a reasonable assurance of a sufficient volume of business and the promotion of public convenience, the commission did not arbitrarily or capriciously authorize the incorporation of the new bank. Commercial Bank v. Hall, 500 S.W.2d 77 (Ky. Ct. App. 1973).

   The denial of an application for a new bank charter was based on substantial evidence and was not arbitrary or capricious, where the commissioner considered all of the evidence pertaining to the probable successful operation requirement and not merely the fact that there was some evidence that the new bank might be profitable within the third year. Department of Banking & Sec. v. Coleman, 594 S.W.2d 895 (Ky. Ct. App. 1979).

   Expert financial testimony on deposit growth, projected profits and unusually low penetration rate in county, as well as testimony on demographic and economic conditions, constituted substantial evidence of a reasonable assurance of a sufficient volume of business for a proposed bank to be successful. Farmers Deposit Bank v. Department of Banking & Sec., 669 S.W.2d 22 (Ky. Ct. App. 1984).

   Where the letters of many of the local merchants and citizens banking outside the county indicated that their banking habits were the result of the inadequate service and hours of the existing bank, it was clear that a new bank with increased hours and Saturday banking would greatly service the public convenience and advantage. Farmers Deposit Bank v. Department of Banking & Sec., 669 S.W.2d 22 (Ky. Ct. App. 1984).

3. Notice and Hearing.
   The commissioner of banking and securities (now financial institutions) is not required to give notice of the filing of the articles of incorporation of a proposed bank for approval under this section, nor is the commissioner required to conduct hearings upon the application. Phelps v. Sallee, 529 S.W.2d 361 (Ky. Ct. App. 1975).

4. Effect of Approval.
   Where the commissioner of banking and securities (now financial institutions) approved the articles of incorporation of a proposed bank but either neglected or refused to stamp his approval on the articles and forward them to the secretary of state for recording, the department was without authority to thereafter modify, change, or set aside the commissioner's order that the articles were approved. Phelps v. Sallee, 529 S.W.2d 361 (Ky. Ct. App. 1975).

5. Effect of Denial.
   Repeated hearings before administrative agencies, brought about by changing commissions, were not intended by the legislative direction to the commissioner of banking (now financial institutions); thus the denial of an application for a bank or a branch thereof shall operate as res judicata, and an exception will be allowed only upon a showing of significant change of conditions or circumstances. Williams v. Cumberland Valley Nat'l Bank, 569 S.W.2d 711 (Ky. Ct. App. 1978).

6. Judicial Review.
   Although there is no provision for an appeal from any order of the commissioner of banking and securities (now financial institutions), protesting parties would be entitled to judicial review on the question of arbitrariness of any administrative action. Phelps v. Sallee, 529 S.W.2d 361 (Ky. Ct. App. 1975).

   Except in cases where the commissioner's findings are clearly erroneous and arbitrary, courts should be inclined to follow the expertise of the banking and securities department (now department of financial institutions) in determining whether there is a reasonable assurance of sufficient volume of business for the proposed corporation to be successful.
BANKS AND TRUST COMPANIES


7. Branch Banks.
Inasmuch as the same standard applies to original bank charters compared with licenses for branch banks, the commissioner's duties under the statutes are the same. Williams v. Cumberland Valley Nat'l Bank, 569 S.W.2d 711 (Ky. Ct. App. 1978).

This section provides for the establishment of a new bank, while KRS 287.180 relates to the establishment of bank branches; however, the commissioner's duties under the two statutes are identical, and essentially the same standards are applicable to the establishment of branches as well as new banks. Department of Banking & Sec. v. Coleman, 594 S.W.2d 895 (Ky. Ct. App. 1979).

Collateral References. 10 Am. Jur. 2d, Banks, §§ 7, 17.
9 C.J.S., Banks and Banking, §§ 7, 8.
Antimonopoly or antitrust laws, application to banks and banking institutions of. 83 A.L.R.2d 374.
287.330. Assets may be pledged to secure deposits — Security not required if deposit insured. — (1) Banks, subject to statutory or charter limitations, may pledge such portion of their assets as may be required by law as collateral security for government deposits made with them, or any of them, by or under the authority of the United States, or for any other deposit required by law to be secured.

(2) Notwithstanding any law requiring security for deposits in the form of collateral, surety bond or in any other form, security for such deposits shall not be required to the extent said deposits are insured under the provisions of section 12B of the Federal Reserve Act (38 Stat. 251) as amended.

(3) If a bank proposes to sell its assets and transfer its deposit liability to another bank and the purchasing bank is unwilling to accept a sufficient amount of the assets to cover the liability to depositors and other creditors, the selling bank may, with the consent of the commissioner, pledge all or a part of its remaining or unacceptable assets to secure a loan for an amount sufficient to cover the remaining liability to the depositors and other creditors. (579: amend. Acts 1984, ch. 324, § 27, effective July 13, 1984.)

Compiler’s Notes. The Federal Reserve Act referred to in subsection (2) of this section is compiled throughout Title 12 of the United States Code.

NOTES TO DECISIONS

ANALYSIS

1. Pledge of assets.
2. Securing public funds.
3. Liquidation.

1. Pledge of Assets.

2. Securing Public Funds.
   Federal reserve members may secure public funds by transferring such deposits to its commercial department and transferring specific and readily marketable securities to its trust department to secure the repayment of same. Louisville Bridge Comm’n v. Louisville Trust Co., 258 Ky. 846, 81 S.W.2d 894 (1935).
   Revenues of the Louisville Bridge Commission are public funds, the deposits of which may be secured by a pledge of specific collateral. Louisville Bridge Comm’n v. Louisville Trust Co., 258 Ky. 846, 81 S.W.2d 894 (1935).

3. Liquidation.
   A bank has no authority to contract with a secured depositor that in event of the bank’s liquidation the depositor may receive its pro rata distributable share upon its debt before applying the security, such a contract being in violation of KRS 287.610 (now repealed). City of Louisville v. Fidelity & Columbia Trust Co., 245 Ky. 704, 54 S.W.2d 40 (1932).
   Collateral References. 10 Am. Jur. 2d, Banks, §§ 419, 420.
   9 C.J.S., Banks and Banking, § 157.
TO: Chief Executive Officers  
All Kentucky State-Chartered Banks  

FROM: Ella D. Robinson, Director  
Division of Supervision  

DATE: October 11, 1993  

RE: Participation Loan Documentation and Examination Procedures  

During the course of recent examinations, field personnel of the Department have experienced an unusual incidence of documentation exceptions on purchased loans. The lack of proper structuring and documentation can cause undue risks to both the buying and selling banks involved in a loan participation. The use of loan participations is considered a viable tool for bankers in portfolio management and is not being discouraged by this Agency. However, in light of the foregoing problems, and in order to insure improved portfolio administration in this area, the following guidelines are being recommended.  

Lending policy guidelines and considerations:  

- banks which anticipate activity in purchasing loan participations shall incorporate into their lending policy guidelines which address such activities:  

- these guidelines should insure that all loans purchased shall conform to all policy provisions, including independent credit analysis, just as if the credit were a direct extension.  

Written participation agreements should, at a minimum, address the following considerations:
obligation of the lead institution in providing credit information on a timely basis and notice of material changes in the obligor's financial condition:

- procedures which require consultation with participants before the lead lender modifies loan terms or any attendant loan documents, such as security instruments or guarantees:

- specific rights and remedies to involved parties upon default or insolvency of the borrower:

- procedures for the resolution of workouts when the lead and participating banks disagree on the handling of defaulted loans:

- procedures for the resolution of conflicts which arise if more than one obligation of the borrower enters into default status; and

- provisions which provide for termination of the agency relationship between participants upon the occurrence of events such as breach of duty, negligence, misappropriation, or insolvency.

In addition to the above considerations, participations between affiliated institutions require that utmost care be exercised in application of underwriting standards, and also require compliance with Section 23A of the Federal Reserve Act. A participation purchased from an affiliate is exempt from Section 23A provided that (1) the commitment for purchase is obtained prior to the funding of the loan by the affiliate, and (2) the purchasing bank's decision is predicated upon an independent analysis of the creditworthiness of the borrower.

In summary, this Agency stands ready to assist its banks in any way regarding loan participations, interpretation of governing rules and regulations or any questions regarding this transmittal. Please do not hesitate to contact the Division of Supervision at (502) 564-3390, in the event of any questions.

EDR:CRR:kdw
Parity Letter 92-1

The Commissioner of the Department of Financial Institutions issues this Finding of Permissible Activity, Product, or Service pursuant to KRS 287.020(3). Competitive inequality exists between some state banks and national banks as a result of the different calculations of their legal lending limits, which for state banks is found in KRS 287.280 and for national banks is found in 12 USC 84 and 12 CFR § 32.4. Because of the differences in the two legal lending limits, a state bank having the same capital as a national bank nonetheless has different legal lending limits.

Therefore, a state bank may in its discretion choose to calculate its legal lending limits as if it were a national bank. Any state bank making such a choice shall:

1. Pass a formal resolution by its board of directors adopting the legal lending limits set forth in 12 USC 84 and 12 CFR § 32.4;

2. Amend the bank's loan policy to conform to the new legal lending limits;

3. Secure and maintain updated copies of all national bank rules and regulations relating to legal lending limits; and

4. Notify the Department and the FDIC that the bank has made such a choice.

Any state bank electing to operate under the national bank lending limits shall make all loans under such limits. The legal lending limit in effect when the loan is extended shall be the applicable legal lending limit for examination purposes. A bank is advised to consult with its legal counsel for assistance in determining whether it would be better served by electing to operate under the national bank lending limits.

Effective Date: August 25, 1992

Edward B. Hatchett, Jr.
Commissioner

AN EQUAL OPPORTUNITY EMPLOYER M/F/H

F - 9
FINDING OF PERMISSIBLE ACTIVITIES, SERVICES, OR PRODUCTS
92-2
OTHER REAL ESTATE OWNED

The Commissioner of Financial Institutions issues this Finding of Permissible Activities, Services, or Products pursuant to KRS 287.020(3). Competitive inequality exists between some state banks and national banks as a result of different rules relating to the treatment of Other real estate owned, which for state banks is found in KRS 287.100(3) and for national banks is found in 12 USC Section 29 and 12 CFR § 7.3025. Because of the differences between the two treatments, state banks must write down the value of Other real estate owned by 10% annually, while national banks may carry on their books a realistic fair market value determined by annual appraisal.

Therefore, a state bank may at its discretion choose to handle Other real estate owned as if it were a national bank. Any state bank making such a choice shall:

1. Pass a formal resolution by its board of directors adopting the rules for handling Other real estate owned set forth in 12 USC Section 29 and 12 CFR § 7.3025;
2. Amend the bank's policies to conform to these new rules;
3. Secure and maintain updated copies of all national bank rules and regulations relating to the handling of Other real estate owned; and
4. Notify the Department and the FDIC that the Bank has made such a choice.

Any state bank electing to handle Other real estate owned under the national bank rules shall handle all such real estate acquired after the date of the election under such rules. A bank is advised to consult with its legal counsel and accountant for assistance in determining whether it would be better served by electing to operate under the national bank rules.

[Signature]
January 15, 1993

Edward B. Hatchett, Jr., Commissioner
Department of Financial Institutions
FINDING OF PERMISSIBLE ACTIVITIES, SERVICES, OR PRODUCTS
92-3
MAIN OFFICE RELOCATIONS

The Commissioner of Financial Institutions issues this Finding of Permissible Activities, Services, or Products pursuant to KRS 287.020(3). Competitive inequality exists between state banks and national banks as a result of the difference in policies and rules governing relocation of the banks' main offices and retention of existing branches. The relocation of a state bank's main office is governed by KRS 287.185, while 12 USC Section 30(b) governs the relocation of a main office of a national bank. 12 USC Section 30(b) provides that a main office may be relocated not more than thirty miles from its present site. The Office of the Comptroller of the Currency has interpreted 12 USC Section 30(b) as allowing national banks to relocate their main offices across county lines and to retain existing branches in the original county of operation. Using this interpretation, the Office of the Comptroller of the Currency has approved several transactions involving main office relocations across county lines by national banks in Kentucky, some of which included retention of existing branches in the original county of operation.

Therefore, a state bank may, through a resolution of its board of directors, adopt the provisions of 12 USC Section 30(b); and upon a vote of the shareholders owning two-thirds of the stock of the bank and upon approval of the Commissioner of Financial Institutions, a state bank may relocate its main office within thirty miles from the city, town, or village in which the main office was originally located. Existing branches in the original county may be retained, but no new branches may be opened in the original county. The main office in the original county must close.

Effective date: August 24, 1993

EDWARD B. HATCHETT, JR.
COMMISSIONER
ETHICAL CONSIDERATIONS IN HANDLING CORPORATE COMMUNICATIONS

Problems, Pitfalls, Practical Pointers

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SECTION G
The presenters gratefully acknowledge the assistance of Laura Westfall Casey, David V. Dilenschneider and Matthew P. Murphy of Vorys, Sater, Seymour and Pease.
# CORPORATE COMMUNICATIONS
Problems, Pitfalls, Practical Pointers

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ATTORNEY-CLIENT PRIVILEGE: WHEN ARE CORPORATE COMMUNICATIONS PROTECTED?

The attorney-client privilege is the oldest of the privileges for confidential communications known to the common law. Its purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client. Admittedly complications in the application of the privilege arise when the client is a corporation, which in theory is an artificial creature of the law, and not an individual; but this Court has assumed that the privilege applies when the client is a corporation.


1. OVERVIEW

The attorney-client privilege is a rule of evidence which shields from disclosure confidential communications made between an actual or potential client and an attorney acting in his capacity as a lawyer, when the communications pertain to the rendering of legal advice or services. See, e.g., Humphreys, Hutcheson and Moseley v. Donovan, 755 F.2d 1211, 1219 (6th Cir. 1985); United States v. Goldfarb, 328 F.2d 280, 281 (6th Cir.), cert. denied, 377 U.S. 976 (1964). The purpose of the rule is "to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice." Upjohn Co. v. United States, 449 U.S. 383, 389 (1981), quoted in United States v. Zolin, 491 U.S. 554 (1989). See also Fausek v. White, 965 F.2d 126, 129 (6th Cir.), cert. denied, 113 S. Ct. 814 (1992); In re Antitrust Grand Jury, 805 F.2d 155, 162 (6th Cir. 1986).

To establish the attorney-client privilege, the following elements must be demonstrated: (1) legal advice was sought, (2) from a professional legal advisor in his/her
capacity as such, (3) by a client, (4) who made the communications in confidence, (5) which communications are at the client's insistence permanently protected, (6) from disclosure by the client or his legal advisor, (7) unless the protection is waived. **Fausek v. White**, 965 F.2d 126, 129 (6th Cir.), cert. denied, 113 S. Ct. 814 (1992).

As a practical matter, courts tend to construe the privilege narrowly. See **Weil Ceramics & Glass, Inc. v. Work**, 110 F.R.D. 500, 503 (E.D.N.Y. 1986) (privilege is an exception to the fundamental principle that discovery should be liberal and broad so as to further the search for truth); **Humphreys, Hutcheson and Moseley v. Donovan**, 755 F.2d at 1219; **In Re Grand Jury Proceedings (Doe)**, 575 F. Supp. 197, 200 (N.D. Ohio 1983), aff'd, 754 F.2d 154 (6th Cir. 1985). In addition, the proponent of the privilege has the burden of establishing that all elements of the privilege, including non-waiver, are present. See **PHE, Inc. v. Department of Justice**, 139 F.R.D. 249, 254 (D.D.C. 1991); **Varo, Inc. v. Litton Sys. Inc.**, 129 F.R.D. 139, 142 (N.D. Tex. 1989) (proponent must show precise facts exist to support claim of privilege; failure of proof as to any element causes claim of privilege to fail); **In re Grand Jury Investigation No. 83-2-35**, 723 F.2d 447, 450 (6th Cir. 1983), cert. denied, 467 U.S. 1246 (1984); **In re Grand Jury Proceedings (Doe)**, 575 F. Supp. at 200.

2. THE PRIVILEGE PROTECTS COMMUNICATIONS FROM THE CLIENT TO THE LAWYER; NOT ALL COURTS EXTEND THE PRIVILEGE TO COMMUNICATIONS FROM ATTORNEYS TO CLIENTS.

Courts uniformly recognize the applicability of the attorney-client privilege to communications from the client to the lawyer. Such communications comprise the foundation of the privilege. The more difficult question sometimes arises, however, when the communication is from the lawyer to the client. Some courts decline to apply the
privilege in such circumstances, finding that no privilege attaches unless the communication from the lawyer to the client relates quite directly to the client's confidential information. See, e.g., American Standard, Inc. v. Pfizer, Inc., 828 F.2d 734, 745 (Fed. Cir. 1987); Mead Data Cent., Inc. v. United States, 566 F.2d 242, 254 (D.C. Cir. 1977). While this narrow approach is not always utilized, e.g., In re LTV Sec. Litig., 89 F.R.D. 595, 601-03 (N.D. Tex. 1981), counsel must be cognizant of this threat to invocation of the privilege. Prudent counsel is advised, to the greatest extent possible, to base his/her legal advice upon confidential communications from the client to the attorney. By so enveloping counsel's communications with client confidences, the likelihood of successfully invoking the privilege will be greater.

The attorney-client privilege does not protect against disclosure of the facts underlying the communication. Upjohn Co. v. United States, 449 U.S. at 395; Humphreys, Hutcheson and Moseley v. Donovan, 755 F.2d at 1219.

3. THE CORPORATE CLIENT IS ALSO PROTECTED BY THE ATTORNEY-CLIENT PRIVILEGE.


However, "complications in the application of the privilege arise when the client is a corporation." Upjohn Co. v. United States, 449 U.S. at 389; see also Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. at 348 (administration of attorney-client privilege presents special problems in the case of corporations). The Upjohn Co. Court explained:

In the case of the individual client the provider of information and the person who acts on the lawyer's advice are one and the same. In the corporate context, however, it will frequently be employees beyond the control group as defined by the court below--"officers and agents . . . responsible for directing [the company's] actions in response to legal advice"--who will possess the information needed by the corporation's lawyers. Middle-level--and indeed lower-level--employees can, by actions within the scope of their employment, embroil the corporation in serious legal difficulties, and it is only natural that these employees would have the relevant information needed by corporate counsel if he is adequately to advise the client with respect to such actual or potential difficulties.

Upjohn Co. v. United States, 449 U.S. at 391. (Copy included in Appendix). The Upjohn Co. Court thus rejected the "control group" test in favor of a "case-by-case" analysis of the
existence and scope of the attorney-client privilege in the corporate context. Id. at 396-97. Under the Upjohn Co. analysis, the determination of whether the communications involving a corporate client are protected depends upon whether, under the circumstances, application of the attorney-client privilege will serve the underlying purposes and policies of the privilege. Id. at 392, 396-97. See also Thomas v. Pansy Ellen Prods., Inc., 672 F. Supp. 237, 243 (W.D.N.C. 1987); Union Carbide Corp. v. Dow Chem. Co., 619 F. Supp. 1036, 1047 (D. Del. 1985).

The Upjohn Co. Court, in acknowledging the privilege, gave weight to the following factors: (a) the employees communicated with counsel expressly to procure legal advice, (b) the communications related to matters in the scope of their employment, (c) employees were directed by superiors to consult with counsel, and (d) top management did not have knowledge of the subject matters. Upjohn Co., 449 U.S. at 394.

4. COMMUNICATIONS MUST BE CONFIDENTIAL.

Because the attorney-client privilege is premised upon a need to protect confidential communications, the privilege does not apply if the circumstances indicate that no confidentiality was intended. See United States v. Weger, 709 F.2d 1151, 1154 (7th Cir. 1983) ("[i]nformation imparted to counsel without any expectation of confidentiality is not privileged"); United States v. Melvin, 650 F.2d 641, 645 (5th Cir. 1981); United States v. Waller, 581 F.2d, 585, 587 (6th Cir.), cert. denied, 439 U.S. 1051 (1978). Thus, communications between an attorney and client made in the presence of third persons are not
privileged, unless the third person is an agent of the attorney or the client.¹ See Parsons v. Jefferson-Pilot Corp., 141 F.R.D. at 417; Humphreys, Hutcheson and Moseley v. Donovan, 755 F.2d at 1219; John H. Wigmore, Evidence, § 2311, at 602 (John T. McNaughton rev. 1961 & 1990 Supp.). The privilege also is waived if the client voluntarily discloses the contents of the communications to a third person. See United States v. Upjohn Co., 600 F.2d 1223, 1227 n.12 (6th Cir. 1979), rev’d on other grounds, 449 U.S. 383 (1981).

5. THE COMMUNICATION MUST PREDOMINANTLY INVOLVE LEGAL ADVICE.

Furthermore, as is discussed elsewhere in these materials, the privilege does not attach when counsel acts in a non-legal manner, providing primarily business and not legal advice. See, e.g., United States v. Loften, 518 F. Supp. 839, 846 (S.D.N.Y. 1981) (where advice is primarily non-legal, mere presence of legal advice will not render communication privileged), aff’d, 819 F.2d 1130 (2d Cir. 1987). Courts are particularly reluctant to use the privilege to shield communications from discovery merely because corporate officials who happen to be lawyers are involved. See Radio Corp. of America v. Rauland Corp., 18 F.R.D. 440, 443 (N.D. Ill. 1955). See also Avianca Inc. v. Corriea, 705 F. Supp 666, 676 (D.D.C. 1989); S.E.C. v. Gulf & Western Indus., Inc., 518 F. Supp. 675, 681-83 (D.D.C. 1981) (limitation necessary to prevent corporation from shielding business transactions from discovery merely by funneling communications through a licensed attorney). Accordingly, courts will find that some discussions are privileged only

¹ In order to qualify as an "agent", the third party must have more than a mere working relationship with the attorney or client. Parsons v. Jefferson-Pilot Corp., 141 F.R.D. 408, 417 (M.D.N.C. 1992). See also Burlington Indus. v. Exxon Corp., 65 F.R.D. 26, 40 (D. Md. 1974) ("Agents are only those persons essential to the lawyer’s performance of legal services").
upon a "clear showing" that the manager-lawyers were giving their advice "in a professional legal capacity." In re Sealed Case, 737 F.2d at 99.

Likewise, the privilege is not applicable to legal advice rendered in aid of a fraudulent scheme or criminal activity. United States v. Zolin, 491 U.S. 554 (1989) (so-called "crime-fraud" exception is a recognized exception to attorney-client privilege). See also Clark v. United States, 289 U.S. 1, 15 (1933); Fausek v. White, 965 F.2d at 129; Misek-Falkoff v. International Business Mach. Corp., 144 F.R.D. 48, 50 (S.D.N.Y. 1992); In re Antitrust Grand Jury, 805 F.2d 155, 162 (6th Cir. 1986) (reason for attorney-client privilege completely eviscerated where client consults attorney for legal assistance in carrying out a contemplated or ongoing crime or fraud). See also Horizon of Hope Ministry v. Clark County, Ohio, 115 F.R.D. 1, 5 (S.D. Ohio 1986) (communications between an attorney and a client are not privileged if prepared in order to perpetrate a tort); but see Coleman v. American Broadcasting Co., Inc., 106 F.R.D. 201 (D.D.C. 1985) (crime fraud exception does not extend to communications allegedly in furtherance of an attempt to conceal acts of sexual harassment or other violations of the federal civil rights law).

6. EXTENSION OR WAIVER OF EXISTING ATTORNEY-CLIENT PRIVILEGE.

While individual discussions may be protected on the basis of their specific circumstances, all discussions about the legal meetings between manager-lawyers and other corporate officials, without regard to purpose, probably will not be protected by an independent, "blanket" attorney-client privilege. As such, we now turn to the question of whether the attorney-client privilege protecting communications made at corporate "legal meetings" protects subsequent discussions of those communications, or whether those subsequent discussions constitute a waiver of the privilege.
A. Only Those Who Need To Know Should Have Access To Privileged Communications.

The determination of whether the attorney-client privilege created during the legal meetings extends to protect subsequent discussions of communications made during those meetings, or whether those discussions amount to waiver of the privilege, is complicated by the nature of the corporate client.

Prior to Upjohn Co., courts had reached an apparent consensus that the subsequent intracorporate discussion of legal advice, or dissemination of privileged materials, did not vitiate the privilege so long as continued confidentiality was intended and the scope of the intracorporate dissemination was limited. One court, applying the "control group" test, noted:

The fact that the communication at issue in this case [a document] may have been circulated among more than one employee of the Air Force does not necessarily destroy their confidentiality, however. Where the client is an organization, the privilege extends to those communications between attorneys and all agents or employees of the organization who are authorized to act or speak for the organization in relation to the subject matter of the communication.


This view applied equally to subsequent oral discussion of an attorney's advice:

A privileged communication should not lose its protection if an executive relays legal advice to another who shares responsibility for the subject matter underlying the consultation. . . . It would be an unnecessary restriction of the privilege to consider it lost when top management personnel discuss legal advice.
SCM Corp. v. Xerox Corp., 70 F.R.D. 508, 518 (D. Conn.), app. dismissed, 534 F.2d 1031 (2d Cir. 1976). See also United States v. Aluminum Co. of America, 193 F. Supp. at 253 (communication which "simply submits to non-legal personnel legal advice already received" is privileged).

Courts applying the "control group" test thus held that the privilege extends to discussion and dissemination of privileged communications among members of the "control group" (however defined). See, e.g., Mead Data Cent., Inc. v. U.S. Department of Air Force, supra; Barr Marine Prods. Co., Inc. v. Borg-Warner Corp., 84 F.R.D. at 634; SCM Corp. v. Xerox Corp., supra; United States v. Aluminum Co. of America, 193 F. Supp. at 253. If the privileged communication was disseminated beyond the control group, it was no longer privileged. Natta v. Hogan, 392 F.2d 686, 693 (10th Cir. 1968); Duplan Corp. v. Deering Milliken, Inc., 397 F. Supp. 1146, 1163 (D.S.C. 1974).

For courts applying the more flexible "multi-factor" tests of the corporate attorney-client privilege, the critical question was whether dissemination of the privileged communication was limited to those employees who, regardless of their status, were involved with the subject matter of the communication by virtue of their corporate duties. See Diversified Indus., Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1977); United States v. A T & T Co., 86 F.R.D. 603, 623 (D.D.C. 1979); SEC v. Texas Int'l Airport, Inc., 29 Fed R. Serv. 2d 408, 409-10 (D.D.C. 1979); In re Ampicillin Antitrust Litig., 25 Fed R. Serv. 2d 1248, 1254 (D.D.C. 1978); Sylgab Steel & Wire Corp. v. Imoco-Gateway Corp., 62 F.R.D. 454, 456 (N.D. Ill. 1974), aff'd, 534 F.2d 330 (7th Cir. 1976); Rockwell Mfg. Co. v. Chicago Pneumatic Tool Co., 57 F.R.D. 111, 113 (N.D. Ill. 1972).

In Upjohn Co., the Supreme Court rejected a "control group" test which limited the attorney-client privilege to communications with "senior management" who
"play a 'substantial role' in deciding and directing a corporation's legal response." 449 U.S. at 390, 393, 397. In lieu of the "control group" test, the Court sanctioned case-by-case analysis of the privilege in the corporate context. Id. at 396-97. The Court's discussion, however, suggests that the policies of the privilege would be furthered by extending the privilege to cover the relaying of legal advice between and among certain "non-control group" corporate employees:

The control group test adopted by the court below thus frustrates the very purpose of the privilege by discouraging the communication of relevant information by employees of the client to attorneys seeking to render legal advice to the client corporation. The attorney's advice will also frequently be more significant to noncontrol group members than to those who officially sanction the advice, and the control group test makes it more difficult to convey full and frank legal advice to the employees who will put into effect the client corporation's policy. See, e.g., Duplan Corp. v. Deering Milliken, Inc., 397 F. Supp. 1146, 1164 (D.S.C. 1974) ("After the lawyer forms his or her opinion, it is of no immediate benefit to the chairman of the board or the president. It must be given to the corporate personnel who will apply it").

Id. at 392. The Upjohn Co. Court also noted that the "narrow scope" of the "control group" test "threatens to limit the valuable efforts of corporate counsel to ensure their client's compliance with the law." Id.

Following Upjohn Co., courts addressing the question have concluded that, for the corporate attorney-client privilege to apply, "the communication must originate in confidence and not be disseminated beyond those persons who need to know its contents." SEC v. Gulf & Western Indus., Inc., 518 F. Supp. 675, 681 (D.D.C. 1981). See also In re Grand Jury Subpoenas Dated Dec. 18, 1981, 561 F. Supp. 1247, 1258-59 (E.D.N.Y. 1982) (attorney-client privilege only attaches "if the communication is disseminated to an employee who needs to know the material because he has a direct responsibility over the


Each of these general principles supports the conclusion that the attorney-client privilege is not waived as a result of limited dissemination of confidential communications to corporate employees whose duties will be affected by such communications. Employees whose employment duties relate to the communications clearly are "agents" of the corporate client for purposes of those communications. Likewise, limited disclosure to such employees is "consistent with an intention to keep the communications confidential," and such employees would "share the client's interest" with respect to the communications.

To enhance the argument that the attorney-client privilege created during corporate legal meetings extends to protect the subsequent intracorporate dissemination of such communications, several considerations should be borne in mind. First, the dissemination must be made with the intent that the privileged communications remain confidential. Second, the dissemination should be limited to those corporate officials and employees who will utilize the privileged communications within the scope of their employment. Third, dissemination should also be restricted to those who need to know.
B. Overly Broad Dissemination May Result In A Waiver Of The Attorney-Client Privilege.

On the other hand, the privilege will likely not extend to widespread dissemination of communications made at the legal meetings, or even to limited dissemination of such communications to corporate officials and employees who, by virtue of their employment, would not be concerned with the communications in their daily duties. In one post-Upjohn Co. case, the court held that the company lost the attorney-client privilege when a document was circulated to a corporate officer who had "deliberate[ly] withdraw[n] from any responsibility" over the subject matter of the document. In re Grand Jury Subpoenas Dated Dec. 18, 1981, 561 F. Supp. at 1258-59.

In the event that the manager-lawyers have disseminated confidential communications to corporate officials who do not need to know of the communications because of their job duties, three questions are raised: (1) Whether the manager-lawyers have the ability to waive a privilege held by the corporation as a whole? (2) Whether the disclosures would amount to waiver when the disclosures presumably were not intended by the manager-lawyers to effect a waiver? (3) What is the extent and effect of any waiver resulting from the disclosures?

It is clear that corporate officers and directors possess the power to waive the corporate attorney-client privilege. See Commodity Futures Trading Comm’n v. Weintraub, 471 U.S. at 348. Thus, courts have concluded that voluntary statements by corporate directors and officers about confidential communications waive the corporate privilege as to those communications. See Weil v. Investment/Indicators, Research and Management, Inc., 647 F.2d 18, 25 (9th Cir. 1981); Velsicol Chem. Corp. v. Parsons, 561 F.2d 671, 674-76 (7th Cir. 1977), cert. denied, 435 U.S. 942 (1978); In re Consol. Litig. Concerning Int'l
Harvester's Disposition of Wisconsin Steel, 666 F. Supp. at 1151-54; Lee National Corp. v. Deramus, 313 F. Supp. 224, 227 (D. Del. 1970). In addition, a corporation's voluntary disclosure of privileged documents to government agencies is generally held to effect a total waiver of the privilege as to those documents. Westinghouse Elec. Corp. v. Republic of Philippines, 951 F.2d 1414, 1423-27 (3rd Cir. 1991); United States v. Rockwell Int'l, 897 F.2d 1255, 1265 (3rd Cir. 1990) ("attorney-client privilege does not apply to communications that are intended to be disclosed to third parties or are in fact so disclosed"); In re Subpoena Duces Tecum, 738 F.2d 1367, 1369-70 (D.C. Cir. 1984); United States v. Upjohn Co., 600 F.2d at 1227 n.12; Artesian Indus., Inc. v. Department of Health and Human Servs., 646 F. Supp. 1004, 1008 (D.D.C. 1986); United States v. Vehicular Parking, 52 F. Supp. 751, 754 (D. Del. 1943). There is some discrepancy, however, as to whether the privilege will attach to drafts of the final product. Compare In re Air Crash Disaster at Sioux City, Iowa, 133 F.R.D. 515, 518 (N.D. Ill. 1990) (an underlying privilege attaching to drafts is not destroyed simply because a final product is disclosed to the public) with United States v. (Under Seal), 748 F.2d 871, 875 n.7 (4th Cir. 1984) (details underlying published data, including drafts, are not privileged) and North Carolina Elec. Membership Corp. v. Carolina Power & Light Co., 110 F.R.D. 511, 517 (M.D.N.C. 1986) and Schenet v. Anderson, 678 F. Supp. 1280, 1283 (E.D. Mich. 1988) (attorney-client privilege applies to all information conveyed by clients to their attorneys for the purpose of drafting documents to be disclosed to third person and all documents reflecting such information to the extent it is not contained in the disclosed document or not otherwise disclosed to third persons).

To the extent that the manager-lawyers are high-ranking corporate officers, their disclosures could be deemed a corporate waiver of the privilege simply by virtue of

In Jonathan Corp., the court reasoned that the Upjohn Co. decision precluded the conclusion that only "control group" members could waive the corporation's attorney-client privilege and held that an employee's voluntary disclosure of a privileged document constituted a waiver because the corporation "intentionally put the individual in a position to make the disclosure as well as gave him the information to disclose." 114 F.R.D. at 697-700. Accordingly, a manager-lawyer's dissemination of privileged communications to "inappropriate" employees could be viewed as a waiver of the corporation's privilege.

Some courts have held that an inadvertent disclosure of confidential material does not waive the privilege because a waiver must be "intentional." See Mendenhall v. Barber-Greene Co., 531 F. Supp. 951, 954-55 (N.D. Ill. 1982); Georgetown Manor, Inc. v. Ethan Allen, Inc., 753 F. Supp. 936, 938 (S.D. Fla. 1991) (endorsed Mendenhall approach as the "better reasoned rule"); Connecticut Mut. Life Ins. Co. v. Shields, 18 F.R.D. 448, 451 (S.D.N.Y. 1955). Other courts have found that inadvertent disclosure always causes a waiver as once confidentiality is lost, the privilege cannot be restored. In re Sealed Case, 877 F.2d 976 (D.C. Cir. 1989). The majority position, however, seems to be that an intent
to waive is not required and even inadvertent or intentionally limited disclosure constitutes a waiver. See 8 John H. Wigmore, Evidence § 2327, at 636 (John T. McNaughton rev. 1961 & 1990 Supp.); McCormick, Handbook of the Law of Evidence § 93, at 194 n.14 (2d ed. 1972); see also Hydraflow, Inc. v. Enidine Inc., 145 F.R.D. 626, 637-38 (W.D.N.Y. 1993); Western Trails, Inc. v. Camp Coast to Coast, Inc., 144 F.R.D. at 8; In re Sealed Case, 676 F.2d 793, 807 (D.C. Cir. 1982); Weil v. Investment/Indicators, Research & Management, Inc., 647 F.2d at 24; Thomas v. Pansy Ellen Prods. Inc., 672 F. Supp. at 243; Ranney-Brown Distrib., Inc. v. E.T. Barwick Indus., Inc., 75 F.R.D. 3, 6 (S.D. Ohio 1977); Duplan Corp. v. Deering Milliken, Inc., 397 F. Supp. at 1161-62; Underwater Storage, Inc. v. United States Rubber Co., 314 F. Supp. at 549. But see KL Group v. Case, Kay & Lynch, 829 F.2d 909, 919 (9th Cir. 1987) (law firm’s inadvertent disclosure of privileged document did not constitute waiver because the disclosure was not the voluntary decision of the corporate client); United States v. Zolin, 809 F.2d at 1417 (when personal secretary to corporate officer delivered privileged tapes to third party under mistaken impression that they were blank, no waiver occurred because the disclosure was inadvertent and involuntary); SCM Corp. v. Xerox Corp., 70 F.R.D. at 519 (inadvertent disclosure did not constitute waiver of privilege).

Courts adopting the majority approach typically apply a balancing test in order to determine whether inadvertent disclosure waives the attorney-client privilege. See, e.g., In re Grand Jury Investigation, 142 F.R.D. 276, 279 (M.D.N.C. 1992). The following factors have been found to be relevant in deciding whether an inadvertent disclosure constitutes a waiver of the privilege:

(1) the reasonableness of precautions taken to prevent disclosure; (2) the amount of time taken to remedy the error;
(3) the scope of discovery; (4) the extent of the disclosure; and
(5) the overriding issue of fairness.


In the event that a waiver is found, it is likely that a court would determine that the waiver existed only as to those confidential communications actually disclosed by the manager-lawyers. Courts are careful to ensure that the attorney-client privilege is not applied so as to give the party asserting the privilege an advantage by allowing him to disclose only those communications which are advantageous to his position. See Fox v. California Sierra Fin. Servs., 120 F.R.D. 520, 527 (N.D. Cal. 1988); Burlington Indus. v. Exxon Corp., 65 F.R.D. at 46; Duplan Corp. v. Deering Milliken, Inc., 397 F. Supp. at 1162; Sylgab Steel & Wire Corp. v. Imoco-Gateway Corp., 62 F.R.D. at 457-58; but see Western Trails, Inc. v. Camp Coast to Coast, Inc., 139 F.R.D. at 12 (court has discretion to impose less than the full scope of waiver "as to all communications on same subject matter where the client has merely disclosed a communication to a third party, as opposed to making some use of it") quoting In re Sealed Case, 676 F.2d at 809 n. 54; Chinnici v. Central Dupage Hosp. Ass'n, 136 F.R.D. 464, 465 (N.D. Ill. 1991) (production of some privileged documents waives the privilege as to all documents of the same subject matter); Standard
Chartered Bank PLC v. Ayala Int'l Holdings, Inc., 111 F.R.D. 76, 85 (S.D.N.Y. 1986). If the privilege is being asserted for such purposes, courts will hold the privilege waived for all communications relating to the same subject matter as the communications already disclosed. See Westinghouse Elec. Corp. v Republic of Philippines, 951 F.2d at 1426; In re Sealed Case, 877 F.2d 976, 980-81 (D.C. Cir. 1989); Burlington Indus. v. Exxon Corp., 65 F.R.D. at 46; Duplan Corp. v. Deering Milliken, Inc., 397 F. Supp. at 1162.

However, "[t]he rule of partial disclosure as a qualification on the privilege should not be applied without reference both to the objectives of the privilege and the qualification. . . . [T]he rule of partial disclosure [is] one dictated by considerations of fairness." International Business Mach. Corp. v. Sperry Rand Corp., 44 F.R.D. 10, 13 (D. Del. 1968). Where disclosures made by the manager-lawyers clearly were not made to gain a tactical advantage in litigation a broad waiver should not result. See In re Sause Bros. Ocean Towing, 144 F.R.D. at 116 (defendant could not argue that it had been prejudiced by disclosure; nor were the documents disclosed to gain an advantage, therefore, expanding scope of waiver inappropriate); In re von Bulow, 828 F.2d 94, 103 (2d Cir. 1987) (no "subject matter" waiver when party asserting privilege did not make advantageous use of disclosure). As such, any waiver should be limited to the communications actually disclosed by the manager-lawyers. See In re Sause Bros. Ocean Towing, 144 F.R.D. at 116; Weil v. Investment/Indicators, Research & Management, Inc., 647 F.2d at 25; Status Time Corp. v. Sharp Electronics Corp., 95 F.R.D. 27, 34 (S.D.N.Y. 1982); Champion Int'l Corp. v. International Paper Co., 486 F. Supp. 1328, 1332-33 (N.D. Ga. 1980).
WORK-PRODUCT DOCTRINE:
CORPORATE COMMUNICATIONS WITH
AN EYE TOWARD LITIGATION

Historically, a lawyer is an officer of the court and is bound to work for the advancement of justice while faithfully protecting the rightful interests of his clients. In performing his various duties, however, it is essential that a lawyer work with a certain degree of privacy, free from unnecessary intrusion by opposing parties and their counsel. Proper preparation of a client's case demands that he assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference. That is the historical and the necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to protect their clients' interests.

Were such materials open to opposing counsel on mere demand, much of what is now put down in writing would remain unwritten. An attorney's thoughts, heretofore inviolate, would not be his own. Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial. The effect on the legal profession would be demoralizing. And the interests of the clients and the cause of justice would be poorly served.


1. OVERVIEW

Many lawyers and, indeed, some courts confuse the protections provided by the work-product doctrine and the attorney-client privilege. These concepts are separate although they do interrelate. Notably, some of the gaps in the protection offered by the attorney-client privilege discussed above can be filled by the work-product doctrine.

The United States Supreme Court first articulated the work-product doctrine in the seminal case of Hickman v. Taylor, 329 U.S. 495 (1947) (copy included in Appendix). The holding in Hickman was later codified in Rule 26(b)(3) of the Federal Rules of Civil
Procedure. Many states, too, have adopted some form of the work-product doctrine as well.

While some lawyers and courts refer to the protection provided to an attorney's work-product as a "privilege," the doctrine creates no more than a qualified immunity for (1) documents and tangible things otherwise discoverable that were (2) prepared in anticipation of litigation or for trial (3) by a lawyer, a party, or a party's representative. As with the attorney-client privilege, the underlying facts incorporated into the work-product are not protected from discovery.

However, unlike the attorney-client privilege, the work-product doctrine is not absolute; it can be overcome, in some situations, by the requisite showing of substantial need and undue hardship. Fed. R. Civ. P. 26(b)(3). Moreover, Rule 26 makes a distinction between "factual work-product", which encompasses documents or exhibits prepared in anticipation of litigation, and "opinion work-product." "Opinion work-product" includes mental impressions, opinions or legal theories. Hickman v. Taylor, 329 U.S. at 508. Rule 26(b)(3) warns that even if substantial need and undue hardship are shown and production of "factual work-product" ordered, "the court shall [nonetheless] protect against the disclosure of "opinion work-product." Fed. R. Civ. P. 26(b)(3).

Lastly, just as the attorney-client privilege can be waived, so too can the protection provided by the work-product doctrine be waived, intentionally or otherwise. Caution, therefore, must be exercised by in-house and outside counsel to avoid the unintentional waiver of the protections afforded by the work-product doctrine.²

²This section of the materials addresses applications of the federal work product doctrine by the federal courts. These materials, for the most part, do not discuss the doctrine's application in criminal cases. (Note, however, that the Supreme Court has stated:
2. FEDERAL WORK-PRODUCT DOCTRINE


A party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and prepared in anticipation of litigation or for trial by or for another party or by or for that other party's representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation. (Emphasis added.)

Thus, Rule 26(b)(3) consists of five different components. First, "documents and tangible things" must be involved. Second, those materials must have been "prepared in anticipation of litigation or for trial." Third, the preparer must be a lawyer, a party or the party's representative. Fourth, discovery of the materials is available only upon a showing of

"we agree that [the work product] doctrine applies to criminal litigation as well as civil." United States v. Nobles, 422 U.S. 225, 236 (1975); see also Rule 16(b)(2) of the Federal Rules of Criminal Procedure. Finally, these materials do not address the doctrine as it relates to the preparation of experts for testimony at trial.
substantial need and undue hardship to obtain substantially equivalent materials. Fifth, "mental impressions, conclusions, opinions, or legal theories" of the representative are given special protection by the court. Each of these components, and other considerations, will be addressed in turn.

A. Work-Product Doctrine Protects Tangible And Intangible Things.

Although Rule 26(b)(3) states that the work-product doctrine applies only to "documents and tangible things" (the first component), some courts have held that the rule applies to intangible materials as well. In re Grand Jury Subpoena Dated November 8, 1979, 622 F.2d 933, 935 (6th Cir. 1980) ("[w]ork product consists of the tangible and intangible material which reflects an attorney's efforts at investigating and preparing a case"); EEOC v. Anchor Hocking Corp., 31 FEP Cases 1049, 1050 (S.D. Ohio 1981) ("[a]lthough unwritten and intangible material is not within the express scope of Fed. R. Civ. P. 26(b)(3), the work-product doctrine in nevertheless applicable to unwritten material developed in anticipation of litigation"); Herwig v. Marine Shale Processors, Inc., No. 92-2753, 1993 U.S. Dist. LEXIS 7781, at *5 (E.D. La. June 8, 1993) ("[d]efendants have made no showing which can overcome the special protection afforded an attorney's recollections"); but see McLaughlin v. Miles Laboratories, Inc., 124 F.R.D. 629, 630 (N.D. Ind. 1988) ("the material must be: ... documents or tangible things"); Anderson v. Torrington Co., 120 F.R.D. 82, 86 (N.D. Ind. 1987) ("[t]he material must ... be documents and tangible things"); Toledo Edison v. G A Technologies, Inc., 847 F.2d 335, 339 (6th Cir. 1988) ("the application of subdivision (b)(3) is limited to 'documents and tangible things otherwise discoverable under subdivision (b)(1)'").
B. Work-Product Protection Only Attaches If Materials Are Prepared In Anticipation Of Litigation Or For Trial.

Rule 26(b)(3) requires that the materials in question, in order to be immune from discovery under the doctrine, must have been "prepared in anticipation of litigation or for trial" (the second component). Thus, materials prepared in the ordinary course of a business pursuant to normal practice are not protected by the work-product doctrine. Linde Thomson Langworthy Kohn & Van Dyke, P.C. v. Resolution Trust Corporation, 5 F.3d 1508, 1993 U.S. App. LEXIS 25279, at *22 (D.C. Cir. October 5, 1993) ("litigant must demonstrate that documents were created 'with a specific claim supported by concrete facts which would likely lead to litigation in mind,' not merely assembled in the ordinary course of business or for other nonlitigation purposes") (quoting Coastal States Gas Corp. v. Department of Energy, 617 F.2d 854, 865 (D.C. Cir. 1980), Harper, 138 F.R.D. at 660 ("[i]f documents and materials are produced in the ordinary and regular course of a party's business, and not to prepare for litigation, they are outside the scope of work-product"); Stout v. Norfolk & W. RY. Co., 90 F.R.D. 160, 162 (S.D. Ohio 1981) ("we conclude that the statements taken . . . in this case were records made in the ordinary course of business and were not taken in anticipation of litigation"), even if the possibility of litigation exists. Binks Mfg. Co. v. Nat. Presto Industries, Inc., 709 F.2d 1109, 1120 (7th Cir. 1983) (remote prospect of litigation is not enough to satisfy the requirement that the materials must be prepared in anticipation of litigation); Galambus v. Consolidated Freightways Corp., 64 F.R.D. 468, 472 (N.D. Ind. 1974) ("even though litigation is already in prospect, there is no work-product immunity for documents prepared in the regular course of business rather than for the purposes of litigation"); Urseth v. City of Dayton, 110 F.R.D. 245, 255 (S.D. Ohio 1986) ("'mere possibility' of litigation is insufficient to prevent disclosure").
Moreover, just because "litigation does eventually ensue does not, by itself, cloak materials prepared by an attorney with the protection of the work-product privilege." Binks, 709 F.2d at 1118; Taroli v. General Electric Co., 114 F.R.D. 97, 98 (N.D. Ind. 1987), aff'd 840 F.2d 920 (7th Cir. 1988) ([n]either does the fact that a lawsuit subsequently was filed automatically require a finding that the investigation was conducted in anticipation of litigation); Mazan v. Schmelzer, 111 F.R.D. 470, 471 (N.D. Ind. 1986) ([a] statement is not deemed to have been prepared in anticipation of litigation merely because an accident has occurred, an investigation was made, and a lawsuit subsequently was filed).

The Sixth Circuit and district courts in that Circuit have not set forth any guidelines with respect to this requirement other than there be more than a "mere possibility" of litigation. See Guy v. United Healthcare Corp., No. 2:92-CV-397, 1993 U.S. Dist. LEXIS 8406 (S.D. Ohio June 16, 1993) (reviewing standards applied by other courts but not adopting a specific standard). Courts in the Seventh Circuit, on the other hand, have construed this requirement to mean "that the document in question be produced because of the anticipation of litigation, i.e., to prepare for litigation or for trial." Harper, 138 F.R.D. at 659; see also Binks, 709 F.2d at 1120; Henderson, 131 F.R.D. at 570 ("the document sought to be protected can be said to have been prepared or obtained because of the prospect of litigation when the primary motivation was to aid in possible future litigation"); Anderson, 120 F.R.D. at 86; Mazan, 111 F.R.D. at 472; Galambus, 64 F.R.D. at 472. However, whereas one Indiana district court has suggested that the probability of litigation must be substantial and imminent for the work-product doctrine to attach to materials prepared at that time, Mazan, 111 F.R.D. at 472, the Seventh Circuit has suggested otherwise. Binks, 709 F.2d at 1119 (adopting the reasoning of Janicker v. George Washington University, 94 F.R.D. 648, 650 (D.D.C. 1982), which stated: "[w]hile
litigation need not be imminent, the primary motivating purpose behind the creation of the document or investigative report must be to aid in possible future litigation").

C. Protected Materials Must Be Prepared By A Lawyer, A Party Or A Party's Representative.

The third component is that the materials desired to be protected must be prepared by a lawyer, a party or other representative of the party working on behalf of the party's interest. Thus, "[t]he work-product rule has no application to a document prepared by and in the hands of a third person who is neither a party to nor interested in the action." Galambus, 64 F.R.D. at 473. Although the language of some cases might seem to suggest otherwise, see Mazan, 111 F.R.D. at 472 ("[s]ince the statements were neither requested by nor prepared for an attorney, they were not prepared in anticipation of litigation"), most courts have held that the doctrine does, in fact, apply to work performed by non-attorneys. Henderson, 131 F.R.D. at 569, n. 8 ("by the express language of the Rule, the work-product privilege is not dependent upon an attorney's involvement, but instead only requires that the materials be prepared by a 'representative' for purposes of the work-product doctrine"); McLaughlin, 124 F.R.D. at 630 ("[t]he qualified work-product privilege extends to documents prepared by or for a representative of a party, including his agent"); Toledo Edison, 847 F.2d at 339. Eoppolo v. National R.R. Passenger Corp., 108 F.R.D. 292, 295 (E.D. Pa. 1985) (attorney need not be involved for doctrine to apply); United States v. Nobles, 422 U.S. 225, 238-39 (1975) (the doctrine protects "material prepared by agents for the attorney as well as those prepared by the attorney himself.").

D. Overcoming The Work-Product Doctrine.

The fourth and fifth components draw a distinction between "opinion work-product" -- 'mental impressions, conclusions, opinions, or legal theories of an attorney or
other representative of a party concerning the litigation" -- and other materials -- "factual work-product." "Factual work-product" is discoverable "upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party’s case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means." Fed. R. Civ. P. 26(b)(3); see e.g. Harper, 138 F.R.D. at 671; McLaughlin, 124 F.R.D. at 631; Toledo Edison, 847 F.2d at 340.

"Opinion work-product" however, requires, if it is even discoverable, a much higher showing. The Sixth Circuit recently held that the "opinion work-product" is simply undiscoverable. Toledo Edison, 847 F.2d at 340 ("the rule flatly states that the court is to not permit discovery of 'mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation' "). Other courts, as well as an earlier decision of the Sixth Circuit, on the other hand, have declared that "opinion work-product" is discoverable upon a showing of extraordinary circumstances or the like. In re Special September 1978 Grand Jury, 640 F.2d 49, 52 (7th Cir. 1980) ("extraordinary need"); Roberts v. Carrier Corp., 107 F.R.D. 678, 688 (N.D. Ind. 1985) (standard is "much higher"); Tronitech v. NCR Corp., 108 F.R.D. 655, 656 (S.D. Ind. 1985) ("[s]uch material will be disclosed, if at all, only under extraordinary circumstances. . . as when the activities of counsel are directly at issue"); Grand Jury Subpoena, 622 F.2d at 936 ("rare and extraordinary circumstances"); United States v. David A. Beck, Potter and Co., 1987 U.S. Dist. LEXIS 14988, *25 (E.D. Ky. 1987) ("such work-product cannot be disclosed simply on a showing of substantial need and inability . . . to obtain the equivalent without undue hardship"); EEOC, 31 FEP Cases at 1050 ("far stronger showing"). The Supreme Court, while acknowledging that a stronger showing is required for discovery of attorneys' mental processes, expressly declined to resolve the issue of whether those processes are dis-

E. Waiver Of The Doctrine And Other Considerations.

Other facets of the work-product doctrine should be noted. For instance, most courts have held that the work-product doctrine protects "work produced in anticipation of other litigation," United States v. Leggett & Platt, Inc., 542 F.2d 655, 660 (6th Cir. 1976), cert. denied 430 U.S. 945 (1977). However, some courts have limited the use of the doctrine to related proceedings. Clark v. City of Munster, 115 F.R.D. 609, 614 (N.D. Ind. 1987) ("[t]he work-product may be claimed in a related proceeding even if the litigation for which the file was created has been terminated"); see also Federal Trade Commission v. Grolier Inc., 462 U.S. 19, 26 (1983). Furthermore, the doctrine's immunity may be claimed by either the attorney or the client. Special September 1978 Grand Jury, 640 F.2d at 62 ("the work-product doctrine may be asserted by either the client or the attorney"); Clark, 115 F.R.D. at 614 (adopting statement in Special September 1978 Grand Jury); Tronitech, 108 F.R.D. at 657 ("[t]he client as well as the attorney may assert work-product protection"); but see Anderson, 120 F.R.D. at 82 ("[w]ork-product is the privilege of the attorney and not of the client"). Moreover, facts are not protected by the doctrine. EEOC, 31 FEP Cases at 1051.

Finally, there are two instances when, even if the requirements for application of the doctrine are met, immunity will not exist. First, actions taken by the attorney or client can waive the protection of the immunity. See Nobles, 422 U.S. at 239 (waiver occurred when attorney made testimonial use of protected materials at trial); Anderson, 120 F.R.D. at 87 ("[i]f documents otherwise protected by the work-product have been disclosed to others with an actual intention that an opposing party may see the
documents, the disclosing party should not subsequently be able to claim protection for the documents as work-product); Roberts, 107 F.R.D. at 688 (no waiver despite disclosure to a non-party "because there is nothing to suggest that [the defendant] disclosed the documents with an eye towards allowing [the plaintiff] access to the information"); Tronitech, 108 F.R.D. at 657 (immunity "is not ordinarily waived by disclosure to third parties"); In re Dayco Corp. Derivative Securities Litigation, 102 F.R.D. 468, 470 (S.D. Ohio 1984) (involuntary disclosure of diary to a newspaper and subsequent publication of excerpts is not a waiver of the immunity).

Second, the "crime-fraud" exception provides that the immunity is not available "when there has been a showing of ongoing client fraud," Special September 1978 Grand Jury, 640 F.2d at 63, or when the work-product is in perpetuation of a tort. Horizon of Hope Ministry v. Clark County, Ohio, 115 F.R.D. 1, 5 (S.D. Ohio 1986).
LAWYER ACTING AS BUSINESS PERSON: WHEN DOES THE ATTORNEY-CLIENT PRIVILEGE APPLY?

1. OVERVIEW

Perhaps one of the most difficult privilege questions arises when the attorney's duties with the corporation include "certain responsibilities outside the lawyer's sphere." In Re Sealed Case, 737 F.2d at 99. In such circumstances, courts scrutinize the context and content of the pertinent communications to determine whether the attorney acted as a lawyer with respect to those communications. Id.; see also Rossi v. Blue Cross & Blue Shield, 540 N.E.2d 703, 705 (N.Y. 1989) ("the need to apply it [attorney-client privilege] cautiously and narrowly is heightened in the case of corporate staff counsel"); Valente v. Pepsico, Inc., 68 F.R.D. 361, 367 (D. Del. 1975); Malco Mfg. Co. v. Elco Corp., 45 F.R.D. 24, 26 (D. Minn. 1968). "The possession of a law degree and admission to the bar is not enough to establish a person as an attorney for purposes of determining whether the attorney-client privilege applies." North Am. Mortgage Investors v. First Wis. Nat'l Bank, 69 F.R.D. 9, 11 (E.D. Wisc. 1975).

As always, the communication pertaining to the rendering of legal advice must be made with the intention of confidentiality before the privilege applies. See Great Plains Mut. Ins. Co. v. Mutual Reinsurance Bureau, 150 F.R.D. 193, 197 (D. Kan. 1993) (minutes of board meeting held privileged when participants kept content of meeting confidential and attorney acted in legal capacity during relevant portions of meetings); In Re Sealed Case, 737 F.2d at 100; Burlington Industries v. Exxon Corp., 65 F.R.D. 26, 37 (D. Md. 1974). Moreover, if the communication involves predominantly legal advice, it is privileged even if relevant non-legal and business considerations are discussed as well. See Advanced Cardiovascular Sys., v. C.R. Bard, Inc., 144 F.R.D. 372, 375-77 (N.D. Cal. 1992);

On the other hand, "[c]ommunications dealing exclusively with the solicitation or giving of business advice...or with any other matters which may as easily be handled by laymen are not privileged." Georgia-Pacific Plywood Co. v. United States Plywood Corp., 18 F.R.D. at 464; accord United States v. Bartone, 400 F.2d at 461; Ray v. Cutter Lab. Div. of Miles, 746 F. Supp. 86, 87 (M.D. Fla. 1990); Valente v. PepsiCo, Inc., 68 F.R.D. at 367; American Cyanamid Co. v. Hercules Powder Co., 211 F. Supp. 85, 88-89 (D. Del. 1962); Zenith Radio Corp. v. Radio Corp. of America, 121 F. Supp. at 794; see also Simon v. G.D. Searle & Co., 816 F.2d 397, 403 (8th Cir.) ("attorney-client privilege does not protect client communications that relate only business or technical data"), cert. denied, 484 U.S. 917 (1987); United States v. Huberts, 637 F.2d 630, 640 (6th Cir. 1980), cert. denied, 451 U.S. 975 (1981) (overseeing sale of equipment not a legal service). But see Hydroflow, Inc. v. Endine, Inc., 145 F.R.D. 626, 630 (W.D.N.Y. 1993) (inclusion of technical information does not vitiate privilege "[i]f the primary purpose of the communication was to receive legal advice or services"). Similarly, if a court concludes that

2. THE APPLICATION OF THE ATTORNEY-CLIENT PRIVILEGE TO COMMUNICATIONS INVOLVING A LAWYER ACTING AS BUSINESS PERSON REQUIRES A FACT SPECIFIC ANALYSIS.

Communications between a corporation and its in-house counsel are protected to the same extent and in the same manner as those with outside counsel. Upjohn Co., 449 U.S. at 389-97; United States v. Mobil Corp., 149 F.R.D. 533, 537 (N.D. Tex. 1993). Nevertheless, the determination of whether the discussions between manager-lawyers and other corporate officials are privileged turns upon the particular circumstances of those discussions. Several factors will be relevant. In order to be within the privilege: (1) the communications must have been made with the intent of confidentiality; (2) the manager-lawyers must have acted in their capacity as lawyers; and (3) the communications must have pertained primarily to the rendering of legal advice by the manager-lawyers.

Since the analysis applied by courts in such situations is fact-specific, both under the authority discussed above and the Upjohn Co. analysis, it is impossible to determine whether the discussions would be protected without exploring the individual
circumstances of each such discussion. Several factors can weigh against a finding that the attorney-client privilege applies, however. First, when the manager-lawyers are not directly affiliated with the corporation's legal department, and they do not engage in the practice of law in their daily corporate duties, it is unlikely that either party to the discussions would view the manager-lawyers as acting as attorneys with respect to the discussion. Second, it is also unlikely that such discussions would pertain to the rendering of legal advice by the manager-lawyers; rather, the discussions presumably would involve the reporting of legal advice rendered by the corporation's in-house and outside counsel. Third, the reporting (or rendering) of legal advice probably would not be the predominant purpose of the discussions. To the extent the discussions relate to dissemination and implementation of business decisions made on the basis of discussions at the legal meetings, the manager-lawyers may be viewed as acting in their business capacity. See Hardy v. New York News, Inc., 114 F.R.D. 633, 644-45 (S.D.N.Y. 1987) (corporate affirmative action plan documents were not within corporate attorney-client privilege when they were part of an "ongoing business effort" to develop a plan and were drafted by a corporate employee who, while he was also an attorney, was acting in his capacity as director of employee relations).

Several examples illustrate how courts assess the lawyer's role: (1) Where an attorney negotiates on behalf of his/her client, many courts hold that these communications, and even related communications between the attorney and client, are not privileged. See United States v. Wilson, 798 F.2d 509, 513 (1st Cir. 1986); J.P. Foley & Co. v. Vanderbilt, 65 F.R.D. 523, 526-27 (S.D.N.Y. 1974); and (2) Where a lawyer simply traced transfers of funds, courts have denied the privilege claim, explaining: "The mere fact that a person is an attorney does not render as privileged everything he does for a
client. Ministerial or clerical services such as those testified to here are not within the privilege." United States v. Bartone, 400 F.2d 459, 461 (6th Cir. 1968), cert. denied, 393 U.S. 1027 (1969).

Business people operating under the misperception that a privilege arises merely by funneling documents past counsel will be sorely disappointed. Communications such as carbon copies to the law department, which reflect the business persons' assessments will be discoverable where their primary purpose is to report on business matters, and not to procure legal advice. See Simon v. G.D. Searle & Co., 816 F.2d 397, 402-04 (8th Cir. 1987); First Wis. Mortgage Trust v. First Wisc. Corp., 86 F.R.D. 160, 174 (E.D. Wisc. 1980). Nevertheless, "the attorney-client privilege clearly applies to communications made to corporate counsel in the course of conducting an internal investigation." United States v. Shyres, 898 F.2d 647, 655 (8th Cir.), cert. denied, 498 U.S. 821 (1990).

Because the in-house lawyer often plays a legal and business role within a corporation, two questions should continually be asked before communicating with corporate clients: Which hat am I wearing? Which hat should I be wearing?
INTERNAL CORPORATE INVESTIGATIONS

1. OVERVIEW

Largely as a result of increasing litigation, expanding governmental regulation and publicity associated with scandals in the business world, internal corporate investigations have become, regrettably, an all too frequent component of corporate America. Businesses must be particularly aware of the pitfalls and traps that can be associated with internal investigations. Well in advance of commencing an internal investigation, in-house and outside counsel should carefully ponder how it will be conducted and, correspondingly, how it can be protected from disclosure in subsequent legal proceedings. Numerous treatises exist on this topic. These seminar materials will attempt only to outline key considerations which inside counsel should consider before commencing an internal investigation.

2. IDENTIFY THE PURPOSE OF THE INTERNAL INVESTIGATION UNDER CONSIDERATION.

Not all internal investigations are alike. The triggering event can be as varied as the situations that confront any business daily. For example, the decision to investigate could flow from an employee's charge of wrongdoing, a competitor's threat of suit, a criminal investigation, a negative story in the press, a lawsuit, Grand Jury subpoenas, administrative agencies' document requests, etc. One constant exists, however: Before commencing an internal investigation, in response to any situation, counsel must carefully assess the potential benefit versus the potential harm that could result from subsequent disclosure in a legal proceeding.
3. THE KEY CONSIDERATIONS

As a threshold matter, any business considering an internal investigation must assess the structure, scope and purpose of the internal investigation. An investigation not properly constituted with substantial lawyer participation will almost always become discoverable later. It is counsel's active involvement that implicates the attorney-client privilege and work-product doctrine. Counsel must therefore quarterback the investigation.

An internal investigation can be costly, time-consuming and simply disruptive. Consequently, its scope should be tailored to address the need. A criminal antitrust investigation would obviously warrant a broader-based investigation than would an employee's complaint regarding a single, isolated claim of wrongful discharge. Concomitant considerations are: What will the investigation accomplish? Will it advance the company's interests? Will it satisfactorily address the pending or impending problem?

With these general concerns in mind, counsel, before authorizing or participating in an internal investigation, should ponder the following:

1. What triggered the request or desire to investigate internally? That is, how serious is the causative agent?
2. What is your corporate exposure, whether criminal or civil?
3. Do extant documents -- once properly assembled and analyzed by counsel and others -- provide enough answers?
4. Will an investigation, with the inherent risk of disclosure, ultimately benefit the corporation?
5. How will the investigative team be structured so as to gather all necessary information and maintain confidentiality?
6. Does counsel's role require the rendition of legal as opposed to business advice, thereby possibly implicating
the attorney-client privilege and/or the work-product doctrine?

7. If non-lawyers, e.g., accountants, are required how should their activities be directed?

8. In sensitive investigations, should more independence be sought by appointing outside lawyers to conduct the investigation?

9. How can inadvertent disclosure be prevented both during and after the investigation?

10. How should the results of the investigation be memorialized? Must they be in writing?

11. Who needs to know?

The general considerations naturally give way to the particulars of the situation confronting the corporation. Caution and confidentiality -- the underpinnings of each question above -- should pervade your deliberations, planning and investigative work.
GOVERNMENTAL RELATIONS:
NEW ETHICAL STANDARDS FOR LEGISLATIVE CONTACTS

William M. Lear, Jr.
Member, Kentucky House of Representatives
Stoll, Keenon and Park
Lexington, Kentucky

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SECTION H
Governmental Relations:  
New Ethical Standards For Legislative Contacts

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SECTION H
I. Legislator Prohibited Practices

1. Shall not use influence as member of General Assembly in any manner which involves substantial conflict between personal interests and duties in the public interest. (Pre-existing law)

   Example - vote for incentive package for company that will buy land from legislator's family.

   Penalty - Class A misdemeanor.

2. Shall not use official position to obtain financial gain for legislator, family member, or business associate. (Pre-existing law)

   Example - Pressure Department of Transportation for road contract for relative.

   Penalty - Class D felony.

3. Shall not use position to secure privileges, exemptions, advantages for legislator or others in derogation of public interest. (Pre-existing law)

   Example - Get refund back early; state police assistance.

   Penalty - Class A misdemeanor.

4. Shall not use public funds, personnel for private gain. (New prohibition)

   Example - Use LRC secretaries to handle correspondence for private business.

   Penalty - Class A misdemeanor.

5. Shall not use public funds, personnel for partisan political purposes. (New prohibition)
Example - LRC staff for campaign work; LRC xerox machines for campaign work.

**Penalty** - Class A misdemeanor.

6. Shall not use official stationery to solicit vote or contribution for a political campaign. (New prohibition, but consistent with last Ethics Commission ruling.)

**Penalty** - Ethical misconduct.

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<th>Punishment:</th>
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<tr>
<td>Issue cease and desist order</td>
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<td>Public reprimand</td>
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<td>Recommend censure or expulsion from the House in which he/she sits</td>
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<td>Civil penalty up to $2,000</td>
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7. Shall not be drunk or under influence of controlled substance to extent of being unable to discharge duties of office. (Pre-existing law)

**Penalty** - Ethical misconduct.

8. Shall not intentionally disclose confidential information acquired in the course of official duties to further own economic interest or that of another. (New, but covered in Penal Code - misuse of confidential information. KRS 522.040.)

**Example** - Economic development project (Toyota) - go out and option up land.

**Penalty** - Class D felony.

9. Shall not be a party to a contract with the state involving more than $100 (up from $25) - whether directly or through others. (Pre-existing law)

**Exceptions:**

1. Contract between state and business he and wife own 5% or less.
2. Contract entered into after public bidding.
3. Contract available on similar terms as offered to other business or profession (e.g., state day care, medicaid, etc.).
4. Contract entered into before he became a legislator.
Penalty - Class D felony and court may void the contract.

10. Shall not sell or lease any real property to state. (Pre-existing law under general "contracts" limitation.)

Exceptions:

1. 5% rule applies.
2. Pre-existing contracts.
3. Nominal consideration contracts if the lease or sale pre-approved by Ethics Commission.
4. Sales or leases in condemnation proceedings or under threat of condemnation.

Issue: Extensions of existing leases - okay under this because a pre-existing contract - probably should go before the Commission first.

11. Shall not use or attempt to use any means to influence a state agency in direct contravention of the public interest. (Pre-existing law)

Example - Help a friend get a permit or strip mine; highway access.

Problem in interpretation and application: What if you try to help new company get EPA permit (e.g., move a creek) and people in the district are split on whether this is in the public interest or not.

Penalty - Ethical misconduct.

12. Shall not appear before a state agency--executive branch, not judicial--for compensation, as an expert witness. (Pre-existing law)

Example - Legislator-engineer cannot appear before EPA (sewage treatment plant permit); Department of Transportation; legislator-doctor cannot testify before workers' compensation hearing officer.

Penalty - Ethical misconduct.

13. Shall not for compensation, represent a client before or in dealings with a state agency in matters relating to:

1. Contracting for sale, lease, purchase, rental of goods or services;
2. Any proceeding relating to rate-making;
3. Adoption, amendment or repeal of any administrative regulation;
4. Obtaining grants of money or loans;
5. Licensing or permitting (except matters relating to drivers licensing);
6. Any proceeding before the PSC.

Exceptions:

1. Ministerial functions (not a defined term except "does not require discretion on the part of the agency") - examples given: filing corporate charters, reports, etc.; filing tax returns; filing reports required by a state agency; filing an application to participate in a state-administered federal program if generally available to similar classes of people. May eat up much of the prohibition.
2. Adversarial proceedings.
3. Workers' Compensation and Special Fund proceedings.
4. Unemployment Compensation proceedings.

(Pre-existing law, but greatly modified.)

Penalty - Ethical misconduct.

14. Shall not represent a state agency. (New prohibition)

Penalty - falls under general ethical misconduct provision.

15. Shall not sue the state or state agency for money damages. (New prohibition)

Exceptions:

1. Appeal of state-initiated action vs. client.
2. Workers' Compensation.
3. Unemployment Compensation.
4. Cases pending on effective date of new law.

Penalty - falls under general ethical prohibition.

16. Shall not receive compensation in any case that is contingent on action by a state agency - contingent fee. (Pre-existing law)

Penalty - Ethical misconduct.
17. Shall not accept honoraria for appearances, speeches or articles - doesn't apply to speeches, etc. related to legislator's private profession. (New prohibition)

*MAY accept pre-paid or reimbursed food and lodging for out-of-state travel associated with official duties - pre-approved by LRC.

Penalty - Ethical misconduct.

8. Shall not accept compensation, except as provided by law, for services as a legislator.
(Pre-existing law)

Example - Need to be at committee meeting - person wants you there for vote - agrees to fly you there in helicopter.

Penalty - Class A misdemeanor.

19. No legislator or spouse shall accept or solicit anything of value from a lobbyist (legislative agent) or employer of a legislative agent - e.g., gifts, golf, trips, tickets, food (except consumed on premises).
(New prohibition)

Definition of anything of value excludes:

1. Campaign contributions.
2. Compensation, etc. from private employer.
3. Usual and customary commercial loan.
4. Certificate plaque, commemorative token - less than $150 value.
5. Informational/promotional items.
7. Food and beverages consumed on the premises.
8. Tickets to events to which all legislators invited; all members of a joint committee or task force are invited; to which a caucus is invited; events sponsored by local government or state institution of higher education; individual legislator if pre-approved by LRC.
9. Gifts from relatives.
10. Gifts if not used and returned or given to charity within thirty days.
11. Cost of attendance at national organization events - NCSL exception.
12. Cost of attendance at events sponsored by civic, charitable, governmental or community organizations.
13. Gift from one legislator to another.
14. Anything for which legislator pays or gives full value.
Penalty - Class B misdemeanor.

20. Shall not advocate or cause the employment, promotion, transfer or advancement of family member to executive branch position; or participate in action relating to the disciplining of a family member; absolute prohibition on family member being employed in legislative branch (existing employees grandfathered in). (New prohibition)

Penalty - Ethical misconduct.

21. Shall not serve as a lobbyist (except for a public agency) for two years after leaving office (or be a lobbyist while in office). (New prohibition)

Penalty - Ethical misconduct.

22. Shall not participate in discussion/debate in Committee or on floor in any matter in which he has a conflict of interest (i.e., where the legislator or a family member has direct monetary loss or gain, or which relates directly to business in which the legislator owns/controls an interest of 5% or $10,000.00). (Largely pre-existing law)

Exceptions:

1. Matter that affects all members of a business or profession the same.
2. Legislative salary, expenses, benefits.

Penalty - Class D felony.

23. Shall not accept appointment as officer or employee of state or state agency, or governing board of local or regional entity which has authority to levy taxes. (New prohibition added to pre-existing law.)

Penalty - Ethical misconduct.

24. Shall not accept a campaign contribution from a lobbyist. (Largely new prohibition - previous Attorney General opinion had limited the prohibition to times when the General Assembly was in session.)

Saving provision: 14 day rule - turn in to Commission within 14 days of receipt.
Penalty - Ethical misconduct.

II. Legislator Reporting/Lobbyists Reporting  (ALL NEW)

1. Legislator reporting requirements - financial disclosure

Report each February 15th on previous year.
$100/day fine by Commission for non-compliance.
Intentionally filing false or incomplete statement -
Class A misdemeanor.

(1) Positions held by filer and spouse in any
business, partnership, corporation, etc.
(2) Information regarding all businesses, investments,
securities - $10,000/5%.
(3) Sources of gross income - filer and spouse.
(4) Fiduciary positions held.
(5) All real property having value of $10,000 or more
- filer, spouse, minor child.
(6) Gifts of $200 or more except from family member.
(7) Creditors owed more than $10,000 except for debts
on consumer goods.
(8) Name of any lobbyist who is member of filer's
immediate family, partner, officer or director of
filer's employer, employer of filer or spouse,
business associate of filer or filer's family.
(9) Names of clients who are lobbyists or lobbyists'
employers.
(10) List of clients represented by partners and the
state agencies they appeared before in areas where
filer prohibited from acting.

2. Lobbyist Registration/Reporting (See def. p. 12 -
legislative agent)

(1) Registration

-File with Commission within 7 days of engagement.
-ID employer and legislation action for which
engaged.
-Updated registration statement each month during
regular sessions, 3 times in non-session years.
-Registration lasts until December 31st of next
odd-number year unless sooner terminated.
-Separate filing for each employer.
-Knowing failure to file - Class D felony.
-Each employer pays 250 fee.

(2) Reporting of Expenditures - at time of each
registration update (see above) by lobbyist and
employer)
- Amounts spent for food and beverages consumed on the premises; names; dates.
- Total amount of lobbying expenditures in period.
- Amounts spent on receptions.
- Compensation paid to/received by lobbyists.
- Details of any financial transaction with or for benefit of legislator.

Note: If claim to have had financial transaction for benefit of legislators or spent money on legislators - send legislators a copy first so they have chance to dispute. (Commission resolves any dispute.)

"Financial transaction" definition - doesn't include transactions entered into on same terms as other members of the general public.

III. Lobbyist Prohibited Practices - Shall Not:

1. Knowingly fail to register or intentionally file a false or incomplete statement of expenditures.
   
   **Penalty** - Class D felony.

2. Fail to keep receipts/maintain records.
   
   **Penalty** - Ethical misconduct.

3. Fail to file a required report.
   
   **Penalty** - Fine of $100/day up to maximum of $1,000.

4. Give anything of value to legislator, spouse or child.
   
   **Penalty** - First offense - ethical misconduct.
   Second or subsequent offense - Class D felony.

5. Serve as campaign treasurer or fundraiser for legislator or candidate for General Assembly.
   
   **Penalty** - First offense - ethical misconduct.
   Second or subsequent offense - Class D felony.

6. Make a campaign contribution to a legislator or candidate for General Assembly.
   
   **Penalty** - First offense - ethical misconduct.
   Second or subsequent offense - Class D felony.
7. Spend more than $100/year on any legislator and immediate family for food and beverages consumed on the premises - collectively (if lobbyist has several employers or employer has several lobbyists).

Penalty - First offense - ethical misconduct.
Second or subsequent offense - Class D felony.

8. Hire a legislator as lobbyist or former legislator for two years after leaves office.

Penalty - First offense - ethical misconduct.
Second or subsequent offense - Class D felony.

9. Lobby for contingent fee or hire lobbyist on contingent fee.

Penalty - Class D felony.

10. Go on floor of House or Senate while in session.

Penalty - Class B misdemeanor.
GOVERNMENTAL RELATIONS:
NEW ETHICAL STANDARDS FOR EXECUTIVE AGENCY CONTACTS

Robert M. Watt, III
Stoll, Keenon & Park
Lexington, Kentucky

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SECTION I
Governmental Relations:
New Ethical Standards For Executive Agency Contacts

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SECTION I
EXECUTIVE AGENCY LOBBYING

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I. Introduction.

A. The executive agency lobbying provision of S.B. 7 is an amendment to Chapter 11A of the Kentucky Revised Statutes, which was originally enacted in 1992 and is entitled "Executive Branch Code of Ethics."

B. The statute, KRS 11A.201 through 11A.246, requires registration and reporting by both the lobbyists and their employers in connection with attempts to influence executive agency decisions.

C. The Executive Branch Ethics Commission is the agency responsible for regulation of persons and conduct under this statute.

D. A violation of these sections exposes the violator to both civil and criminal penalties.

II. Who Is Regulated? (KRS 11A.201)

A. "Employer" - any person who engages an executive agency lobbyist. KRS 11A.201(3).

1. "Person" - an individual, proprietorship, firm, partnership, joint venture, joint stock company, syndicate, business, trust, estate, company, corporation, association, club, committee, organization, or group of persons acting in concert. KRS 11A.201(13).

B. "Executive Agency Lobbyist" - any person engaged to influence executive agency decisions or to conduct executive agency lobbying activity as one of his main purposes on a regular and substantial basis. KRS 11A.201(8)(a).

1. Barring other unusual circumstances, only those who lobby concerning executive agency decisions involving state expenditures of more than $5,000 per decision will be considered by the Executive
Branch Ethics Commission as acting on a "regular and substantial basis" and thus subject to regulation as executive agency lobbyists. Advisory Opinion 93-34.

a. Those selling goods and services are not exempt from the provisions of S.B. 7. Advisory Opinion 93-34.

b. A law firm partner must register as a lobbyist when pursuing a personal service contract if the activities of the partner or any lawyer exceed the levels in the foregoing guidelines. Advisory Opinion 93-34.

2. "Executive Agency Lobbyist" does not include an elected or appointed officer or employee of a federal or state agency, state college, state university, or political subdivision who attempts to influence or affect executive agency decisions in his fiduciary capacity as a representative of his agency, college, university or political subdivision. KRS 11A.201(8)(b).

C. "Executive Agency" - the office of an elected executive official, a cabinet listed in KRS 12.250, or any other state agency, department, board, or commission controlled or directed by an elected executive official or otherwise subject to his authority. KRS 11A.201(6).

1. "Executive agency" does not include any court or the General Assembly.

2. The office of Property Valuation Administrator is an "executive agency." Advisory Opinion 93-41.

D. "Executive Agency Official" - an officer or employee of an executive agency whose principal duties are to formulate policy or to participate directly or indirectly in the preparation, review, or award of contracts, grants, leases or other financial arrangements with an executive agency. KRS 11A.201(10).

E. "Elected Executive Official" - Governor, Lieutenant Governor, Secretary of State, Auditor of Public Accounts, State Treasurer, Attorney General, Commissioner of Agriculture and Railroad Commissioners. KRS 11A.201(10).

F. "Staff" - any employee in the office of the Governor, or a cabinet listed in KRS 12.250, whose official duties are to formulate policy and who exercises administrative or supervisory authority, or who authorizes the expenditure of state funds. KRS 11A.201(14).
III. What Activity Is Regulated? (KRS 11A.201)

A. "Executive Agency Lobbying Activity" - contacts made to promote, oppose, or otherwise influence the outcome of an executive agency decision by direct communication with an elected executive official, the secretary of any cabinet listed in KRS 12.250, or a member of the staff of any one of the foregoing officials. KRS 11A.201(9)(a).

1. "Executive agency lobbying activity" does not include:
   a. The action of any person having a direct interest in any executive agency decision which is protected by Section 1 of the Kentucky Constitution: lawful assembly or petition for redress of grievances;
   b. Contacts made for the sole purpose of gathering information contained in a public record; or
   c. Appearances before public meetings of executive agencies. KRS 11A.201(9)(b).

B. "Executive Agency Decision" - a decision of an executive agency regarding the expenditure of funds of the state or of an executive agency with respect to the award of a contract, grant, lease or other financial arrangement under which those funds are distributed or allocated. KRS 11A.201(7).

1. "Other financial arrangement" has been interpreted to mean any arrangement whereby funds of the state or an elected executive official or agency are distributed or allocated to the benefit of the person, company or organization seeking the distribution or allocation of such funds, e.g. the deposit of state funds into a particular commercial banking system, costs associated with the maintenance of any service agreement, and any type of retainer fees associated with management consulting services. Advisory Opinion 93-41.

2. Decisions concerning licenses and permits, tax decisions, material specifications, bank charters, administrative regulations, enforcement actions and other non-expenditure decisions are not executive agency decisions. Advisory Opinion 93-41.

C. "Expenditure" - any of the following that is made to, or for the benefit of an elected executive official, the secretary of a cabinet listed in KRS 12.250, an executive agency official, or a member of the staff of any of the foregoing officials KRS 11A.201(2)(a):
1. A payment, distribution, loan, advance, deposit, reimbursement, or gift of money, real estate, or anything of value, including, but not limited to, food and beverages, entertainment, lodging, transportation, or honoraria;

2. A contract, promise, or agreement to make an expenditure; or

3. The purchase, sale, or gift of services or any other thing of value.

4. "Expenditure" does not include a gift to an organization exempt from taxation under Section 501(c)(3) of the Internal Revenue Code or the purchase, sale, or gift of services or any other thing of value that is available to the general public on the same terms as it is available to the foregoing persons. KRS 11A.201(2)(b).

5. "Expenditure" has been interpreted to include refreshments, luncheon, meeting room, travel and consulting fees paid by the lobbyist, but "expenditure" has been interpreted not to include the cost of maintaining an office and support services for an executive agency lobbyist. Advisory Opinion 93-34.

D. "Financial Transaction" - A transaction or activity that is conducted or undertaken for profit and arises from the joint ownership, or the ownership, or part ownership in common of any real or personal property or any commercial or business enterprise of whatever form or nature between the following KRS 11A.201(5)(a):

1. An executive agency lobbyist, his employer, or a member of the immediate family of the executive agency lobbyist or his employer; and

2. Any elected executive official, the secretary of a cabinet listed in KRS 12.250, an executive agency official, or any member of the staff of any of the foregoing officials.

3. "Financial transaction" does not include any of the foregoing transactions if they are available to the general public on the same terms. KRS 11A.201(5)(b).
IV. Registration of Executive Agency Lobbyists and Employers. (KRS 11A.206 and 11A.211)

A. An executive agency lobbyist or employer shall not knowingly fail to register.

1. The lobbyist and the employer must file an initial registration statement within 10 days following the engagement of the lobbyist containing information about the lobbyist, the employer, the executive agency and the executive decision.

2. In addition to the initial registration statement, the lobbyist and the employer must file updated registration statements on or before the last day of January, May and September of each year.
   a. Confirms the continuing existence of each engagement described in the initial registration statement;
   b. Lists the specific executive agency decisions the lobbyist sought to influence under the engagement during the period covered by the updated statement; and
   c. Attaches a statement of expenditures required by KRS 11A.216 and any details of financial transactions required to be filed by KRS 11A.221.

3. If a lobbyist is retained by more than one employer, the lobbyist must file an initial and updated registration statement for each employer, but if an employer employs more than one lobbyist, it must file only one updated registration statement with information regarding all lobbyists.

4. Any change in the information required to be filed in registration statements must be reflected in the next updated registration statement. The lobbyist must file notice of termination of an engagement within 30 days after termination of the engagement.

5. No registration fee is charged for the filing of the statements.

6. Upon registration, each lobbyist receives a card issued by the Executive Branch Ethics Commission which is valid until January 31 of each year.

7. The Commission must review each registration statement to determine if it is accurate and complete and notify the lobbyist or employer of deficiencies who will then have 15 days to file a
corrected statement. The Commission may also initiate an investigation of a failure to file. If the Commission initiates such an investigation, the executive official and secretary of the cabinet must also be notified.

8. The Commission will publish statistical information about executive agency lobbying annually on or before March 15.

9. If an employer who engages a lobbyist is the recipient of a contract, grant, lease, or other financial arrangement pursuant to which funds are distributed or allocated, the executive agency or any aggrieved party may consider the failure of the employer or the lobbyist to comply with KRS 11A.211 as a breach of a material condition of the contract, grant, lease or other financial arrangement.
   a. "Aggrieved party" means a party entitled to resort to a remedy.

10. Executive agency officials may require certification of compliance with KRS 11A.211 from any person seeking the award of a contract, grant, lease or financial arrangement.

V. Statement of Expenditures by Executive Agency Lobbyists and Employers. (KRS 11A.206 and 11A.216)

A. Each lobbyist and each employer must file a statement of expenditures with the updated registration statement. The lobbyist must file a separate statement for each employer engaging him.

B. The contents of the statement.

1. The lobbyist must show the total expenditures made by the lobbyist during the reporting period.

2. If the lobbyist or the employer made expenditures on behalf of a particular elected executive official, the secretary of a cabinet listed in KRS 12.250, a particular executive agency official or a particular member of the staff of any of those officials, the lobbyist or the employer shall state the name of the official or employee on whose behalf the expenditure was made, the total amount of expenditures made, a brief description of
expenditures made and the approximate date of the expenditures made.

3. In addition, the statement filed by the employer must show the total amount of expenditures made by the employer.

4. An employer is not required to show any expenditure on his statement if it is shown on a statement filed by the employer's lobbyist.

C. If it is impractical or impossible to determine exact dollar amounts or values of expenditures, reporting of good faith estimates, based on reasonable accounting procedures, constitutes compliance with this requirement.

D. Lobbyists and employers are required to retain receipts or maintain records for all expenditures that are required to be reported. These receipts or records must be maintained for a period ending on December 31 of the second calendar year after the year in which the expenditure was made.

E. At least 10 days before the filing of the statement, each employer or lobbyist shall deliver a copy of the statement, or the portion thereof showing the expenditure, to the official or employee who is listed in the statement as having received the expenditure or on whose behalf it was made.

F. The Executive Branch Ethics Commission has concluded that there is no exclusion for expenditures made on behalf of an official or employee which the employer or lobbyist may not be trying to influence. If the employer or lobbyist is registered, all expenditures made to or for the benefit of any state employee must be reported on the statement of expenditures. Advisory Opinion 93-41.

VI. Statement of Financial Transactions. (KRS 11A.206 and 11A.221)

A. Any lobbyist who has had a financial transaction with, or for the benefit of, an elected executive official, the secretary of a cabinet listed in KRS 12.250, an executive agency official, or any member of the staff of any of those officials must describe the details of the transaction, including the name of the official or employee, the purpose and nature of the transaction, and the date it was made and entered into, in a statement filed with the Commission with the updated registration
Each statement shall describe each financial transaction during the four months preceding the filing of the updated registration statement.

B. Any employer who has had a financial transaction with, or for the benefit of, the same officials or employees as listed above, must file a statement containing the same information with the Commission with the updated registration statement.

C. At least 10 days before the date on which the statement is filed, each employer or lobbyist must deliver a copy of the statement to the official or employer with whom or for whose benefit the transaction was made.

D. An employer is not required to file a statement of financial transactions or to deliver a copy of the statement to the official or employee with whom or for whose benefit the transaction was made if the financial transaction to which the statement pertains is reported by the lobbyist engaged by the employer.

VII. Disputes Arising Out of Statements of Expenditures or Financial Transactions. (KRS 11A.226)

A. Complaints arising out of statements of expenditures or financial transactions may be filed with the Executive Branch Ethics Commission.

B. The complaint must be filed at least three days prior to the time the statement is required to be filed with the Commission. The filing of a complaint extends the time for filing the disputed, but not the undisputed, portions of the statement. If the Commission decides that the disputed expenditure or financial transaction should be reported, the employer or lobbyist must include the matter in an amended statement to be filed within 10 days after receiving notice of the decision of the Commission.

C. An employer or lobbyist who files a false statement of expenditures or details of a financial transaction is liable in a civil action to any official or employee who sustains damage as a result of the filing or publication of the statement.
VIII. Exceptions to the Filing Requirements. (KRS 11A.231)

A. Registration statements and expenditure statements are not required to be filed in connection with executive agency lobbying activity by any of the following:

1. Appearances at public hearings of the committees or interim committees of the General Assembly, at court proceedings, at rule-making or adjudication proceedings, or at other public meetings;

2. News, editorial and advertising statements in newspapers, journals or magazines or broadcast over radio or television;

3. The gathering and furnishing of information and news by bona fide reporters, correspondents or news bureaus to news media; or

4. Publications primarily designed for and distributed to members of associations or charitable or fraternal nonprofit corporations.

B. Nothing in the executive agency lobbying portions of KRS 11A requires the reporting of, or prohibits an elected official from soliciting or accepting, a contribution from or an expenditure by any person if the contribution or expenditure is reported in accordance with KRS Chapters 121 or 121A.

IX. Restrictions on the Form of Compensation for Executive Agency Lobbying. (KRS 11A.236)

A. Contingent fee arrangements are prohibited.

B. The foregoing prohibition does not prohibit any person from compensating his sales employees pursuant to an incentive compensation plan, such as commission sales, if the incentive compensation plan is the same plan used to compensate similarly situated sales employees who are not lobbyists.

X. Miscellaneous Provisions Relating to the Executive Branch Ethics Commission. (KRS 11A.241)

A. The Commission is required to keep on file all statements required to be filed by the Executive Agency Lobbying
sections of KRS 11A and to computerize the files for ready accessibility by the general public.

B. Twice a year, in February and October, the Commission must compile a list of registered lobbyists and their employers and distribute the list to each elected executive branch official and to each cabinet secretary listed in KRS 12.250. Copies of the list must be provided to the public at cost.

C. The Commission must maintain a list of all executive agency lobbyists which must be provided to the public at cost.

D. The Commission must prescribe and make available forms for filing registration, expenditure and financial transaction reports.

1. The initial registration statement has been drafted by the Commission and is in the process of being finalized.

E. Any rules promulgated by the Commission must be adopted as administration regulations in accordance with KRS Chapter 13A.

F. The Commission must publish a handbook that explains in clear and concise language the executive agency lobbying provisions of KRS 11A.

XI. Attorney General Investigations and Penalties. (KRS 11A.266 and 11A.990)

A. The attorney general and any assistant or special counsel designated by him may investigate compliance with the executive agency lobbying provisions of KRS 11A.

B. The penalties for violation of KRS 11A.206, which requires the filing of the initial and update registration statements, the maintenance of receipts and records and the filing of expenditure and financial transaction reports, are as follows:

1. For the first violation, the lobbyist or employer is guilty of ethical misconduct; and

2. For the second and each subsequent violation, the lobbyist or employer shall be guilty of a Class D felony.
C. Any lobbyist or employer who fails to file an initial or updated registration statement, KRS 11A.211 and 11A.216, or who fails to remedy a deficiency in a filing in a timely manner, may be fined by the Commission an amount not to exceed $100 per day, up to a maximum total fine of $1,000.

D. Any lobbyist or employer who intentionally fails to register, or who intentionally files an initial or updated registration statement, required by KRS 11A.211 and 11A.216, which he knows to contain false information or to omit required information shall be guilty of a Class D felony.

E. Any lobbyist or employer who files a false statement of expenditures or details of a financial transaction under KRS 11A.221 and 11A.226, is liable in a civil action to any official or employee who sustains damage as a result of the filing or publication of the statement.

F. Violation of KRS 11A.236, which prohibits contingent fee arrangements, is a Class D felony.
GOVERNMENTAL RELATIONS:
NEW ETHICAL STANDARDS IN CAMPAIGN FINANCING

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SECTION J
# Governmental Relations:
New Ethical Standards In Campaign Financing

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SECTION J
PACs and Campaign Financing After Senate Bill 7
presented by Herbert A. Miller, Jr.
Stoll, Keenon & Park, Attorneys

1. Introduction


3. New Provisions (all references are to changes in KRS Chapter 121):

   (a) All of the following will be required to identify all PAC contributors "of any amount" and all of contributors of more than $100 (was $300) by name, address, description of the PAC's business, social or political interest, age (if under 18), employer, spouse (if applicable) and occupation ("Businessman" is not a sufficient description):

   (1) Registry of Election Finance (.120)

   (2) Campaign Treasurer (.160(2)(b)) - also must keep similar deposit records (.220(2)). "Businessman" is not sufficient.

   (3) State and County executive committees (.180(2))

   (4) Fundraisers of more than $3,000 (.180(3))

   (5) PACs, Inaugural committees and contributory organizations (.180(6)(a))

   (b) Prohibition against cash contributions to candidates, committees and contributing organizations of over $50 (was $100). (.150(4)).
(c) No person may contribute to all PACs and contributing organizations more than $1,500 in any one (1) year (was $4,000). (.150(10)).

(d) Effective January 1, 1994, "affiliated" PACs will be treated as if they were one PAC for contribution limits to candidates, campaign committees and political issues committees. The limit is $500 per election (except school board races which have their own limits. See, .150(7)).

(e) A candidate (except slates for Governor and Lt. Governor) may not accept more than 35% (or $5,000 whichever is greater) of all contributions in an election from PAC funds (calculated as of the regular election day which ends the cycle). Carryover funds are not counted in the next regular cycle. To avoid PAC limits, a candidate may contribute to his/her campaign account or refund excess PAC funds pro rata. (.150(25)). Balances in campaign accounts on November 2, 1993 are not subject to this restriction.

(f) Effective January 1, 1994, no member of the General Assembly may organize, form or register a PAC.

4. Other New Provisions:

(a) A legislative agent may not lawfully give a campaign contribution to a member of the General Assembly, candidate for the General Assembly or his/her campaign committee (Section 26 of SB 7).
(b) A legislative agent shall not serve as a campaign treasurer or a fundraiser (Section 26 of SB 7),

(c) **Allowable Campaign Expenditures** (Section 63 of SB 7):

(1) Funds in a campaign account may only be used for expenditures (including reimbursements for actual expenses) made directly and primarily in support of or opposition to a candidate, constitutional amendment or public question which will appear on the ballot.

(2) **Allowable Campaign Expenditures Under Proposed Regulation 32 KAR 2:200:**

a) Advertising through charitable donations;

b) Personal property with a value of $10 or less each (hats, shirts, calendars, cards, etc.)

   Tickets distributed generally to influence an election are not allowed under this section;

c) Services directly related to the campaign;

d) Transportation directly related to the campaign, including of voters to the polls;

e) Tickets to events for candidate, spouse and staff if a direct benefit to the campaign;

f) Flags to donate to schools, charities, etc.;

g) Campaign event meals of $5 or less value each;

h) Purchase or rental of phones, copiers, computers, fax machines, etc. directly related to the campaign. A presumption will exist in
favor of the candidate in the year of the election. In non-election years the campaign use must exceed 50%.

(3) **Unlawful Campaign Expenditures Under Proposed 32 KAR 2:200:**

a) Dues to professional, civic or other organizations;

b) Defraying costs of the individual's performance as an officeholder;

c) Gifts, flowers, food, etc. for to benefit campaign staff or volunteers or "any other expenditure which bestows a private, pecuniary benefit to an individual."

(4) Burden of proof placed on the candidate or officeholder.

5. "Contribution" Rules:

(a) A "contribution" is any:

(1) payment, distribution, loan, deposit or gift of money or other thing of value ("loan" includes a guaranty) (See Advisory. Opinion 92-008);

(2) payment by any other person for personal services rendered to a candidate;

(3) goods, advertising or services valued over $100 in any election furnished or utilized without charge, or less than the rate normally charged; and
(4) independent expenditures made or furnished to influence election results.

(b) A "contribution" is not:

(1) volunteer services of an individual (See Advisory Opinion 93-025); or

(2) loans from financial institutions made per banking regulations and in the ordinary course of business.

(c) Continuing Contribution Limits (see generally KRS 121.150):

(1) $500 per election per candidate and PAC (except school boards and party executive committees);

(2) No anonymous contributions over $50, or aggregate of $1,000 in any one election;

(3) No contributions over $100 from anyone not 18 by the general election;

(4) Personal Loans from candidates to committees shall not exceed $50,000 per election for Governor/Lt. Governor slates; $25,000 for other statewide offices; and $10,000 for other offices sought by a candidate.

(d) Other Continuing Contribution Restrictions:

(1) Prohibition against corporate contributions, directly or indirectly (including in-kind). Corporate PAC expenses must be reimbursed with detailed records kept.

(2) Prohibition against candidates and PAC from soliciting from and contributing to charitable
causes or organizations, except the candidates continuation of regular personal contributions (See Advisory Opinions 93-005 and 93-031).

(3) Cannot solicit nor accept contributions after the date of a primary, regular election, or special election for these respective elections. Includes solicitations by others on behalf of the candidate. Excludes the candidate's own contributions (See Advisory Opinion 93-013).

(4) No commingling of funds with candidate's own contributions. (121.180(9))

(5) Cannot use campaign funds for other offices or issues (121.180(10)), except for admission tickets not over $100 per event.

6. Treasurers and Fundraisers:

(a) Definitions.

(b) Fundraisers to report as treasurers once threshold reached (121.180(3)) on a Registry form (See Advisory Opinion 93-015).

(c) Must establish a primary campaign depository. (121.220)

(d) Expenditures over $25 to be made by check. (121.160)

(e) Retain records for 6 years from date of last report filed.

(f) Can serve as treasurer for more than one candidate or slate but cannot be both treasurer and chairman of a committee.
(g) Vacancies shall be filed within 3 days of notice of vacancy.

7. Special Rules of KRS 121.330 (See Advisory Opinion 93-002):
   (a) Entities whose officers or employees (including their spouses) knowingly contribute more than $5,000 in the aggregate (in any one election) to an elected official's campaign, cannot knowingly receive, or be awarded by the elected official or his appointees, any non-bid contract with any governing authority on which the elected official serves during the term of office following the campaign in which the contributions were made.
   (b) Fundraisers (and their immediate families, employer or employee) raising over $30,000 in any one election for the elected candidate cannot receive or be awarded non-bid contracts, lease or appointment to any office or board with a governing authority on which the elected official serves. (121.330)

8. Registration Rules:
   (a) Campaign Treasurer - KRS 121.160
   (b) Fundraisers - KRS 121.160
   (c) PACs ($200 to register, plus $200 annually)

9. Reporting Rules - KRS 121.180

10. Registry Advisory Opinions
Summary of Advisory Opinions  
Registry of Election Finance

**92-001:** Attorney's campaign must pay for use of property (phones, copiers, etc.) owned by the attorney's P.S.C. and used in the campaign.

**92-002:** Affiliated PACs. Now moot.

**92-003:** A PAC's 5% administrative fee must be remitted with each PAC report. Expenditures to federal candidates do not count in the calculation. Reports under KRS 121.180(6) are not applicable to federally-regulated out-of-state PACs.

**92-004:** Campaign funds can buy tickets to another candidate's event not to exceed $100 per event. Cautions against giving them away in order to influence a vote (this could be a "bribe").

**92-005:** PAC contributions cannot be commingled with corporate funds.

**92-006:** Local Democratic Party cannot sponsor a scholarship at a local college to aid incoming Democratic freshmen.

**92-007:** Democratic National Committee can contribute to Kentucky Democratic Party to help elect candidates to federal office. The funds should be separately maintained.

**92-008:** Donated office space constitutes an in-kind contribution.

**92-009:** A candidate may use personal funds to buy UK basketball tickets and donate them to raise scholarship money provided that there is no linkage as to who the recipients are.

**92-010:** A legislator cannot use his campaign funds to run for Speaker of the House.

**92-011:** A PAC may fund a status report on the finances and services of Jefferson County as long as the report is not candidate specific.

**93-001:** A PAC is limited by statute in how much it can contribute to other PACs ($500/$1,500), state executive committees ($2,500) and the like. A PAC is included under the definition of "person".

**93-002:** The prohibition against getting no-bid contracts in KRS 121.330 still applies even if the elected official (and his/her appointees) constitute minority membership on an independent board.

**93-003:** PVA candidates may accept contributions from those whose property they assess.

**93-004:** A candidate's corporation owned by the candidate and his wife cannot contribute to his campaign, and cannot provide reduced rate facilities and services to the campaign (or the campaigns of others).
93-005: A candidate may continue to make personal contributions to charitable causes.

93-006: The sole-owner of a personal service corporation (P.S.C.) can contribute to the sole-owner's campaign. Based on Gable v. Jones case on appeal to the Kentucky Court of Appeals.

93-007: A dissolving PAC cannot distribute surplus funds to another PAC.

93-008: A corporation may pay for advertising in the Democratic Party newspaper as long as the paper charges market rates and uses the money for administrative purposes, not for elections.

93-009: Candidates may split the costs of campaign materials if each pays pro rata. Payment should be made by campaign fund checks if paid to the vendor or by individual checks if reimbursing another candidate.

93-010: While a Kentucky corporation cannot contribute to candidates in other states, a Kentucky PAC can.

93-011: PACs not regulated by KRS 121 do not fall within the contribution limits of the chapter.

93-012: Not Yet Issued.

93-013: Discusses generally the timely receipt of contributions mailed or delivered before election day but received after election day. "Several days creates an impermissible gap."

93-014: Not Yet Issued.

93-015: To qualify as a "fundraiser" a person must both solicit and receive contributions.

93-016: A candidate may use bulk rate mailing services but is required to include the sponsorship identification on them.

93-017: A person who has contributed the $500 limit to a candidate can still give the limit to an executive committee (but not earmarked for a specific candidate).

93-018: A trust created by the Jefferson County Democratic Party to pay its operating expenses would be regulated by the Registry as a permanent committee or a political action committee and subject to the contribution limitations, etc. of those entities.

93-019: The Citizens for Better Judges PAC may endorse judicial candidates through newspaper advertising not to exceed $500 per candidate, which must be reported as in-kind contributions to those candidates.

93-020: Discusses the transfer of contribution money between the Republican Party of Kentucky and its affiliates and subdivisions, and the limitations thereon.
93-021: A tax-exempt neighborhood association may not lawfully contribute to a Kentucky judicial candidate.

93-022: When a person endorses a check in blank to a PAC, the instrument is treated as cash and subject to the cash contribution limit of $50 in KRS 121.150(4). The Registry recommends such giving from a person's personal checking account.

93-023: A Republican Party newsletter may sell advertising space to corporations provided it charges regular rates for comparable publications and puts the money in a separate, segregated administrative account dedicated for party administrative expenses. (See also Advisory Opinion 93-008).

93-024: See Advisory Opinion 93-032.

93-025: (1) A full partner of a law firm partnership may donate legal services to a candidate for elected office without it being considered an in-kind contribution. (2) However, such services by employees of the firm (such as non-equity partners, associates and clerks) which are paid by the partnership are considered in-kind contributions. To the extent the dollar value of these services exceeds $100 per full partner, each partner's pro rata share should be reported by the candidate as an in-kind contribution. (3) Services provided to a candidate after the general election must either be volunteered services by the employees or fully compensated at their fair market value by the campaign.

93-026: Volunteered legal services for a campaign are not contributions. See Advisory Opinion 93-025.

93-027: A vendor (in this case, a corporation providing long-distance telephone discounts) to a state political party may enter into arm's length business agreements provided that revenue to the party be deposited into a separate, segregated bank account designated for administrative purposes only (see 93-008 and 93-023).

93-028: In order to qualify as an "independent expenditure" under KRS 121.150(1), printed political speech (newspaper advertisement) need not contain literal language urging the defeat of a political candidate. Citing federal cases, the Registry concluded that the speech qualifies if it is "susceptible of no other reasonable interpretation but as an exhortation to vote . . . against . . . specific candidate(s)."

93-029: A campaign may award a bonus to a campaign worker after an election only if: (1) the worker is a paid employee, (2) the worker has an advance agreement with the campaign regarding the bonus and (3) the bonus is reasonable in light of all the facts and circumstances.

93-030: Bumper stickers are exempt under 32 KAR 2:110 from the disclaimer language required by KRS 121.190(1).

93-031: (1) A candidate for re-election may not make contributions to charities with surplus campaign funds from the previous election. KRS 121.180(10) governs the final disbursements of a fund. (2) The expense of a computer and computer operator or other equipment in the year of the election will be a permitted campaign expense if at east 50% of its use is in re-election campaign related activities. (3) A newsletter
by a candidate for re-election may be viewed as campaign material (as opposed to a report of an officeholder's activities), particularly as to its timing to an election. (4) If a potential candidate for re-election ultimately declines to run, the individual may have to reimburse the campaign for expenses not directly related to the campaign. (5) Expenses for the next election (re-election), even though incurred within 60 days of the most previous election, cannot be considered part of the previous campaign. [Note: the foregoing is premised upon adoption of proposed regulation 32 KAR 2:200.]

**93-032:** The state Republican party may establish a building fund governed by federal election laws, provided that all contributions to the fund and expenditures by the fund are reported to the Registry.

**93-033:** An unincorporated Democratic Women's Club is a "person" as used in KRS 121.150(11), and may contribute $1,000 in a calendar year to a local party executive committee.

* * * * *

**WARNING**

The above are just summaries of Advisory Opinions. Please obtain and read the whole Opinion in order to get the benefit of the full text.

KRS 121.135 provides that an Advisory Opinion is binding on the Registry only to the person to whom it is addressed and only if the facts stated were complete and correct at the time the opinion was rendered, and the person acted in good faith reliance on the opinion.
ADVISORY OPINION 93-025

Any advisory opinion rendered by the registry under subsections (1) or (2) of this section may be relied upon only by the person or committee involved in the specific transaction or activity with respect to which the advisory opinion is required. KRS 121.135(4).

November 10, 1993

Hon. Spencer D. Noe
Stoll, Keenon & Park
201 East Main Street
Suite 1000
Lexington, Kentucky 40507-1380

Dear Mr. Noe:

Thank you for contacting the Registry. Also, thank you for supplementing your facts in our phone conversation. Based on the information you have provided, the facts to your question can be stated as follows:

Dennis Clark ("Clark") is the 1993 Republican Party candidate for County Judge Executive of Oldham County, Kentucky. To gain the office of Oldham County Judge Executive, Mr. Clark needed to raise funds for his campaign. Because Mr. Clark is an employee of a county merit system, the Oldham County Police Department, he or his advisors decided that he needed to obtain a declaratory judgment which clearly affirmed his right to run for political office and do everything necessary to gain office under KRS 95.017, in spite of what appeared to be a prohibition against a merit system employee soliciting funds for any political activity under KRS 78.435(1).
Kentucky Republican Party officials, asked you, as a practicing attorney (and an equity partner in a Kentucky law firm), to volunteer legal services by filing the above-referenced declaratory judgment action in the Oldham County Circuit Court.

After you obtained a favorable ruling for candidate Clark, the Oldham Circuit Court's ruling was appealed. A summer law clerk with your firm assisted you through the Circuit Court judgment stage of the lawsuit. Since you received notice of the appeal, a non-equity partner in your firm has assisted you with the case. Neither the non-equity partner nor the summer law clerk knew that you had volunteered your services for Mr. Clark's campaign effort. Clark has paid all out-of-pocket expenses required in the above action. Also, Clark will receive no bill for the services provided.

Based on the above facts, your question can be stated as follows:

Under KRS Chapter 121, may a practicing attorney volunteer legal services for a candidate for political office in Kentucky, or would this practice constitute an in-kind contribution to the candidate's campaign?

The answer to your question is a qualified yes. In general, an attorney may volunteer services in support of a candidate for elective office in Kentucky. A basic tenant of Kentucky campaign finance law is that anyone may volunteer various services in support of a candidate for elective office. For instance, KRS 121.015(7)(a) excludes "services provided without compensation" from the definition of the term "contribution." Id. KRS 121.160(6) further develops this concept by stating that "The candidate or slate of candidates may pay a campaign treasurer a salary for his services which shall be considered a campaign expense and shall comply with the reporting provisions of KRS 121.180 and administrative regulations promulgated by the registry." Id. (Emphasis added). Many times treasurers for Kentucky candidates are attorneys or licensed certified public accountants who volunteer professional services as campaign treasurers. KRS 121.160(6)
does not require that a professional be paid by a candidate or campaign committee for services rendered in support of the candidacy. Clearly a treasurer's duties are fundamental to a campaign effort. In your particular case, legal services are fundamental to Clark's candidacy, since he is an employee of the Oldham County Police Department.

Recently, the Registry considered a similar question in KREF v. Studio Arts, Inc., KREF 93-105. In that case, which considered whether or not the services in question constituted a corporate contribution, commercial artists had volunteered their services to design a logo for a political campaign in Kentucky. The commercial artists created the logo design on their own personal time. The Registry ruled that the services involved constituted volunteered professional services.

You have indicated that you are not incorporated as a professional service corporation; therefore, the corporate contribution issue is not part of your question. However, your services as an attorney would easily exceed the $500 contribution limit set forth in KRS 121.150(6) if such services counted as a contribution. As the treasurer may volunteer in KRS 121.160(6), and the professionals were allowed to volunteer in Studio Arts, Inc., you may volunteer your services to the Clark campaign.

You did not ask the question of whether or not your non-equity partner and your summer law clerk may volunteer services to a campaign. Using the same reasoning as above, these employees would also be allowed to volunteer services to a campaign. However, you indicated that these employees performed legal services for Clark during regular work hours and knew nothing of the "volunteer" billing arrangement. Therefore, the amount spent by the equity partners as salary paid to these employees for their work on the lawsuit in question, constitutes an in-kind contribution. The amount of this in-kind contribution should be reported by Clark. Therefore, you may value the in-kind contribution by determining the hours spent by your employees on the project and multiplying that figure by the hourly amounts the firm compensates these employees. This figure should be divided by the number of equity partners in your law firm and Clark should itemize and report (or record and report) these amounts depending on whether the amounts are less than $300 per equity partner. For example: The non-equity partner earns $50 per hour in salary and he or she works twenty
(20) hours on the project. If there are ten (10) equity partners in the firm, each partner has contributed $100 in-kind to Clark. Clark should report these as ten (10) unitemized in-kind contributions. Note: If the separate contributions exceeded $300 each, Clark would have to itemize these on his report. [See KRS 121.160(2)(b)]. After the 1993 general election, the threshold amount for itemized reporting will be $100. Finally, no contribution may be made or accepted after the general election. [See KRS 121.150(16)]. Therefore, in the event the litigation in question continues after the 1993 general election, your employee(s) would have to volunteer any services provided after the general election date or the Clark campaign would have to pay fair market value for such services.

This opinion is based upon the course of action outlined in your letter. If you should have any more questions, please give us a call. Thank you.

Sincerely,

Timothy E. Shull
General Counsel

TES/dt
KENTUCKY REGISTRY OF ELECTION FINANCE
ADMINISTRATIVE REGULATIONS

* 32 KAR 2:180 Extension of Credit to Candidates, Campaign Committees, or Political Issues Committee

* 32 KAR 2:190 Committee Affiliation

* 32 KAR 2:200 Allowable Campaign Expenditures

* 32 KAR 2:170 In-Kind Contributions
DEPARTMENT OF STATE
Registry of Election Finance

32 KAR 2:180. Extension of credit to candidates, campaign committees, or political issues committees.

RELATES TO: KRS 121.180(7)
STATUTORY AUTHORITY: KRS 121.120(1)(g)
NECESSITY AND FUNCTION: KRS 121.180(7) provides that if the final statement of a candidate, campaign committee, or political issues committee shows an unexpended balance or outstanding debt, the entity shall continue to file supplemental reports until all debts have been settled and any outstanding balance depleted. Except for debts incurred in campaigns prior to January, 1989, only candidates may contribute after an election to defray outstanding debts. As a result, obligations owed by a candidate are of necessity assumed by the candidate personally. Regardless of whether an outstanding debt is the result of a pre-1989 campaign or subsequent election, the failure to settle a debt may result in a contribution, and often an illegal corporate contribution, or a contribution in excess of the contribution limit in effect at the time of the election. It is necessary to promulgate this administrative regulation to establish the criteria on which the registry shall determine if an outstanding debt has been converted to a contribution.

Section 1. Scope. This administrative regulation shall apply only to debts incurred for elections held subsequent to November, 1993.

Section 2. Extensions of credit to candidates, campaign committees, or political issues committees.

(1) For purposes of this section, an "unsatisfied extension of credit" means an outstanding debt which has not been satisfied within a reasonable time after the date of an election and which has not been assumed by a candidate personally.

(2) An unsatisfied extension of credit through deferred billing or payment for goods and services rendered to a candidate, campaign committee, or political issues committee shall be construed as a campaign contribution if:

(a) The transaction was entered into with no reasonable expectation of repayment;

(b) The transaction is based upon terms and conditions not available to other customers served by the creditor;

(c) The transaction is not a transaction between two (2) unrelated parties bargaining at arms length; or

(d) The transaction constitutes a significant deviation from the creditor's regular commercial practices.

(3) An extension of credit through deferred billing or payment for goods and services rendered to a candidate, campaign committee, or political issues committee, may be considered a campaign contribution if:

(a) The creditor abandons efforts to enforce or collect the debt on grounds that are not commercially reasonable;

(b) The creditor abandons, forgives, or cancels the debt under conditions not generally available to other customers of the creditor;

(c) The creditor abandons, cancels or forgives the debt for no reasonable business purpose; or

(d) In the case of a creditor who is an individual or unincorporated entity, if any of the conditions in this subsection are determined to exist, and the amount of the debt forgiven, abandoned, or cancelled, when added to other monetary or in-kind contributions made by the creditor exceed the contribution limits in effect at the time of the extension of credit.

(4) An extension of credit through deferred billing or payment for goods and services rendered by a creditor to a candidate or campaign committee or the cancellation, forgiveness, or abandonment of such a debt may be determined by the registry to be a campaign contribution if a totality of the evidence indicates that the transaction is not commercially reasonable. The mere passage of time shall not be determinative, nor shall the finding that a transaction was merely unwise. In making the determination, the registry shall consider:

(a) Whether owners or controllers of the creditor are contributors to or political supporters of the candidate;

(b) Whether the amount of credit extended exceeds the amount of credit extended to nonpolitical customers of the creditor; and

(c) Whether the terms under which the credit was extended are substantially different than the terms and conditions generally applied in transactions between the creditor and its nonpolitical customers.

JOSEPH H. TERRY, Chair

APPROVED BY AGENCY: November 12, 1993

FILED WITH LRC: November 15, 1993 at 11 a.m.

PUBLIC HEARING: A public hearing on this proposed administrative regulation shall be held on December 21, 1993, at 9 a.m. at 140 Walnut Street, Frankfort, Kentucky. Individuals interested in attending this hearing shall notify this agency in writing by December 16, 1993, five days prior to the hearing, of their intent to attend. If no notification of intent to attend the hearing is received by that date, the hearing may be cancelled. This hearing is open to the public. Any person who attends will be given an opportunity to comment on the proposed administrative regulation. A transcript of the public hearing will not be made unless a written request for a transcript is made. If you do not wish to attend the public hearing, you may submit written comments on the proposed administrative regulation to: George Russell, Executive Director, Kentucky Registry of Election Finance, 140 Walnut Street, Frankfort, Kentucky 40601, (502) 564-2226.

REGULATORY IMPACT ANALYSIS

Contact Person: Anita Stanley

(1) Type and number of entities affected: This administrative regulation affects all candidates, campaign committees, political issues committees, and also indirectly affects creditors of those entities. The administrative regulation shall apply only to debts incurred for elections held subsequent to November, 1993.

(a) Direct and indirect costs or savings to those affected:

1. First year: No direct or indirect cost will result from the promulgation of this administrative regulation.
2. Continuing costs or savings: No direct or indirect cost will result from the promulgation of this administrative regulation.

3. Additional factors increasing or decreasing costs (note any effects upon competition): None

(b) Reporting and paperwork requirements: The only additional paperwork resulting from this administrative regulation will be that associated with actions before the Registry in which the determination will be made as to whether an unsatisfied debt has become a contribution.

(2) Effects on the promulgating administrative body:
       (a) Direct and indirect costs or savings:
               1. First year: This administrative regulation will result in no additional direct or indirect cost to the agency.
       2. Continuing costs or savings: This administrative regulation will result in no additional direct or indirect cost to the agency.
       3. Additional factors increasing or decreasing costs: None

(b) Reporting and paperwork requirements: The agency will experience some increase in paperwork associated with actions before the registry in which the determination will be made as to whether an unsatisfied debt has become a contribution.

(3) Assessment of anticipated effect on state and local revenues:

        This administrative regulation will have no effect on state and local revenues.

(4) Assessment of alternative methods; reasons why alternatives were rejected:

        The provisions of this administrative regulation establish fair guidelines to be used by the registry in determining whether an outstanding debt has become a contribution.

(5) Identify any statute, administrative regulation or government policy which may be in conflict, overlapping, or duplication:

        None

(a) Necessity of proposed regulation if in conflict: None

(b) If in conflict, was effort made to harmonize the proposed administrative regulation with conflicting provisions: None

(6) Any additional information or comments: None

TIERING: Is tiering applied? Tiering is not applied because the provisions of this administrative regulation will apply uniformly to debts incurred subsequent to 1993.

DEPARTMENT OF STATE
Registry of Election Finance

32 KAR 2:190. Committee affiliation.

RELATES TO: KRS 121.150(7)
STATUTORY AUTHORITY: KRS 121.120(1)(g), 121.150(7)
NECESSITY AND FUNCTION: KRS 121.150(7) provides that permanent committees affiliated by bylaws, structure, or registration, as determined by the registry, shall be considered one (1) committee for purposes of the contribution limitations contained in KRS 121.150. It is necessary to promulgate this administrative regulation to establish guidelines to be followed by the registry in making the affiliation determination.

Section 1. (1) For purposes of applying the contribution limits contained in KRS 121.150, permanent committees shall be considered affiliated committees if they are established, financed, maintained, or controlled by or in common control with:

(a) A single corporation or its subsidiaries;

(b) A single national or international union or its state and local unions or subordinate organizations; and

(c) A membership organization, other than a political party committee, including a trade or professional association or group.

(2) The registry may examine the relationship between organizations that sponsor committees, between the committees themselves, or between one (1) sponsoring organization and a committee established by another organization to determine whether the committees are affiliated. In determining whether committees not otherwise covered by this administrative regulation are affiliated for purposes of contribution limitations, the registry may consider the circumstantial factors described in this subsection in the context of the overall relationship between the entities. Such factors include, but shall not be limited to:

(a) Whether a sponsoring organization of one (1) committee owns a controlling interest in the voting stock or securities of the sponsoring organization of another committee;

(b) Whether a sponsoring organization or committee has the authority or ability to direct or participate in the governance of another sponsoring organization or committee through provisions of constitutions, bylaws, contracts, or other rules, or through formal or informal practices or procedures;

(c) Whether a sponsoring organization or committee has the authority or ability to hire, appoint, demote, or otherwise control the officers or other decisionmaking employees or members of another sponsoring organization or committee;

(d) Whether a sponsoring organization or committee has a formal or ongoing relationship with another sponsoring organization or committee which indicates a formal or ongoing relationship between the sponsoring organizations or committees;

(e) Whether a sponsoring organization or committee has any members, officers, or employees who were members, officers, or employees of another sponsoring organization or committee which indicates the creation of an alter ego of the original committee; and

(f) Whether a sponsoring organization or committee provides funds or goods in a significant amount or on an ongoing basis to another sponsoring organization or committee, such as through direct or indirect payments for administrative, fundraising, or other costs.

Section 2. No person, organization, or committee shall establish an entity which would qualify as a contributing organization as defined in KRS 121.035 for the purpose of circumventing the contribution limitations contained in KRS 121.150 and the affiliation guidelines established by this administrative regulation.

JOSEPH H. TERRY, Chair
APPROVED BY AGENCY: November 12, 1993
FILED WITH LRC: November 15, 1993 at 11 a.m.
PUBLIC HEARING: A public hearing on this proposed administrative regulation shall be held on December 21, 1993, at 9 a.m. at 140 Walnut Street, Frankfort, Kentucky. Individuals interested in attending this hearing shall notify this agency in writing by December 16, 1993, five days prior to the hearing, of their intent to attend. If no notification of intent to attend the hearing is received by that date, the hearing may be cancelled. This hearing is open to the public. Anyone who attends will be given an opportunity to comment on the proposed administrative regulation. A transcript of the public hearing will not be made unless a written request for a transcript is made. If you do not wish to attend the public hearing, you may submit written comments on the proposed administrative regulation to: George Russell, Executive Director, Kentucky Registry of Election Finance, 140 Walnut Street, Frankfort, Kentucky 40601, (502) 564-2228.

REGULATORY IMPACT ANALYSIS

Contact Person: Anita Stanley

(1) Type and number of entities affected: This administrative regulation applies to all permanent committees registered with the Kentucky Registry of Election Finance and their affiliates.

(a) Direct and indirect costs or savings to those affected:

1. First year: No direct or indirect cost will result from the promulgation of this administrative regulation.

2. Continuing costs or savings: No direct or indirect cost will result from the promulgation of this administrative regulation.

3. Additional factors increasing or decreasing costs (note any
Effects upon competition: None

(b) Reporting and paperwork requirements: No additional paperwork and reporting requirements will result from this administrative regulation.

(2) Effects on the promulgating administrative body:
(a) Direct and indirect costs or savings:
1. First year: This administrative regulation will result in no additional direct or indirect cost to the agency.
2. Continuing costs or savings: This administrative regulation will result in no additional direct or indirect cost to the agency.
3. Additional factors increasing or decreasing costs: None
(b) Reporting and paperwork requirements: Some additional paperwork requirements may result through the submission of documentation by permanent committees related to the question of whether or not a particular committee is an independent committee or an affiliate of another committee.

(3) Assessment of anticipated effect on state and local revenues:
No significant effect on state and local revenues is expected.

(4) Assessment of alternative methods; reasons why alternatives were rejected: No alternative were considered because the registry is charged with the responsibility for making the affiliation determination.

(5) Identify any statute, administrative regulation or government policy which may be in conflict, overlapping, or duplication: None
(a) Necessity of proposed regulation if in conflict: None
(b) If in conflict, was effort made to harmonize the proposed administrative regulation with conflicting provisions: None

(6) Any additional information or comments: None
TIERING: Is tiering applied? Tiering is not applied because the provisions of this administrative regulation will apply uniformly to all permanent committees.
Section 1. Allowable Expenditures. In addition to the general categories of allowable campaign expenditures provided by law, the following expenditures shall be considered allowable:

(1) Expenditures made or items donated to charitable and civic organizations such as clubs, neighborhood organizations, schools, and churches, provided that the expenditure furthers a candidacy through advertising;

(2) Expenditures for items of personal property bearing the name or likeness of the candidate in a conspicuous manner for distribution by a candidate which have a value of ten (10) dollars or less, and which are distributed for the purpose of advertising that individual's candidacy. These items include, but are not limited to, hats, shirts, calendars, magnets, holiday greeting cards, and similar items. The purchase of tickets for general distribution for the purpose of influencing and electing, either directly or indirectly, shall not be allowed under the subsection;

(3) Reasonable expenditures for services such as distribution of campaign literature, staff services, and similar services which are primarily and directly related to the individual's candidacy;

(4) Expenditures for the purchase of transportation services, including but not limited to the transportation of voters to the polls, provided that the expenditures are reasonable in light of the number of persons transported, mileage driven, and time spent. All transportation expenditures shall be primarily and directly related to the candidacy of the individual on whose behalf the expenditures are made;

(5) Expenditures for tickets to political and other events to be attended by the candidate, his spouse, or a campaign staff representative, and from which the candidate derives a direct benefit to his candidacy. The burden shall be on the candidate to prove to the registry that representation at the event provided a direct benefit to his candidacy;

(6) The purchase of American, state, or other flags which are donated to schools, civic, or charitable organizations;

(7) Campaign events such as bean suppers, breakfasts, luncheons, or similar events, regardless of whether admission is charged, provided that the value of the meal does not exceed five (5) dollars per person; and

(8) The purchase or rental of items such as cellular telephones, copiers, computers, automobiles, facsimile machines, and similar items. Such purchase or rental shall be presumed to be primarily and directly related to the individual's candidacy if the purchase or rental occurs during the year in which the individual will appear on the ballot or seeks election as a write-in candidate. The purchase of such items in a year in which the individual is not a candidate shall be allowed only if the item is purchased solely for use in an upcoming campaign. The continued rental of such items during a year in which an individual is not a candidate shall be allowed, provided that the prorated use thereof which is primarily campaign related exceeds fifty (50) percent of the total use. Only that use attributable to the campaign may be paid for with campaign funds and the burden shall be on the candidate to prove that an expenditure is allowable under this subsection.

Section 2. Unlawful Campaign Expenditures. In addition to the expenditures specifically prohibited by law, the following categories of campaign expenditures shall not be considered allowable expenditures from a campaign account:

(1) Payment of dues to professional, civic, or other organizations to which the individual belongs or desires to join;

(2) Expenditures made to defray the costs associated with an individual's performance of his official duties as an officeholder; and

(3) Costs associated with gifts, flowers, food, or similar items which are purchased for the benefit of campaign staff or volunteers, or any other expenditure which bestows a private, pecuniary benefit to an individual.

Section 3. Expenditures made by a candidate or an incumbent officeholder during a year in which he will not appear on the ballot as a candidate shall be subject to strict scrutiny. If the registry staff, in the course of reviewing a candidate's or incumbent's campaign finance statements, determines that a questionable expenditure has been made, whether or not the expenditure was made during an election year, the burden shall be on the candidate or incumbent to prove that the expenditure was directly and primarily related to his candidacy.

JOSEPH H. TERRY, Chairman

APPROVED BY AGENCY: December 9, 1993
FILED WITH LRC: December 15, 1993 at 10 a.m.
PUBLIC HEARING: A public hearing on this proposed administrative regulation shall be held on January 24, 1994, at 9 a.m., at 140 Walnut Street, Frankfort, Kentucky. Individuals interested in being heard at this hearing shall notify this agency in writing by January 19, 1994, five days prior to the hearing, of their intent to attend. If no
notification of intent to attend the hearing is received by that date, the hearing may be cancelled. This hearing is open to the public. Any person who wishes to be heard will be given an opportunity to comment on this proposed administrative regulation. A transcript of the public hearing will not be made unless a written request for a transcript is made. If you do not wish to be heard at the public hearing, you may submit written comments on the proposed administrative regulation. Send written notification of intent to be heard at the public hearing or written comments on the proposed administrative regulation to: George Russell, Executive Director, Kentucky Registry of Election Finance, 140 Walnut Street, Frankfort, Kentucky 40601, (502) 564-2226.

REGULATORY IMPACT ANALYSIS

Agency Contact Person: Anita Stanley
(1) Type and number of entities affected: This proposed administrative regulation will affect all candidates for public office in the state.
   (a) Direct and indirect costs or savings to those affected:
      1. First year: None
      2. Continuing costs or savings: None
      3. Additional factors increasing or decreasing costs (Note any effects upon competition): None
   (b) Reporting and paperwork requirements: No additional paperwork will result except some recordkeeping on vote haulers.
(2) Effects on the promulgated administrative body:
   (a) Direct and indirect costs or savings:
      1. First year: None
      2. Continuing costs or savings: None
      3. Additional factors increasing or decreasing costs: None
   (b) Reporting and paperwork requirements: No additional paperwork will result to the agency.
(3) Assessment of anticipated effect on state and local revenues: This proposed administrative regulation will have no effect on state and local revenues.
(4) Assessment of alternative methods; reasons why alternatives were rejected: No alternative methods were considered because the agency was required by statute to promulgate this administrative regulation.
(5) Identify any statute, administrative regulation or governmental policy which may be in conflict, overlapping, or duplication: None
   (a) Necessity of proposed administrative regulation if in conflict:
   (b) If in conflict, was effort made to harmonize the proposed administrative regulation with conflicting provisions:
(6) Any additional information or comments:
   TIERING: Was tiering applied? Tiering is not applied because these provisions regarding allowable campaign expenditures apply in a uniform manner to all candidates for public office.
DEPARTMENT OF STATE
Registry of Election Finance

32 KAR 2:170. In-kind contributions.

RELATES TO: KRS 121.015(6)(b), (c), (d), 121A.010(11)(a)(2), (3), (4).

STATUTORY AUTHORITY: KRS 121.120(1)(g), 121A.020(7)
NECESSITY AND FUNCTION: KRS 121.015(6)(b), (c), and (d) and 121A.010(11)(a)(2), (3), and (4) include the payment for or provision of certain goods and services to a candidate, slate of candidates, committee, or contributing organization within the definition of "contribution". Such payments are known as "in-kind" contributions. It is necessary to promulgate this administrative regulation to clearly identify the circumstances under which a contribution falls within the in-kind category.

Section 1. (1) A candidate, slate of candidates, committee, or contributing organization shall not conspire with an individual or other entity to disguise an illegal contribution as an in-kind contribution.

(2) It shall be considered an in-kind contribution when an individual or other entity provides direct goods or services to a candidate, slate of candidates, committee, or contributing organization or if an individual purchases goods or services from a third party for the benefit of a candidate, slate of candidates, committee, or contributing organization.

(3) A business enterprise may make an in-kind contribution to a candidate, slate of candidates, committee, or contributing organization provided, however, that the business enterprise is not incorporated. The owner of a corporation may make personal in-kind contributions provided that no corporate funds or assets are involved, or, if corporate property such as copiers, telephones, or other office equipment are utilized, the actual costs are billed to the owner and reimbursed with personal funds, and the cost does not exceed the applicable individual contribution limit contained in KRS 121.150. A candidate shall not accept the use of the assets of any corporation unless the fair market value is billed to the campaign and paid for with campaign funds.

(4) If goods or services are provided at less than the rate normally charged, the amount of the in-kind contribution shall be the difference between the usual and normal charge for the goods and services at the time of the contribution and the amount actually charged.

(5) The payment by any person of compensation for the personal services of another if those services are rendered without charge to a candidate, slate of candidates, committee, or contributing organization shall be an in-kind contribution. No compensation shall be considered paid to any employee under the following conditions:

(a) If an employee is paid on an hourly or salaried basis and is expected to work a particular number of hours per period, no contribution results if the employee engages in activity for the benefit of a candidate, slate of candidates, committee, or contributing organization during what would otherwise be a regular work period, provided that the taken or released time is made up or completed by the employee within a reasonable time;

(b) No contribution results where an employee engages in activity for the benefit of a candidate, slate of candidates, committee, or contributing organization during what would otherwise be normal working hours if the employee is paid on a commission or piecework basis, or is paid only for work actually performed and the employee’s time is considered his own to use as he sees fit; or

(c) No contribution results where the time used by the employee to engage in activity for the benefit of a candidate, slate of candidates, committee, or contributing organization is bona fide, although compensable, vacation or other earned leave time.

Section 2. A contribution made under the following circumstances shall not be considered an in-kind contribution:

(1) Payment for goods and services previously or simultaneously acquired by a candidate, slate of candidates, committee, or contributing organization; or

(2) Payment of a debt with cash received by a candidate, slate of candidates, committee, or contributing organization without depositing the funds into the campaign account and complying with all applicable reporting requirements.

Section 3. (1) A candidate, slate of candidates, committee, or contributing organization shall not attempt to circumvent the contribution limits of KRS 121.150 or the contribution and expenditure limits of KRS Chapter 121A by conspiring with an individual, business enterprise, or other entity to engage in activity which would otherwise constitute an independent expenditure for the benefit of the candidate, slate of candidates, committee, or contributing organization.

(2) Candidates, slates of candidates, committees, or contributing organizations shall have no duty to report expenditures made on their behalf which qualify as independent expenditures. They shall report receipt of in-kind contributions resulting from expenditures made on their behalf and with their direct or indirect cooperation, consent, request, suggestion, or consultation.

JOSEPH H. TERRY, Chair
APPROVED BY AGENCY: November 12, 1993
FILED WITH LRC: November 15, 1993 at 11 a.m.
PUBLIC HEARING: A public hearing on this proposed administrative regulation shall be held on December 21, 1993, at 9 a.m. at 140 Walnut Street, Frankfort, Kentucky. Individuals interested in attending this hearing shall notify this agency in writing by December 16, 1993, five days prior to the hearing, of their intent to attend. If no notification of intent to attend the hearing is received by that date, the hearing may be cancelled. This hearing is open to the public. Any person who attends will be given an opportunity to comment on the proposed administrative regulation. A transcript of the public hearing will not be made unless a written request for a transcript is made. If you do not wish to attend the public hearing, you may submit written comments on the proposed administrative regulation to: George Russell, Executive Director, Kentucky Registry of Election Finance, 140 Walnut Street, Frankfort, Kentucky 40601, (502) 564-2225.

REGULATORY IMPACT ANALYSIS

Contact Person: Anita Stanley
(1) Type and number of entities affected: This administrative regulation affects all candidates for public office in Kentucky as well as individuals who contribute to those candidates.

(a) Direct and indirect costs or savings to those affected:
1. First year: No direct or indirect cost will be associated with this administrative regulation.

2. Continuing costs or savings: No direct or indirect cost will be associated with this administrative regulation.

3. Additional factors increasing or decreasing costs (note any effects upon competition): None

(b) Reporting and paperwork requirements: All in-kind contributions in excess of $100 per election must be reported to the Registry as provided in KRS 121.180. There will be no additional paperwork and reporting requirements as a result of this administrative regulation.
# Uniform Commercial Code Update

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UNIFORM COMMERCIAL CODE UPDATE

John T. McGarvey
Morgan & Pottinger, P.S.C.

RECENT DECISIONS AFFECTING KENTUCKY BANKS:

Article 1


The Kentucky Court of Appeals applied KRS 355.1-207, the UCC section on performance or acceptance under reservation of rights, to allow the payee of a "payment in full" check to accept the check under an explicit reservation of rights without the acceptance constituting an accord and satisfaction. Kentucky has accepted the position that the enactment of the Uniform Commercial Code modified the old common law rule. Although this is a minority position among the states, it is one in accord with most commentators on the Code and the law of several other states including Missouri, New York, and Ohio.

Article 2


This case involves issues that fall across the full breadth of the Code from Article 2 to Article 9. Applying the exception to the parol evidence rule found at KRS 355.2-202(b), the Court recognized an oral agreement that was in addition to, but not contradictory to, a written contract.


This is one of the many cases that have come out of the liquidation of the assets of Calumet Farm. The Keeneland Association sued the buyer of a Calumet filly for breach of contract. The buyer removed the action to federal court, sought recision of the contract, and brought his own claim against Calumet. Keeneland prevailed partially because of the warranty disclaimer language in its sales contract: "THERE IS NO WARRANTY IMPLIED BY AUCTIONEER OR CONSIGNOR (INCLUDING OWNER), EXCEPT AS SET FORTH HEREIN, AS TO THE MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY ANIMAL OFFERED IN THIS SALE. ALL SALES ARE MADE ON AN AS IS BASIS, WITH ALL FAULTS." Relying on prior Kentucky law (Greg Coats Cars, Inc. v. Kasey, Ky. App., 576 S.W.2d 251 (1978); Childers & Venters, Inc. v. Sowards, Ky. 460

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In companion cases decided on September 30, 1993, the Kentucky Supreme Court found, that for liability insurance purposes, automobile dealers are the legal owners of a vehicle until such time as the AVIS System shows their customer as the owner. In the Potts case, the Court referred to the 1983 Commentary (the unofficial Commentary found in the Bank’s Baldwin edition of the statutes) to KRS 355.2-202 (parol evidence rule) in finding that "actual performance of the parties must be considered the best indication of what they intended the writing to mean and that it is not proper to include testimony or other evidence of the parties’ conduct as opposed to their words". The specific ruling was on the question of whether the transaction between the dealer and customer was a conditional sale as opposed to a transfer with a retention of a security interest. Although the dicta in regard to KRS 355.2-202 remains, the practical effect of both cases is being overruled by Senate Bill 106, passed by both houses and delivered to the Governor on February 28.


The Court of Appeals was called upon to settle a dispute between two innocent parties concerning the purchase of a 1984 Corvette that was stolen. The vehicle was recovered by the Kentucky State Police and returned to an Illinois insurer. The last owner of the vehicle, Wyatt, brought an action against his seller, Mullins, for breach of warranty of good title pursuant to KRS 355.2-312. (The Court notes that the actual warranty involved was the warranty of merchantability, KRS 355.2-314.) Mullins’ defense was based on the notice requirements of KRS 355.2-607(3)(a). Mullins alleged that Wyatt was required to notify him of any breach prior to commencing a lawsuit or be barred from relief. Our Court of Appeals found that the summons and suit could serve as a notice under KRS 355.2-607 but remanded the case for the determination of whether Wyatt’s notice was "reasonably timely."

Article 3


This is another case where Kentucky courts have ruled that the enactment of the Uniform Commercial Code "superseded" the prior rule of law in the Commonwealth. In this case, KRS 355.3-111 on bearer paper was applied to overturn the decision of Finley v. Rose, 189 Ky. 359, 224 S.W. 1059 (1920). The case involved a note with a blank payee line. The holder argued that the note constituted bearer paper. However, the Court ruled that KRS 355.3-111 restricted bearer paper to instruments payable to a bearer, a specified person or bearer, or cash. The Court determined that the instrument in question was incomplete and could not be enforced until completed.

This decision is described by Leibson and Nowka as "... an opinion packed with incorrect and ambiguous analysis made in order to reach what the Court felt was a fair result." (The Uniform Commercial Code of Kentucky 2 Ed., Section 4.6(A)(1).) The opinion of the Court of Appeals, as affirmed by the Supreme Court, held that: (1) forged instruments are a nullity, and (2) that a bank as payee of a check, presented by one who is not a maker, and who directs the bank to credit the check to his personal account, cannot be a holder in due course and is on notice that it should inquire further as to the presenter's authority. The Court places a burden on Kentucky banks far greater than that prescribed by the Uniform Commercial Code. The UCC allocates the primary risk of loss and forgeries to the drawee or payor bank, not the payee as does the decision in Hardin-Mapes.

The decision may well have resulted due to application of the principles of equity and, several procedural twists in the underlying litigation. Hardin-Mapes never brought a claim against its bank that paid the forged check and the Federal Land Bank of Louisville did not raise on appeal Hardin-Mapes' failure to timely report the forgery.

Hopefully, this aberration in Kentucky law can be corrected legislatively or through future litigation that brings a more attractive case, in a better procedural posture, before our courts. Bank counsel must be careful to distinguish Hardin-Mapes based on both its facts and the legal issues presented to our Supreme Court. (Thus far the case has not been cited as authority in any other decision from any jurisdiction. In nearly identical facts, the New York Supreme Court recently reached a different but correct result in Gino's of Caprie, Inc. v. Chemical Bank, 592 N.Y.S. 2d 682 (January 1993).)


The holder of notes associated with the sale of Arabian horses claimed holder in due course status. That the original transferor of the notes did not endorse the notes. Applying KRS 355.3-201, the Court found that subsequent transferees were entitled to have the endorsement of the original transferor; however, without the endorsement the subsequent transferees could not attain holder in due course status (KRS 355.3-202).

Article 4


The Court applied KRS 355.4-303 to allocate priorities between a judgment creditor that levied a garnishment on a depositor's account and the bank's right of setoff. Picking up on the concept of the Code section, the Court said that a bank cannot charge a customer's account with a setoff after accepting a garnishment thereon, the garnishment being the type of legal process anticipated by the Code. Regardless of whether the debtor's loan account was in default, the
Court ruled that the setoff must be effected prior to receipt of the garnishment in order for the setoff to take priority. To determine when a setoff takes effect, our Court of Appeals followed the Sixth Circuit in using the following criteria: (1) the decision to exercise the right, (2) some action which accomplishes the setoff, and (3) some record which evidences that the right of setoff has been exercised. The burden of proof is allocated to the bank to demonstrate when the setoff actually occurred as evidenced by intent, affirmative acts, and records.

In the event the Kentucky Supreme Court allows this decision to stand, the KBA is currently working on a legislative solution.


The Court determined that a safe deposit box is not an "account" or "other like arrangement" for the purposes of KRS 391.300(1) entitling the surviving party to the balance. The Court cited as authority KRS 355.4-104(1)(a) that defines "account" as any account with a bank including "a checking, time, interest or savings account; . . . ."

Article 9

Validity of Security Agreement and Rights of Parties Thereto


The debtor, Marvin T. Bush, and his P.S.C., Marvin T. Bush, D.M.D., P.S.C., filed, respectively, a Chapter 7 petition and Chapter 11 petition on the same date. Conn was an unsecured creditor who challenged the security interest of First National Bank of Pikeville in the personal property associated with the dental practice. Although the debtor practiced as a P.S.C. in February 1989, the Bank took its security interest from the individual. The P.S.C. was administratively dissolved in December 1990. On the issue of attachment of the security interest, the Court found for the Bank on the basis that the security agreement clearly referred to the debtor's dental practice and that third parties could not fail to be put on notice that the Bank was claiming a security interest in the personal property related to the dental practice whether or not the debtor was identified as a P.S.C. Although ruling on the attachment of the security interest under Part 2 of Article 9, the Court apparently applied, without specifically stating, the seriously misleading error test of KRS 355.9-402(7).


The second aspect of the Morgan case concerns KRS 355.9-206(1). The holder of the note, having failed in its attempt to claim holder in due course status, attempted to assert its rights under KRS 355.9-206(1) as an assignee/beneficiary of a waiver of defenses clause in a security agreement. Although the Court recognized the statutory defense, it found the defense inapplicable due to its location on the reverse of the contract without proper incorporation language above the signature on the face of the contract.
Priority of Liens


This case presented the Court of Appeals with a classic confrontation between the claim of a mechanic for towing, repairs, storage, and service charges versus the claim of the secured creditor. The boat, on which a balance of over $28,000.00 was owed, was placed in the possession of Dan's Marina in May 1989. A total bill of $4,574.00 accumulated by February 1992. The bill was composed of towing and storage charges, service charges, and actual repair costs. For a resolution of the priority claim, the Court looked at KRS 355.9-310:

When a person in the ordinary course of his business furnishes services or materials with respect to goods subject to a security interest, a lien upon goods in the possession of such person given by statute or rule of law for such material or services takes priority over a perfected security interest unless the lien is statutory and the statute expressly provides otherwise.

The Court thus found that the repair costs and the towing and storage charges, properly came ahead of the bank’s lien but denied priority to the claim for services charges. This was in keeping with the spirit and intent of the mechanic's lien statute. The Court reaffirmed the law of this state as first enunciated in Corbin Deposit Bank v. King, Ky., 384 S.W.2d 302, (1964). The Court particularly noted that Dan's Marina retained possession of the boat continuously from May 1989. Possession is the key to the mechanic's retention of priority. Once possession is released, even if the vehicle or boat returns to the possession of the mechanic, the priority on the original claim is lost.

A different result might have been reached had Central Trust Company taken a ship mortgage. The law of ship mortgages is more akin to the law of real estate. Except for certain claims to wages, and marine torts, the holder of a properly recorded ship mortgage primes all other liens.

McGonigle v. Combs, 968 F.2d 810 (9th Cir. 1992).

The Ninth Circuit Court of Appeals applied Kentucky law in a dispute between a Louisville law firm and a Kentucky bank as to the priority of their respective claims to settlement funds from a securities claim. The bank argued that the settlement funds constituted proceeds from the disposition of stock in which it held a prior perfected security interest. The Court ruled in favor of the bank, based on Kentucky's Uniform Commercial Code, and the Code's definition of proceeds as "whatever is received upon the sale, exchange, collection or other disposition of collateral ..." Citing In re Stone, 52 BR 305 (Bankr. W.D.Ky. 1985), the Court ruled that it was the intent of the Kentucky Legislature to give the term "proceeds" the broadest possible definition. After making the determination that the settlement funds constituted proceeds under the Code, the Ninth Circuit determined, outside the Code, that a perfected security interest that is prior in time is superior to a later lien.
Perfection of Security Interests


Judge Gudgle, in a decision cited in the December 1992 UCC Bulletin, applied the brightline rule of most jurisdictions on the period during which a continuation statement can be filed. A filed financing statement is effective for five years. KRS 355.9-403(2). To continue the perfection of a lien for another five years from the date of expiration of the original financing statement, a creditor must file a continuation statement "within six months prior to the expiration of the five year period." KRS 355.9-403(3). Banque Worms' continuation statement was filed six months and two days before the end of the five year perfection period. Thus, under the decision of our Court of Appeals, it was ineffective. Although the brightline standard has been criticized by some commentators, the position taken by Kentucky is in accord with that of other states.


Having survived the test for attachment of its security interest, the bank lost on a perfection issue. The perfection question borders on a law school exam. The individual debtor maintained residences in Floyd County and Fayette County. His dental practice was located in Pike County. The bank recorded in Floyd County. The Court applied KRS 355.9-401(5)(a) and found the proper place to record a lien against an individual is their principal place of business. With the dental practice located in Pike County, the Court found the bank not to have properly perfected its security interest. This gets back to the old Kentucky rule on where to record: EVERYWHERE.

Default and Remedies


GMAC repossessed a 1984 Cadillac from its customers. After GMAC had applied for and obtained a repossession title, the customers exercised their right under KRS 355.9-506 and redeemed the collateral. Here, the Code conflicts with the new Supreme Court decisions in Potts v. Draper and Rogers v. Wheeler. The debtor was entitled to redeem the collateral at any time prior to its disposition under KRS 355.9-504. GMAC properly surrendered its collateral upon payment and forwarded documents to reverse the repossession title to the Pike County Clerk. Unfortunately for GMAC, its debtors were involved in an accident prior to the time of transfer.


There were formerly two camps on the issue of whether a creditor could collect a deficiency if its sale of collateral failed to meet any of the several tests of commercial
reasonability. One line of cases held that a rebuttable presumption was created that the value of the collateral was equal to the debt but that a creditor could present evidence to show it remained entitled to a deficiency. Other jurisdictions, including Kentucky, held that any failure on the part of a creditor in the disposition of collateral negated its legal right to sue for a deficiency. *Bank Josephine v. Conn*, Ky. App., 599 S.W.2d 773 (1980).

The decision in *Holt* strikes a middle ground that has received favorable comment. A secured creditor who properly notifies the debtor of the sale will not forfeit a deficiency if it can prove that the commercial unreasonableness did not reduce the selling price, or that if the selling price was reduced, the amount of the reduction did not wipe out the deficiency. The critical difference between this and the former line of rebuttable presumption cases relates to the notice of sale. Writing for the Court, Justice Lambert emphasized the importance of a notice of sale as a fundamental right of due process and held that a creditor’s failure to give notice borders on conversion and voids the right to a deficiency.


*Bank Josephine v. Conn*, Ky. App., 599 S.W.2d 773 (1980) may have been partially reversed by *Holt v. Peoples Bank of Mt. Washington*; however, the federal court applied, properly, the rule that the burden of proof is on the secured party to show that it has acted with commercial reasonableness.


The fact situation addressed by the Court involved a bank with insurance coverage relating to deficiencies on certain of its installment sale contracts. When the bank repossessed its collateral, a car, it notified its debtor that the vehicle would be sold at public auction. At the auction, the highest bid, $7,400.00, was rejected by the bank on the advice of its insurance carrier. Subsequently, the bank was paid off by the insurance carrier and assigned to the insurance carrier all of its rights in the security agreement and collateral. The insurance carrier applied $7,400.00 to the debtor’s account and sued for a deficiency. The Kentucky Court of Appeals held that the sale to the insurance carrier did not constitute the public auction of which the bank’s debtor was notified. The Court further ruled that the insurance carrier could have collected a deficiency as an assignee of the bank (KRS 355.9-504(5)) if it had met the statutory requirements for a commercially reasonable sale.

**THE STATUS OF KENTUCKY’S UNIFORM COMMERCIAL CODE**

Kentucky was one of the first, if not the first, states to enact the Code in 1958. There were no substantial changes in Kentucky’s Code until 1986 when the legislature adopted the 1972 amendments to Article 9 and the 1977 amendments to Article 8. There were minor amendments in a "clean-up" bill in 1988 to iron out certain problems, particularly in relation to
motor vehicle and mobile home liens. The 1990 Legislature enacted the model version of Article 2A on leases. The 1992 Legislature, following the recommendations of the American Law Institute and National Conference of Commissioners on Uniform State Laws, repealed Article 6 on bulk transfers and enacted the model amendments to Article 2A. A small but significant amendment in the 1992 UCC bill added KRS 355.1-110. This section adopts the comments of the National Conference of Commissioner's on Uniform State Laws and the American Law Institute as interpretative of the Code. This can be very useful in a state where reported case law provides little guidance in interpretation of the Code.

Kentucky’s Code has recently stayed abreast of the remainder of the country with the possible exception of action on the amendments to Articles 3 and 4. As of December 1, 1993, 40 states have adopted Article 2A on leases with 38 adopting the model amendments, 30 states have adopted the amendments to Articles 3 and 4, 47 states have enacted Article 4A, and 24 states, including Kentucky, have repealed the Bulk Sales Act in its entirety (Louisiana never adopted Article 6) while 5 have enacted an amended and less burdensome version.

Although we have less than two years of experience with the repeal of Article 6, the sky has not fallen in Kentucky. The ability of inventory creditors to obtain purchase money security interest, ahead of other filers, and use of the Uniform Fraudulent Transfer Act have essentially alleviated the need for the Bulk Sales Act. The Bulk Sales Act has been a greater burden on commerce since the enactment of Article 9 than it has been a protector of vendors who sell inventory.

**AMENDED ARTICLE 2A**

The model amendments adopted by the 1992 Legislature are generally lender friendly. The new KRS 355.2A-303 (3) voids provisions in lease agreements that prohibit the assignment
or sale of leases by a lessor. Equipment leases are now freely available to lenders as collateral and can be treated much as accounts receivable and general intangibles under KRS 355.9-318(4).

Taking the leased equipment as collateral remains risky. If goods are leased to "a lessee in the ordinary course of business," the lessee takes free of any security interest created by the lessor. KRS 355.2A-307(3). The equipment does not become available to the secured lender until expiration of the lease term for default by the lessee. This follows the pattern set by KRS 355.9-307(1).

If the leased equipment is unavailable to the secured party while in the possession of the lessee, the lease payments may be available as proceeds of the collateral. Case law has been to the contrary; however, Permanent Editorial Board Commentary No. 9 (1992) treats equipment lease payments as proceeds except where the lease term is of a very short term such as daily car rental payments.

A companion amendment to Article 1 sets a statutory distinction between a true lease and a disguised security transaction. The text, found at KRS 355.1-201(37) "Security Interest", focuses on economic reality. If the lease term covers the economic life of the collateral, or if a purchase option at the end of the lease term is for little or nominal consideration, the transaction will be deemed to be in the nature of a security interest. A protective filing should be made in borderline cases. KRS 355.9-408. If the lessor is confident under the new and more precise definition that the transaction is a pure lease, filing is not necessary. The new definition should resolve a point that has created a significant amount of litigation under the Code.

AMENDMENTS TO ARTICLES 3 AND 4: The Prospects For Change In Kentucky

Article 3
Article 3 of the Uniform Commercial Code, governing commercial paper and negotiable instruments, is essentially a spruced up version of the old Negotiable Instruments Law first promulgated in 1896. Shortcomings of the current Article 3 include the failure to address modern check processing where numbers of checks unanticipated by the drafters of Article 3 are processed using visual and electronic scanners and computers, and the failure to recognize the different functions of notes and the various forms of drafts.

In 1990 the American Law Institute and National Conference of Commissioners on Uniform State Laws recommended revisions for Article 3, and corresponding revisions to Article 4, to cure deficiencies identified both through the decisions of courts and operational experience. Highlights of the proposed revisions include:

- Narrowing the scope to include only checks and bearer or order instruments.

- The requirement that a negotiable instrument state a "sum certain" is eliminated in favor of a requirement for a "readily ascertainable amount of money, with or without interest or other charges described in the promise or order." Interest may be fixed or variable. (Kentucky adopted language authorizing a variable rate in 1990. See KRS 355.3-106(2).)

- A party who satisfies an instrument has a right of contribution from co-parties signing in the same capacity. When a co-party is insolvent, contribution is divided between the parties who remain solvent.

- A new statute of limitations requires that any action under Article 3 must be brought according to the ordinary statute of limitations existing in the state.

- The effect of restrictive endorsements is limited. Endorsements conditioning the right to payment do "not effect the right of the endorsee to enforce the instrument." A person paying the instrument, or an intermediary party that takes for value, may disregard conditions imposed by endorsement.

- The effect of certain restrictive endorsements such as "for deposit", "for collection", and "pay any bank", is retained.

- Non-depository payor banks join intermediary banks as being exempt from wrongfully paying over a restrictive endorsement.
• Indicia of a regularly executed instrument is added to the requirements for attaining holder-in-due-course status. "Apparent evidence of forgery or alteration" prevents a holder from becoming a holder-in-due-course.

• Modern check processing is addressed by relaxation of rules from the old mechanical system requiring "presentment as a condition of payment."

Corresponding Changes in Article 4

Article 4 is not as fully revised as Article 3. The primary reason being uncertainty as to whether the Federal Reserve Board will exercise greater authority over bank deposits and collections. Only amendments necessary to take care of immediate problems and corresponding amendments required by changes in Article 3 have been suggested.

Primary changes include:

• Truncation agreements between banks and customers are permitted allowing presentment for payment by "transmission of an image of an item or information describing the item rather than delivery of the item itself."

• The statute of limitations requires that actions to enforce obligations, duties, and rights under Article 4 be brought within three years of the time the action accrues.

• Warranties relating to encoding and retention are added. One who encodes information on an item warrants that the encoding is correct. Retention warranties relate to original instruments subject to truncation agreements.

• Customers provided with a sufficiently detailed statement of items credited and debited, in lieu of the actual item, must notify the payor bank of an altered or forged item following receipt of the statement as opposed to the item.

• Banks providing statements of items credited and debited must keep the item or legible copies for seven years and supply legible copies at the customer’s request.

Amendments to Articles 3 and 4 in Kentucky

Until this Legislature, Kentucky’s Special Study Commission on the Uniform Commercial Code, sponsored by the Legislative Research Commission, had met each biennium since 1984. At the request of legislative leadership, and due to the continuing specter of special sessions and
large legislative agendas, the Commission did not meet to consider legislation for the 1994 session. As of December 1, 1993, 31 states have enacted the amendments for Articles 3 and 4. This is significant in that 12 states enacted the amendments in the first eleven months of 1993. If Kentucky banks and their counsel are interested in enacting the amendments in Kentucky they should make their wishes known to the legislators.

**Article 4A Funds Transfer**

The transfer of money takes place through three primary systems: checks that are regulated by Articles 3 and 4 of the UCC, electronic funds transfers by consumers (primarily automated teller machines) regulated by the Federal Electronic Funds Transfer Act, and "funds transfers", sometimes referred to as wholesale transfers or wire transfers. Funds transfers are unregulated except for rules of the Fedwire (Reg. J), clearing houses and private contracts.

Article 4A is designed to provide certainty as to what the rights and obligations of the parties to funds transfers are. The Article addresses the interests of banks, commercial users and the public. The Article establishes who takes the risk of loss and who will be liable and what the damages will be.

Article 4A has been enacted more quickly than any other article of the Code. First recommended in 1989, as of December 1, 1993, Article 4A had been adopted in its uniform version by all states except New Jersey, South Carolina, and Vermont.

It is easy to understand the quick acceptance of Article 4A. Funds transfers account for many times the amount of money transferred each day than the system of checks and consumer use of electronic funds transfers combined. On an average day, over a trillion dollars transfers through funds transfers. More than three trillion dollars have transferred on a single day. This is roughly equivalent to the country's annual gross national product. In the average funds transfer, five million dollars changes hands.
Important Definitions:

A. "payment order" means an instruction of a sender to a receiving bank, transmitted orally, electronically, or in writing, to pay, or to cause another bank to pay, a fixed or determinable amount of money to a beneficiary i: (i) the instruction does not state a condition to payment to the beneficiary other than time of payment, (ii) the receiving bank is to be reimbursed by debiting an account of, or otherwise receiving payment from, the sender, and (iii) the instruction transmitted by the sender directly to the receiving bank or to an agent, funds transfer system, or communication system for transmittal to the receiving bank.

B. "beneficiary" means the person to be paid by the beneficiary’s bank.

C. "beneficiary’s bank" means the bank identified in a payment order in which an account of the beneficiary is to be credited pursuant to the order or which otherwise is to make payment to the beneficiary if the order does not provide for payment to an account.

D. "receiving bank" means the bank to which the sender’s instruction is addressed.

E. "sender" means the person giving the instruction to the receiving bank.

F. "funds transfer" means the series of transactions, beginning with the originator’s payment order, made for the purpose of making payment to the beneficiary of the order. The term includes any payment order issued by the originator’s bank or an intermediary bank intended to carry out the originator’s payment order. A funds transfer is completed by acceptance by the beneficiary’s bank of a payment order for the benefit of the beneficiary of the originator’s payment order.

G. "intermediary bank" means a receiving bank other than the originator’s bank or the beneficiary’s bank.

H. "originator" means the sender of the first payment order in a funds transfer.

I. "originator’s bank" means (i) the receiving bank to which the payment order of the originator is issued if the originator is not a bank, or (ii) the originator if the originator is a bank.

Article 4A divides the funds transfer process into three primary areas: issuance and acceptance of payment orders, execution of sender’s payment orders by receiving banks, and payment. A final part of Article 4 governs such miscellaneous provisions as a variation of the statutory requirements by agreement, creditors actions against funds in the transfer process, rates of interest, and choice of law. 
Consumer transactions are specifically outside the scope of Article 4A. The statute also provides that to the extent it is inconsistent with regulations and operating circulars of the Federal Reserve Board, those regulations take precedence. Transfer system rules will also prevail over the statutory provisions of Article 4A.

Two major subjects covered by Article 4A are unauthorized payment orders and authorized but erroneous payment orders. If a bank is to avoid liability, it must provide a "commercially reasonable security procedure."? The words "commercially reasonable" have been a source of substantial litigation under Article 9 and in all likelihood will follow in Article 4A. However, as opposed to Article 9, the question of commercially reasonable under Article 4A is a question of law that is to be decided by the courts. [4A-202(c)] The courts are directed to consider the instructions of the customer, the circumstances surrounding the customer including their normal funds transfer activity, alternative security procedures issued to the customer, and security procedures used in similar transactions by similar parties. A bank that has complied with the security procedures, and relied on written instructions of its customer, will generally not bear a loss for an unauthorized transfer. However, if a bank's customer meets its burden of proof, and a crook has initiated the transfer, the loss does fall on the bank.

A more frequent occurrence than a fraudulent payment order is an authorized but erroneous order. Here a bank is liable to its customer for direct expenses but is exempted from consequential damages unless there is a written contract to the contrary. Article 4A also imposes a one year statute of repose.

Benefits for users of funds transfers include:

- Finality of payment; funds transfers, although equivalent to cash, are made with a more certain degree of finality.
- Customers have a "money back guarantee" if a transfer is not completed.
• There is a statutory discharge of underlying obligations upon acceptance by the beneficiary’s bank.

• In order to take advantage of loss allocation rules, banks will provide reasonable security procedures.

• A receiving bank suffers the loss for an unauthorized transfer unless the bank can prove: (i) its security procedure was commercially reasonable, (ii) the bank followed the procedure, (iii) the bank acted in good faith, and (iv) the bank complied with the customer’s written agreement or instructions restricting acceptance of payment orders. Regardless, the loss will fall on the bank, if a customer can prove it is without fault.

• A customer may receive damages for dishonor if its bank has accepted an order and the bank fails to pay. Consequential damages are available to customers if the beneficiary gave notice of particular circumstances that would give rise to such damages and an indication of the magnitude of the damages.

**Benefits to Banks Under Article 4A:**

• Enactment of a body of statutory law fills the large gaps that now exist in determination of the rights and remedies of parties to the payment system.

• When banks are users of the system, they have all of the benefits of users noted above.

• Bank liability is limited to loss of interest and principal and in certain instances incidental costs and attorneys fees. Consequential damages are available to a customer only in the event of intentional dishonor. The statute of limitations requires objections to payment be made within one year from the time the customer receives notice that the order was sent (4A-502)

• There is statutory guidance for choice of law that will promote certainty as to legal rights (4A-507)

• There is statutory recognition of the netting of obligations between banks. This is particularly important in the reduction of insolvency risks. (4A-402)

• Banks are authorized to rely upon numbers used by customers to identify a beneficiary, even if there is a conflict with name. (4A-305)

• Banks can rely upon a message that tests against a security procedure unless a customer proves that a payment order was unauthorized and any breach of confidential security procedures was not the fault of the customer.
**FUTURE CHANGES IN OTHER ARTICLES OF THE CODE**

**Article 1 (General Provisions)**

During 1993, the Permanent Editorial Board issued a draft commentary on the meaning of the term "good faith" as used in the Code. The commentary has not yet been adopted. The essence of the commentary is that the "good faith" requirement of the Code does not support an independent cause of action where no other basis for a cause of action exists. Once adopted, no legislative action will be necessary. See KRS 355.1-110.

**Article 2 (Sale of Goods)**

A comprehensive redraft of Article 2 is being prepared following a study report and preliminary draft proposals. The primary changes will accommodate cases dealing with computer software and other intangible commercial property.

**Article 5 (Letters of Credit)**

A fifth discussion draft of amendments to the article on letters of credit is being circulated. The drafting committee has particularly worked to harmonize Article 5 with the Uniform Customs and Practices for Documentary Credits (500).

**Article 7 (Warehouse Receipts)**

The Uniform Commercial Code Committee of the American Bar Association formed an Article 7 Task Force in 1992, to consider the need for revisions.

**Article 8 (Securities)**

A final reading of draft amendments was expected before the National Conference of Commissioners on Uniform State Laws last summer. However, the time schedule has been pushed back. The primary changes address the indirect holding system for securities. The term "securities entitlement" is coined to deal with the interest in securities held by most customers of brokerage houses. The rules for priority in regard to security interest in securities are returned to Article 9. However, a special section, 8-502 would deal with purchase money interest in securities. A final draft is now expected this summer.

**Article 9 (Secured Transactions)**

A drafting committee has been appointed to consider a final report of the Article 9 Study Commission of the permanent Editorial Board on the Uniform Commercial Code. A massive Study Commission Report is available for those with incurable insomnia. There are no radical changes in the scope of Article 9. Some of the primary changes relate to remedies of both the secured party and the debtor. One proposed amendment does away with the absolute bar to a deficiency rule. Other amendments clear up the relation of
security interest in personal property to real property. Amendments are proposed to
make the filing system more accurate and fundamental.

REGULATION B-UPDATE

Section 223 of the Federal Deposit Insurance Corporation improvement act of 1991
amended the Equal Opportunity Act by adding a new section (e) to 15 USC 1691. The new
section requires a creditor to furnish to an applicant, upon the applicant’s request, a copy of any
appraisal report used by the creditor in connection with its evaluation of a loan secured by
residential real estate. At the creditor’s option, it may require reimbursement of the cost of the
appraisal from the applicant. The requirement applies to applicants whose applications are
rejected as well as those whose applications are accepted. Section 223 of F.D.I.C.I.A. became
effective December 19, 1991; however, the correspondent amendments to Regulation B of the
Federal Reserve Board were not published in the Federal Register until December 14, 1993.
The new portions of the regulation were effective that date; however, compliance is optional
until June 14, 1994.

Transactions Affected:

All loans (whether business or consumer) secured by a lien on a dwelling. Dwelling is
defined in the regulation as "a residential structure that contains one to four units whether or not
that structure is attached to real property. The term includes, but is not limited to, an individual
condominium or cooperative unit and a mobile or other manufactured home.

What Must Be Provided:

The documents relied upon by the creditor in evaluating the value of the dwelling,
collectively defined as an "appraisal report."

Compliance:
A creditor may routinely provide a copy of the appraisal report to an applicant (whether credit is granted or denied or the application is withdrawn)." Section 202.5(a)(1). If a creditor does not routinely provide appraisal reports, it shall provide a copy upon an applicant’s written request. If the creditor does not routinely provide appraisal reports, the applicant must be notified in writing of their right to receive an appraisal report. The notice may be given at any time during the application process but no later than when the creditor provides a notice of action. The notice must specify that the applicant’s request must be in writing, give the creditor’s mailing address, and state that the request must be received within 90 days after the creditor has provided notice of action taken on the application. The creditor must mail or deliver the copy of the appraisal report "promptly" after receiving the applicant’s request. The regulation defines promptly as "generally within 30 days." Mailing or delivery may also be contingent upon receipt of the report or receipt of reimbursement from the applicant.

Model Notice:

You have the right to a copy of the appraisal report used in connection with your application for credit. If you wish a copy, please write to us at the mailing address we have provided. We must hear from you no later than 90 days after we notify you about the action taken on your credit application or you withdraw your application.

Federal Reserve Form C-9.
Robert E. HOLT; Connie Holt; and  
Marion E. Holt, Appellants,  

v.  

The PEOPLES BANK OF MT.  
WASHINGTON, Appellee.  

No. 90-SC-0429-DG.  

Supreme Court of Kentucky.  


In action to recover deficiency judgment, the Circuit Court, Bullitt County, determined that secured party did not act in a reasonable commercial manner when, after repossession, it failed to timely dispose of truck which secured indebtedness. Diminution in value of vehicle was fixed at $1,439 and debtors were allowed a credit for such sum against amount of deficiency judgment entered in favor of creditor. On review from Court of Appeals, the Supreme Court, Lambert, J., held that secured party may present evidence as to amount of damage caused by its lack of commercial reasonableness in disposing of collateral and such sum will be deducted from deficiency.  

Affirmed.  

1. Secured Transactions 4=240  

Secured party who fails to give notice to debtor that collateral is about to be disposed denies debtor an opportunity to assert defenses, contest the amount claimed or pay any indebtedness prior to sale of the collateral; when notice is omitted, principle of estoppel prevents recovery of any deficiency judgment. KRS 355.9-504(3), 355.9-507.  

2. Secured Transactions 4=240  

It is presumed that collateral is worth at least the amount of debt it secures, and burden is cast upon secured party to prove that its commercial unreasonableness in
disposing of collateral did not result in diminished proceeds, or if it did, by what amount; upon failure of secured party to prove that his conduct did not diminish the proceeds, presumption that collateral is of sufficient value to satisfy the debt controls and claim for deficiency is forfeited; if, in such circumstances, secured party is unwilling to depend entirely upon contention, that its conduct did not result in diminished proceeds, it may present evidence as to amount of damage it caused and such sum will be deducted from the deficiency. KRS 355.9-504 et seq., 355.9-507.

John A. Schmidt, Shepherdsville, for appellants.

Joseph J. Wantland, Shepherdsville, for appellee.

LAMBERT, Justice.

The issue presented is whether any failure of a secured party to dispose of the collateral in a commercially reasonable manner necessarily results in a forfeiture of its right to a deficiency judgment. Decisions of the Court of Appeals of Kentucky in Bank Josephine v. Conn, Ky.App., 599 S.W.2d 773 (1980), Rexing v. Doug Evans Auto Sales, Inc., Ky.App., 703 S.W.2d 491 (1986), and Bailey v. Navistar Financial Corp., Ky.App., 709 S.W.2d 841 (1986), broadly hold that a secured party found to be in violation of the requirements of KRS 355.9-504 is estopped to claim entitlement to a deficiency judgment. Despite these decisions, in the instant case, the trial court and the Court of Appeals fashioned an equitable remedy which allowed the debtors a credit against the amount of the deficiency for the damage which resulted from the commercially unreasonable disposition of the collateral.

In the trial court it was determined that the secured party, appellee herein, did not act in a commercially reasonable manner when, after repossession, it failed to timely dispose of the truck which secured the indebtedness. Diminution in value of the vehicle, earlier appraised at $18,000—$19,000, was fixed at $1,439 and appellants were allowed a credit for this sum against the amount of the deficiency judgment entered in favor of appellee. In this Court there is no viable contention that the finding of commercial unreasonableness and the amount of loss occasioned thereby is clearly erroneous. CR 52.01.

Throughout this litigation, appellants have argued that the finding of commercial unreasonableness barred recovery of any deficiency judgment. The courts below rejected this contention, but failed to distinguish or adequately explain their failure to follow what appears to be controlling authority. See Bank Josephine v. Conn, supra, Rexing v. Doug Evans Auto Sales, Inc., supra, and Bailey v. Navistar Financial Corp., supra. The Court of Appeals simply said “[i]n light of the minimal decrease in value of the truck due to the bank’s action, it would not be fair to the bank to completely bar it from seeking a deficiency judgment.” Instead, the Court of Appeals adopted the view found in Wilson Leasing Co. v. Seaway Pharmacal Corp., 220 N.W.2d 83 (Mich.App.1974), which allows an offset for the damage caused by the secured party.

Prior to addressing the real issue, appellee has contended that the loss was occasioned by appellants’ own misconduct or that the trial court’s finding was clearly erroneous. This issue was settled against appellee in the Court of Appeals, “We cannot say then that the trial court’s finding that the bank did not act in a commercially reasonable manner is clearly erroneous,” and appellee’s failure to present the issue to this Court by means of a cross-motion for discretionary review precludes any further review. CR 76.21 and Commonwealth of Kentucky, Transportation Cabinet, Department of Highways v. Taub, Ky., 766 S.W.2d 49 (1989).

On the merits, appellee contends that if the debtor can prove damages occasioned by the secured party’s improper disposition of the collateral with reasonable certainty, such sum should be deducted from the amount of the deficiency judgment allowed. If such damages are not subject to reasonable calculation, appellee concedes that the
entire deficiency should be forfeited. While this view is not unappealing, in most cases it would provide little incentive to the secured party to strictly observe the requirements of KRS 355.9-504. In one study of repossession and resale of automobiles, the author concluded that the code procedure which permits recovery of deficiency provided a disincentive to the secured creditor to obtain the highest price and recommended elimination of all deficiency judgments in this context. Shuchman, "Profit on Default: An Archival Study of Automobile Repossession and Resale," 22 Stan.L.Rev. 20 (1969). If the approach urged by appellee was followed, in many cases a secured party would be entitled to ignore or circumvent the requirements of the law with no greater risk of loss than payment of that which its misconduct brought about. We considered a similar question in the context of bad faith refusal to pay insurance policy proceeds and held that an insurer should not be entitled to wrongfully withhold payment "with no greater possible detriment than payment of the amount justly owed plus interest." Curry v. Fireman's Fund Ins. Co., Ky., 784 S.W.2d 176 (1989). The analogy is appropriate. Duties arising under an insurance contract are consensual and the duties of a secured party are imposed by law. We decline to wholly adopt the approach urged by appellee.

The parties and the courts below have relied heavily upon the decisions of the Court of Appeals in Bank Josephine v. Conn, supra, Rexing v. Doug Evans Auto Sales, Inc., supra, and Bailey v. Navistar Financial Corporation, supra, cases in which the real controversy was whether the secured party breached its duty to act in a commercially reasonable manner, a question which is not before us now. It appears to have been conceded that upon such a determination, the doctrine of estoppel prevented recovery of a deficiency judgment. Whether the doctrine of estoppel arises to automatically forfeit a secured party's right to recover any deficiency judgment does not appear to have been the main event. For the proposition that any violation of commercial reasonableness results in the forfeiture, Rexing and Bailey rely exclusively on Bank Josephine, which relies exclusively on the common law doctrine of estoppel rather than a provision of the Uniform Commercial Code. In our view, estoppel was too broadly applied and should be limited as hereinafter explained.

Whether or to what extent a secured party should be denied a deficiency judgment upon a determination that it failed to act in a commercially reasonable manner is not clear in the Uniform Commercial Code. See J. White and R. Summers, Uniform Commercial Code, § 26-15 (1972). KRS 355.9-504 provides that the debtor is liable for any deficiency, but KRS 355.9-507 provides that the secured party is liable for any loss caused by its failure to comply with the requirements of KRS 355.9-504, et seq. In an effort to achieve a proper remedy, we have examined the approach taken by numerous state courts and various text writers. See generally, Annot., Improper Sale of Collateral—Judgment Bar, 10 A.L.R.4th 413, (1980), and J. White and R. Summers, Uniform Commercial Code, supra.

[1] At the outset, a distinction should be made between the failure to give pre-sale notice of the intended disposition of collateral and other acts of commercially unreasonable behavior. Notice to the debtor that the collateral is about to be disposed of is so fundamental that no remedy less severe than forfeiture of the deficiency amount would be adequate and this remedy is by no means exclusive. In a proper case, criminal and tort liability may be imposed and a debtor is entitled to the benefits of KRS 355.9-507. See J. White and R. Summers, Uniform Commercial Code, § 26-12, et seq. The essence of the notice requirement was explained in Bailey v. Navistar Financial Corporation, supra, as follows:

"The purpose of pre-sale notice is to give the debtor sufficient time to protect his interest in the collateral by participating in the sale, or by taking appropriate steps to oppose the sale. See KRS 355.9-504, Kentucky Commentary to subsection (3). Here, Bailey alleged that he
would have participated in or opposed the sale, and there is no evidence that his interests were protected by any other person or that he was not damaged by lack of notice." Bailey, supra, at 843.

A secured party who fails to give the notice required by KRS 355.9–504(3) denies the debtor an opportunity to assert defenses, contest the amount claimed or pay the indebtedness prior to sale of the collateral. The greatest protection available to debtors from unscrupulous conduct by secured parties who have repossessed collateral is notice of disposition of the collateral. When notice is omitted, the principle of estoppel hereinafter recognized by the courts of this Commonwealth prevents recovery of any deficiency judgment. Skeels v. Universal CIT Credit Corporation, 222 F.Supp. 696 (W.D.Pa.1963).

We now turn to the myriad of other circumstances in which the finding of commercial unreasonableness is based on some defect other than a failure to give notice. Three possible remedial formulas are described in D. Leibson and R. Nowka, The Uniform Commercial Code of Kentucky, § 8.6(G)(2) (1983). Having heretofore reaffirmed our reliance on the first of these when the defect is lack of notice but rejected it in other circumstances, the first approach need not be discussed further.

[2] The second and third approaches described by Professor Leibson and Nowka are substantially the same except as to the allocation of the burden of proof. In our view, the second approach is preferable. It begins with a presumption that the collateral is worth at least the amount of debt secured and the burden is cast upon the secured party to prove that its commercial unreasonableness did not result in diminished proceeds, or if it did, by what amount. Upon failure of the secured party to prove that its conduct did not diminish the proceeds, the presumption that the collateral is of sufficient value to satisfy the debt would control and the claim for deficiency would be forfeited. If, in such circumstances, a secured party is unwilling to depend entirely upon the view, if any, that its conduct did not result in diminished proceeds, it may present evidence as to the amount of damage it caused and such sum will be deducted from the deficiency. To avoid application of the presumption that the collateral is of sufficient value to satisfy the debt, a secured party whose conduct has been found to be commercially unreasonable must prove that its conduct did not cause damage or if it did, by what amount.

In the case at bar, the trial court determined that appellee failed to dispose of the collateral in a commercially reasonable manner and that this reduced its value in the sum of $1439. Appellants were given a credit for this sum in the trial court's deficiency judgment and this was affirmed by the Court of Appeals. While our reasoning may differ to some extent from that of the courts below, we are obliged to affirm if the result achieved was correct. Keese v. Smith, 289 Ky. 609, 159 S.W.2d 56 (1941), and Ritchie v. Perry County, 276 Ky. 57, 122 S.W.2d 988 (1938). While the burden of proof may not have been allocated precisely as we have directed, the result would have been the same and the error, if any, was harmless. CR 61.01.

One final issue merits brief discussion. It was contended in the courts below and at oral argument in this court that the discharge provisions of KRS 355.3–606(1)(b) operate to absolve appellant, Marion E. Holt, of liability. Of course, this necessarily depends on the view that said appellant was an accommodation party whether as maker or endorser. See Schmuckie v. Alvey, Ky., 758 S.W.2d 31 (1988). Appellants construe the statute too broadly, however, when they seek complete discharge of the accommodation party. The Court of Appeals correctly construed the statute when it granted relief "to the extent" the collateral was unjustifiably impaired. Appellant, Marion E. Holt, along with the other appellants, was benefited by the credit allowed for the diminished value resulting from the commercially unreasonable conduct of appellee.

We affirm.

All concur.

K - 22
EMPLOYMENT LAW ISSUES
IN A TIME OF
DOWNSIZING AND STAFF CONSOLIDATIONS

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Pages 1-16 only
Employment Law Issues
In A Time Of Downsizing
And Staff Consolidations

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SECTION L
Depressed economic conditions, recent technological developments, business restructuring, financial losses and a whole host of variables frequently cause employers to make reductions in force. In these instances, employers must be cognizant of the requirements of the Workers Adjustment and Retraining Notification Act (WARN), and the Age Discrimination in Employment Act (ADEA), which protects employees over the age of 40.

If the reduction disproportionately affects employees within the protected age group, groups of such employees and/or individual employees may believe the reduction in force was prompted to get rid of older workers to bring in younger workers in the future. Thus, any reduction in force raises the prospect of affected employees filing age discrimination claims. Therefore, when an employer contemplates reductions in force, it must exercise caution to avoid ADEA violations and violation of the WARN Act.

I. GENERAL SCOPE AND PROHIBITIONS OF ADEA

A. Coverage

(i) ADEA applies to all employers who are "engaged in an industry affecting commerce" and who have twenty or more employees. (29 USC §630); and

(ii) ADEA protects anyone who has attained at least age 40. (29 USC §631)
B. Prohibitions

Employers are prohibited from discriminating against any employee over the age of 40 in employment decisions including hiring, promotions, work assignments, compensation, and terms and conditions of employment. In addition employers shall not limit, segregate or classify employees in a way which would deprive or tend to deprive any individual of employment opportunities because of such individual's age. (29 USC §623)

C. Proof

(i) Prima Facie Case

With respect to a reduction in force, to establish a prima facie case, the employee must establish (l) that he/she is a member of the protected age class; (2) that he/she is qualified for the available position;(3) that he/she was terminated; and (4) he/she must provide circumstantial or direct evidence that the employer intended to discriminate in reaching its reduction decisions. Mauter v. Hardy Corp., 825 F2d 1554 (11th Cir., 1987).

Prima facie case of discriminatory impact may be established by showing that an employer's facially neutral practice has a disparate impact on members of plaintiff's class. Geller v. Markham 24 FEP Cases 920 (1980).

(ii) Defenses

(a) Legitimate non-discriminatory reasons

(b) Job related policy
(c) Statutory exemption or exception
- BFOQ: Bona fide occupational qualification
- Differentiations based on reasonable factors other than age
  [29 USC §623(f)(1)]
- Observation of the terms of a bona fide seniority system
  that is not intended to evade the Act [29 USC
  §623(f)(2)(A)]
- Observation of the terms of a bona fide employee benefit
  plan [29 USC §623(f)(2)(B)]

D. Remedies

ADEA specifically authorizes the courts to grant prevailing plaintiffs "such
legal or equitable relief as may be appropriate to effectuate the purposes of " the Act. 29
USC §626(b). Courts have held that such relief includes back pay, reinstatement,
promotions, liquidated damages, attorneys' fees, costs, injunctive relief and criminal
penalties.

II. PLANNING AND IMPLEMENTING A REDUCTION IN FORCE

A. Consideration of Alternatives to Discharge or Layoff

Before an employer makes a final decision to make a reduction in staff,
other less burdensome alternatives should be explored. Exploring alternatives to reduction
in force is most effective when the magnitude of the anticipated reduction is relatively
small. Even when a relatively large layoff or reduction is planned, the use of several
alternatives may be effective to reduce the size of employee displacement.
However, to the extent alternatives are helpful in addressing the employers needs, they should be utilized. In defending a civil action based on age discrimination, the fact that the employer considered and/or adopted alternatives to staff reductions lends credence to the employers argument that it sought to protect its employees to the extent possible. Before reducing its workforce, an employer might consider the feasibility and/or appropriateness of personnel alternatives including:

--Hiring and Recruitment Freeze

--Reduction of work force through attrition

--Part time positions

--Freeze on Pay Raises

--Examination of unit and Department Budgets

--Pay Reductions

--Reassigning displaced workers to other jobs within the company

* --Voluntary Early Retirement*

*Note: Many believe that this option creates more problems than it solves. Employees within the protected age group represent the greatest concern in these endeavors. Many view "voluntary" early retirement options as dangerous because of the hidden ADEA pitfalls. The issue usually turns on whether or not the choice was actually "voluntary". And, in reduction in force situations, the issue is also whether or not the employer targeted older workers and forced them into retirement.

If an employer does utilize voluntary early retirement to diminish or avoid reduction in force, the employer should offer the option to all eligible employees before particular job functions are targeted for reduction.

Although waivers have been effective in protecting employers from liability under ADEA, waivers have been the source of much litigation under ADEA. To withstand judicial review, the waiver must: (1) be written in language easily understood; (2) not allow employee to waive or release future claims which may arise after the date of the agreement; (3) be given in exchange for consideration beyond other benefits to which the employee is already entitled; (4) make specific reference to rights and claims under ADEA; (5) give the employee a reasonable time period in which to consider and review the document (21 days); (6) advise the employee to seek the advice of an attorney; and (7) allow the employee at least 7 days within which to revoke the agreement after it is signed.
Documentation of alternatives is essential to an employer in the event of a civil action based on age discrimination. And, remember, the larger the number of employees affected by a reduction in force, the higher the probability of a civil action being filed under ADEA since reductions virtually always include some persons age 40 or over.

B. Establishing Business Justifications for Staff Reductions

Courts generally defer to employer's business justifications in cases of reduction in force, so long as the actions are carried out in a non-discriminatory manner and the reasons are not pretext for age discrimination. The U.S. Court of Appeals at Richmond denied an age discrimination claim from older employees who were demoted in a reduction in force, finding that the employer "attempted to achieve its overall reduction in force objectives in a fair and legitimate way and the employer's reasons were grounded on qualifications and geographical considerations". EEOC v. Western Electric Co., 32 FEP Cases 708, 712 (1983). Legitimate business reasons for reductions in force are numerous, but typically include technological advances, financial problems, turn down in business and reorganization. Also, See Chappell v. GTE Prods. Corp., 803 F2d 261 (6th Cir. 1986); Bechold v. IGW Sys. Inc., 817 F2d 1282 (7th Cir. 1987) and Tice v. Lampert Yards, Inc., 761 F2d 1210 (7th Cir., 1985).

The identification of a legitimate business justification is crucial evidence to show the relationship of the particular layoff to a valid business objective. The Court in Sahadi v. Reynolds Chem., held that ".a prima facie case of age discrimination is not shown by mere termination of a competent employee where it is shown that an employer is making cutbacks due to economic necessity." 636 F2d 1116, 1118 (6th Cir., 1980).
While no action taken by an employer making personnel decisions that result in reduction in force will guarantee that no civil action will be filed, proper actions taken by such an employer will minimize the prospect of such actions and will increase the probability of a favorable outcome for the employer.

C. Essential Tools For The Evaluation Process

(i) Workforce Statistical Analysis

An employer considering a reduction in force should make a determination of the race, sex and age distribution of all employees in the company. Next, a similar analysis should be made with respect to the facilities and/or departments to be affected by the reduction. This information is necessary for the employer to evaluate the impact of its reduction decisions. If patterns of disparate impact on older workers are detected, the employer can reexamine the process for bias and take corrective action when necessary.

This statistical information should not be shared with decision-makers in the reduction process, as this would afford a plaintiff an opportunity to allege that the decision-maker did in fact base the decision on race, sex or age. Before reduction decisions are final, top-management should use this statistical data to determine the effect of planned reduction decisions.

(ii) Job-Function Evaluation

The next step in implementing a selection and evaluation process to facilitate force reduction is the identification by management of the particular operations of the employer that will be curtailed or eliminated. Management should also determine which jobs within the identified operations would be subject to cutback. Finally,
management must decide which functions within jobs must be curtailed or eliminated. Further consideration should be given to whether new functions will be performed by the employer and whether these new functions can be absorbed by present employees who otherwise would face layoff or termination.

A review of the job functions in the different departments will be necessary to determine the qualifications required to perform these jobs. Evidence that the employer made a determination of the qualifications required to perform the retained jobs will help prove that those employees laid off or terminated as a result of the reduction in force were less qualified to fill the positions than those employees retained.

In some cases, plaintiffs can establish a prima facie case of discrimination by showing that a policy underlying a layoff disproportionately affected employees within the protected age group. Geller v. Markham, 24 FEP Cased 920 (1980). An employer's defense can be buttressed by this type of job function evaluation, which objectively determines necessary qualifications.

(iii) **Employee Appraisal Criteria**

Since the lack of qualifications by an employee to perform a particular job is a sound defense to a legal challenge, it is vital that the criteria used to evaluate employees be objective and job-related. Again, the aim or purpose of employee evaluations is to establish a basis to show that those employees laid off or terminated were less qualified for the available positions than those retained.

Job-related criteria includes: knowledge of a particular job function (Matthews v. Allis-chalmers, 769 F2d 1215, (7th Cir., 1985); quality of work supported by
records; past performance evaluations, if based on objective criteria (Mistretta v. Sandia Corp., 15 FEP Cases 1690, (1977); education; training if training was available to all employees equally; attendance, test scores, length of service with employer (Gill v. Union Carbide, 368 F. Supp. 364, (1973).

(iv) Market Conditions

Market conditions should be studied prior to any use of criteria based on salary. It is best to avoid salary as a criteria for evaluation in the reduction process. Some courts might find salary inextricably tied to the age of an employee. (Poklitar v. CBS, Inc. 652 F. Supp. 1023 (SDNY 1987). Metz v. Transit Mix, 44 FEP Cases 1339, (1989).

However, the U.S. Court of Appeals at New York in Bay v. Times Mirror Magazines, 56 FEP Cases 407 (1991) found that during cutbacks, ADEA does not "... prohibit an employer from making employment decisions that relate to an employee's salary to contemporaneous market conditions ... so long as the employer's decisions view each employee individually ... do not impose a general role that has a disparate impact on older workers and are based solely on financial considerations ..." 56 FEP Cases 407, 411.

(v) Consultant Guidelines

In reduction in force cases involving a significant number of employees, an outside consultant familiar with the industry might be hired to help develop job-related evaluation guidelines. The use of a consultant would further underscore the
job-relatedness of the evaluation criteria and help defeat a prima facie case of age
discrimination based on the disproportionate impact of the criteria.

D. The Evaluation Process

Once management has determined which job functions are essential to the
remaining operations of the employer and has determined the qualifications necessary for
these jobs; and management has developed appropriate job-related criteria to evaluate
employees, the next step involves the actual evaluation of employees.

(i) Role of Department Heads and Supervisors

Employee evaluations should be performed by department heads
and first line supervisors who have been trained on how to properly apply the developed
criteria and to maintain the necessary records. Ratings of employees should be done on a
comparative basis so that department heads and supervisors are forced to actually rank all
employees relative to each other.

Supervisors and department heads should be cautioned against
making any statements, comments or remarks relative to age. Although such comments or
remarks alone are insufficient to prove an age discrimination case, courts will allow
plaintiffs to introduce evidence of such comments to show that a policy underlying a staff
reduction is based on discrimination. Naton v. Bank of Cal., 649 F2d 691 (9th Cir.,
(ii) **Reduction in Force Committee**

If the reduction in force involves a significant number of employees, an additional review of employee appraisals is worthwhile. This can be accomplished by establishing a Reduction in Force (RIF) Committee. This is an internal committee comprised of management and non-management personnel, including representatives of all protected groups. The review conducted by this Committee should include a comparison between each employee's previous evaluation and the reduction evaluation. Discrepancies should be resolved and any significant changes should be based on legitimate grounds. More importantly, this Committee's review should determine the impact of the reduction on all employees and groups of employees over the age of 40. The review should not confine its impact analysis to the single group of employees over 40, but should look for patterns of impact on groups within the protected age group (i.e. age 50 or above; age 60 or above, etc.). *Mistretta v. Sandia Corp.*, 15 FEP Cases 1690 (1977) and *Lowe v. Commack Union School District*, 50 FEP Cases 1400, (1989) Also, See EEOC Interpretations of ADEA, 29 CFR §1625.2

If an adverse impact is observed, the evaluation of each employee in that particular age group should be reexamined to ensure that the evaluations are based on job-related factors. The employer must be able to substantiate its decision on legitimate grounds.

E. **Notice to Employees**

The final step in the reduction in force process, is employee notification. To be more humane, notification should be given in a meeting with the employee. The employer should establish guidelines to be used by individuals conducting the notification.
meetings. These guidelines should be written; should cover the issues common to all employees; and should provide information on how the selection process works. Further, the individual conducting the notification meeting should be able to inform the employees of how and why job functions were eliminated or curtailed. Employees should then be told how their individual evaluations were made and in what ways their performance was less than other employees who were retained.

During this meeting management might solicit comments or input from employees affected by the reduction.

The notification meetings should be limited to conveying the essential information to employees and should avoid gratuitous remarks referencing age (e.g. "You've had a number of good years here"; or, "you will not suffer much because you are eligible for early retirement").

If the employer is subject to the WARN Act, there are precise notification requirements discussed later in this outline.

F. Appeal Process

As a final check and balance of the reduction in force process, an employer might also consider providing affected employees with an appeal process. This process need not be complex to be effective. The scope of the appeal could be tailored to the number of affected employees, with a more thorough process used when significant numbers of the workforce are affected. The RIF Committee could function in an appeals capacity. Or, the employer might use members of higher management to review employee appeals.

Giving employees advanced notice of the possibility of a reduction in force and establishing an approach that: considers reduction alternatives; determines necessary
job functions and qualifications, evaluates employees based on job-related criteria and provides for reexamination of employee reviews, has many advantages. First, it forces the employer to document and substantiate the reasons for termination or layoff. And, it assures that uniform criteria are uniformly applied to all employees. This process will boost employee morale by demonstrating fairness and will create a strong psychological effect that will help deter lawsuits.

III. WORKER ADJUSTMENT AND RETRAINING NOTIFICATION ACT

The Worker Adjustment and Retraining Notification Act (WARN), commonly referred to as the Plant Closing Act, was enacted by Congress in 1988 and took effect February 4, 1989. (29 USC §2101 et seq.). Congress enacted this legislation in response to concerns arising out of unannounced plant closings and mass layoffs.

Though commonly known as the Plant Closing Act, WARN in fact applies to situations other than plant closings. Any employer who is shutting down a unit or facility within a plant or site of employment, or who is laying off a significant number of employees at a single site of employment, must comply with the notice requirements mandated by the WARN Act.

A. Requirements

The basic requirement of the WARN Act is for all employers subject to the Act to give sixty days' advance written notice of shutdowns or mass layoffs. This notice must be given to: (1) the bargaining representative of the affected employees, or absent such representative, each individual employee; (2) the local community where the work
force reduction is to take place; and (3) to the state dislocated workers unit. 29 USC §2102 (a)(1) and (2)

The Act contains exceptions to the sixty days advance notice requirement where the employer can show that at the time of plant closing the employer was actively seeking capital or business to avoid a plant closing; or the employer must show that the circumstances necessitating the closing or layoff were "not reasonably foreseeable" as of the time notice should have been given. 29 USC §2102(b)(1) and (2).

B. Coverage

The Act covers all employers with more than 100 employees at all sites combined. Part-time employees are excluded from this definition 29 USC §2101(a)(1)(A) and (B). "Part-time" employee is defined in the Act as "an employee who is employed for an average of fewer than 20 hours per week or who has been employed for fewer than 6 of the 12 months preceding the date on which notice is required". 29 USC §2101(a)(8).

The Act defines a "plant closing" as "the permanent or temporary shutdown of a single site of employment, or one or more facilities or operating units within a single site of employment, if the shutdown results in an employment loss at the single site of employment during any 30-day period for 50 or more employees excluding any part-time employees" 29 USC §2101(a)(2).

The statute defines "mass layoff" as "a reduction in force which is not the result of a plant closing; and results in an employment loss at the single site of employment during any 30 day period for at least 33 percent of the employees and at least 50 employees or at least 500 employees. 29 USC §2101(a)(3)(A)and (B).
The Act defines "employment loss" as (A) any employment termination, other than a discharge for cause, voluntary departure, or retirement, (B) a layoff exceeding 6 months, or (C) a reduction in hours of work of more than 50 percent during each month of any 6-month period. 29 USC §2101(1)(b).

An employee has not suffered an employment loss if the employer has offered him/her a transfer to a different site of employment within a reasonable commuting distance with no more than a six-month break in employment or if the employer offers to transfer the employee anywhere with no more than a six-months break, and the employee accepts within thirty days of the offer or of the closing or layoff, whichever is later. No employment loss has occurred in this instant, therefore notice is not required. 29 USC §2101(b)(2)(A) and (B).

Thus, under the definition of "employment loss", a bargaining representative or in the absence thereof, an employee terminated or otherwise displaced as a result of reduction in force is entitled to the required advanced written notice, if all of the above mentioned jurisdictional requirements are met.

C. Exemptions

The Act exempts from its coverage temporary facilities, and the completion of a particular project or undertaking. However, to escape the notice requirements under these circumstances, the employer must show that the employee was hired with the understanding that the employment was limited to the duration of the facility or project. 29 USC §2103(1)
Strikes and lockouts will also negate an employer's responsibility to give notice under this act, if the closing or layoff is caused by the strike or lockout. 29 USC §2103 (2).

D. Contents of Written Notice

The regulations requires that notices of layoffs and plant closings be specific. 20 CFR §639.7. Notices to representatives of affected employees must contain the name and address of the employment site; the nature of the planned action and whether it is expected to be permanent or temporary; if the entire plant is to be closed, a statement to that effect; the expected date of the first separation and the schedule for making separations; the job titles of positions to be affected and the names of the people currently holding those jobs; and the name and telephone number of an employer official to contact for further information.

Notices to individual employees, absent a collective bargaining agreement, must contain a statement as to whether the planned action is expected to be temporary or permanent and whether the entire plant is to be closed; the expected date when the plant closing or mass layoff will begin; the expected date when the individual employee will be separated; a statement on the existence of applicable bumping rights; and the name and telephone number of an employer official to contact for further information.

The regulations also suggest that employers include in these notices other useful information such as the availability of retraining assistance and other assistance for dislocated workers.
E. Enforcement

The WARN Act may be enforced in court by individual employees, their representatives, or local units of government. A person seeking to enforce the WARN Act may sue for him or herself or on behalf of a class in any U.S. district court in which the violation is alleged to have occurred or in which the employer transacts business. 29 USC §2104(a)(5).

Thus, while the Act authorizes the Department of Labor to issue regulations interpreting the WARN Act, no federal government agency has enforcement power to process claims by aggrieved employees.

F. Remedies

An employer who violates the WARN Act is liable to each aggrieved employee for back pay for each day of violation and any benefits available under an employee benefit plan, up to a maximum of sixty days but in no event for more than one half the number of days the employee was employed by the employer. The amount of back pay is reduced by any wages that were paid during the period of violation, any voluntary payment of the employer that is not required by any legal obligation, and any payment by the employer to a third party or trustee attributable to the employee, such as premiums for health benefits. 29 USC §2104(a).

The Act specifically states that the remedies provided for in this Act shall be the exclusive remedies for any violation of the Act. Federal courts are specifically prohibited from enjoining a plant closing or mass layoff. 29 USC §2104(b).
Age Discrimination in Employment Act of 1967


AGE DISCRIMINATION IN EMPLOYMENT ACT

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Sec. 621. Statement of Findings and Purpose

(a) The Congress hereby finds and declares that—
(1) in the face of rising productivity and affluence, older workers find themselves disadvantaged in their efforts to retain employment, and especially to regain employment when displaced from jobs;
(2) the setting of arbitrary age limits regardless of potential for job performance has become a common practice, and certain otherwise desirable practices may work to the disadvantage of older persons;
(3) the incidence of unemployment, especially long-term unemployment with resultant deterioration of skill, morale, and employer acceptability is, relative to the younger ages, high among older workers; their numbers are great and growing; and their employment problems grave;
(4) the existence in industries affecting commerce, of arbitrary discrimination in employment because of age, burdens commerce and the free flow of goods in commerce.

(b) It is therefore the purpose of this chapter to promote employment of older persons based on their ability rather than age; to prohibit arbitrary age discrimination in employment; to help employers and workers find ways of meeting problems arising from the impact of age on employment.

[Editor's note: The Older Workers Benefit Protection Act, P.L. 101-433, effective October 16, 1990, provided as follows:
Sec. 101. Finding
The Congress finds that, as a result of the decision of the Supreme Court in Public Employees Retirement System of Ohio v. Betts, 109 S.Ct. 256 (1989), legislative action is necessary to restore the original congressional intent in passing and amending the Age Discrimination in Employment Act of 1967 (29 U.S.C. 621 et seq.), which was to prohibit discrimination against older workers in all employee benefits except when age-based reductions in employee benefit plans are justified by significant cost considerations.]

Sec. 622. Education and Research Program

(a) The Secretary of Labor shall undertake studies and provide information to labor unions, management, and the general public concerning the needs and...
abilities of older workers, and their potentials for continued employment and contribution to the economy. In order to achieve the purposes of this chapter, the Secretary of Labor shall carry on a continuing program of education and information, under which he may, among other measures—

(1) undertake research, and promote research, with a view to reducing barriers to the employment of older persons, and the promotion of measures for utilizing their skills;

(2) publish and otherwise make available to employers, professional societies, the various media of communication, and other interested persons the findings of studies and other materials for the promotion of employment;

(3) foster through the public employment service system and through cooperative effort the development of facilities of public and private agencies for expanding the opportunities and potentials of older persons;

(4) sponsor and assist State and community informational and educational programs.

(b) Not later than six months after the effective date of this chapter, the Secretary shall recommend to the Congress any measures he may deem desirable to change the lower or upper age limits set forth in section 631 of this title.

Sec. 623. Prohibition of Age Discrimination

(a) Employer practices

It shall be unlawful for an employer—

(1) to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's age;

(2) to limit, segregate, or classify his employees in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's age; or

(3) to reduce the wage rate of any employee in order to comply with this chapter.

(b) Employment agency practices

It shall be unlawful for an employment agency to fail or refuse to refer for employment, or otherwise to discriminate against, any individual because of such individual's age, or to classify or refer for employment any individual on the basis of such individual's age.

(c) Labor organization practices

It shall be unlawful for a labor organization—

(1) to exclude or to expel from its membership, or otherwise to discriminate against, any individual because of his age;

(2) to limit, segregate, or classify its membership, or to classify or fail or refuse to refer for employment any individual, in any way which would deprive or tend to deprive any individual of employment opportunities, or would limit such employment opportunities or otherwise adversely affect his status as an employee or as an applicant for employment, because of such individual's age;

(3) to cause or attempt to cause an employer to discriminate against an individual in violation of this section.

(d) Opposition to unlawful practices; participation in investigations, proceedings, or litigation

It shall be unlawful for any employer to discriminate against any of his employees or applicants for employment, for an employment agency to discriminate against any individual, or for a labor organization to discriminate against any member thereof or applicant for membership, because such individual, member, or applicant for membership, has opposed any practice made unlawful by this section, or because such individual, member, or applicant for membership has made a charge, testified, assisted, or participated in any manner in an investigation, proceeding, or litigation under this chapter.
(e) Printing or publication of notice or advertisement indicating preference, limitation, etc.

It shall be unlawful for an employer, labor organization, or employment agency to print or publish, or cause to be printed or published, any notice or advertisement relating to employment by such an employer or membership in or any classification or referral for employment by such a labor organization, or advertising for employment by such an employment agency, indicating any preference, limitation, specification, or discrimination, based on age.

(f) Lawful practices; age an occupational qualification; other reasonable factors; laws of foreign workplace; seniority system; employee benefit plans; discharge or discipline for good cause

It shall not be unlawful for an employer, employment agency, or labor organization—

(1) to take any action otherwise prohibited under subsection (a), (b), (c), or (e) of this section where age is a bona fide occupational qualification reasonably necessary to the normal operation of the particular business, or where the differentiation is based on reasonable factors other than age or where such practices involve an employee in a workplace in a foreign country, and compliance with such subsections would cause such employer, or a corporation controlled by such employer, to violate the laws of the country in which such workplace is located;

(2) to take any action otherwise prohibited under subsection (a), (b), (c), or (e) of this section—

(A) to observe the terms of a bona fide seniority system that is not intended to evade the purposes of this chapter, except that no such seniority system shall require or permit the involuntary retirement of any individual specified by section 631(a) of this title because of the age of such individual; or

(B) to observe the terms of a bona fide employee benefit plan—

(i) where, for each benefit or benefit package, the actual amount of payment made or cost incurred on behalf of an older worker is no less than that made or incurred on behalf of a younger worker, as permissible under section 1625.10, title 29, Code of Federal Regulations (as in effect on June 22, 1989); or

(ii) that is a voluntary early retirement incentive plan consistent with the relevant purpose or purposes of this chapter.

Notwithstanding clause (i) or (ii) of subparagraph (B), no such employee benefit plan or voluntary early retirement incentive plan shall excuse the failure to hire any individual, and no such employee benefit plan shall require or permit the involuntary retirement of any individual specified by section 631(a) of this title, because of the age of such individual. An employer, employment agency, or labor organization acting under subparagraph (A), or under clause (i) or (ii) of subparagraph (B), shall have the burden of proving that such actions are lawful in any civil enforcement proceeding brought under this chapter; or (As amended by the Older Workers Benefit Protection Act, eff. Oct. 16, 1990)

(3) to discharge or otherwise discipline an individual for good cause.

[Editor's note: Paragraph (g), Entitlement to coverage under group health plan, was repealed by P.L. 101-239, effective December, 19, 1989.]

(h) Practices of foreign corporations controlled by American employers; foreign persons not controlled by American employers; factors determining control

(1) If an employer controls a corporation whose place of incorporation is in a foreign country, any practice by such corporation prohibited under this section shall be presumed to be such practice by such employer.

(2) The prohibitions of this section shall not apply where the employer is a
foreign person not controlled by an American employer.

(3) For the purpose of this subsection the determination of whether an employer controls a corporation shall be based upon the—

(A) interrelation of operations,

(B) common management,

(C) centralized control of labor relations, and

(D) common ownership or financial control, of the employer and the corporation. (As added by P.L. 98-459, eff. Oct. 9, 1984)

(i) Employee pension benefit plans; cessation or reduction of benefit accrual or of allocation to employee account; distribution of benefits after attainment of normal retirement age; compliance; highly compensated employees (As amended by the Older Workers Benefit Protection Act, eff. Oct. 16, 1990)

(1) Except as otherwise provided in this subsection, it shall be unlawful for an employer, an employment agency, a labor organization, or any combination thereof to establish or maintain an employee pension benefit plan which requires or permits—

(A) in the case of a defined benefit plan, the cessation of an employee’s benefit accrual, or the reduction of the rate of an employee’s benefit accrual, because of age, or

(B) in the case of a defined contribution plan, the cessation of allocations to an employee’s account, or the reduction of the rate at which amounts are allocated to an employee’s account, because of age.

(2) Nothing in this section shall be construed to prohibit an employer, employment agency, or labor organization from observing any provision of an employee pension benefit plan to the extent that such provision impose, (without regard to age) a limitation on the amount of benefits that the plan provides or a limitation on the number of years of service or years of participation which are taken into account for purposes of determining benefit accrual under the plan.

(3) In the case of any employee who, as of the end of any plan year under a defined benefit plan, has attained normal retirement age under such plan—

(A) if distribution of benefits under such plan with respect to such employee has commenced as of the end of such plan year, then any requirement of this subsection for continued accrual of benefits under such plan with respect to such employee during such plan year shall be treated as satisfied to the extent of the actuarial equivalent of in-service distribution of benefits, and

(B) if distribution of benefits under such plan with respect to such employee has not commenced as of the end of such year in accordance with section 1056(a)(3) of this title [Employee Retirement Income Security Act of 1974] and section 401(a)(14)(C) of title 26 [Internal Revenue Code of 1986], and the payment of benefits under such plan with respect to such employee is not suspended during such plan year pursuant to section 1053(a)(3)(B) of this title [Employee Retirement Income Security Act of 1974] or section 411(a)(3)(B) of title 26 [Internal Revenue Code of 1986], then any requirement of this subsection for continued accrual of benefits under such plan with respect to such employee during such plan year shall be treated as satisfied to the extent of any adjustment in the benefit payable under the plan during such plan year attributable to the delay in the distribution of benefits after the attainment of normal retirement age.

The provisions of this paragraph shall apply in accordance with regulations of the Secretary of the Treasury. Such regulations shall provide for the application of the preceding provisions of this paragraph to all employee pension benefit plans subject to this subsection and may provide for the application of such provisions, in the case of any such employee, with respect to any period of time within a plan year.
(4) Compliance with the requirements of this subsection with respect to an employee pension benefit plan shall constitute compliance with the requirements of this section relating to benefit accrual under such plan.

(5) Paragraph (1) shall not apply with respect to any employee who is a highly compensated employee (within the meaning of section 414(q) of title 26 [Internal Revenue Code of 1986]) to the extent provided in regulations prescribed by the Secretary of the Treasury for purposes of precluding discrimination in favor of highly compensated employees within the meaning of subchapter D of chapter 1 of title 26.

(6) A plan shall not be treated as failing to meet the requirements of paragraph (1) solely because the subsidized portion of any early retirement benefit is disregarded in determining benefit accruals.

(7) Any regulations prescribed by the Secretary of the Treasury pursuant to clause (v) of section 411(b)(1)(H) of title 26 and subparagraphs (C) and (D) of section 411(b)(2) of such title 26 shall apply with respect to the requirements of this subsection in the same manner and to the same extent as such regulations apply with respect to the requirements of such sections 411(b)(1)(H) and 411(b)(2).

(8) A plan shall not be treated as failing to meet the requirements of this section solely because such plan provides a normal retirement age described in section 1002(24)(B) of this title [Employee Retirement Income Security Act of 1974] and section 411(a)(8)(B) of title 26. [Internal Revenue Code of 1986]

(9) For purposes of this subsection—
(A) The terms "employee pension benefit plan", "defined benefit plan", "defined contribution plan", and "normal retirement age" have the meanings provided such terms in section 1002 of this title. [Employee Retirement Income Security Act of 1974]

(B) The term "compensation" has the meaning provided by section 414(s) of title 26. [Internal Revenue Code of 1986]

(Added by P.L. 99-509, effective with respect to plan years starting on or after Jan. 1, 1988. For collectively bargained plans, it is effective on the earlier of (1) Jan. 1, 1990 or (2) the later of Jan. 1, 1988 or the expiration date of the last contract.)

(j) Employment as firefighter or law enforcement officer

(i) It shall not be unlawful for an employer which is a State, a political subdivision of a State, an agency or instrumentality of a State or a political subdivision of a State, or an interstate agency to fail or refuse to hire or to discharge any individual because of such individual's age if such action is taken—

(1) with respect to the employment of an individual as a firefighter or as a law enforcement officer and the individual has attained the age of hiring or retirement in effect under applicable State or local law on March 3, 1983, and

(2) pursuant to a bona fide hiring or retirement plan that is not a subterfuge to evade the purposes of this chapter. (Added by P.L. 99-592, eff. Jan. 1, 1987, through Dec. 31, 1993)

[Editor's note: The above section does not apply to any causes of action arising under ADEA before Jan. 1, 1987. Section 5 of P.L. 99-592 directed EEOC and the Labor Department to conduct a study and make recommendations on the use of physical and mental fitness tests to measure the ability and competence of police officers and firefighters. In addition, by Nov. 1991, EEOC must propose guidelines for the administration and use of such tests.]

(k) Seniority system or employee benefit plan; compliance

A seniority system or employee benefit plan shall comply with this chapter regardless of the date of adoption of such system or plan. (As added by the Older Workers Benefit Protection Act, eff. Oct. 16, 1990)

(l) Lawful practices; minimum age as condition of eligibility for retirement
benefits; deductions from severance pay; reduction of long-term disability benefits

Notwithstanding clause (i) or (ii) of subsection (f)(2)(B) of this section—

(1) It shall not be a violation of subsection (a), (b), (c), or (e) of this section solely because—

(A) an employee pension benefit plan (as defined in section 1002(2) of this title [Employee Retirement Income Security Act of 1974]) provides for the attainment of a minimum age as a condition of eligibility for normal or early retirement benefits; or

(B) a defined benefit plan (as defined in section 1002(35) of this title) provides for—

(i) payments that constitute the subsidized portion of an early retirement benefit; or

(ii) social security supplements for plan participants that commence before the age and terminate at the age (specified by the plan) when participants are eligible to receive reduced or unreduced old-age insurance benefits under title II of the Social Security Act (42 U.S.C. 401 et seq.), and that do not exceed such old-age insurance benefits.

(2)(A) It shall not be a violation of subsection (a), (b), (c), or (e) of this section solely because following a contingent event unrelated to age—

(i) the value of any retiree health benefits received by an individual eligible for an immediate pension;

(ii) the value of any additional pension benefits that are made available solely as a result of the contingent event unrelated to age and following which the individual is eligible for not less than an immediate and unreduced pension; or

(iii) the values described in both clauses (i) and (ii); are deducted from severance pay made available as a result of the contingent event unrelated to age.

(B) For an individual who receives immediate pension benefits that are actuarially reduced under subparagraph (A)(i), the amount of the deduction available pursuant to subparagraph (A)(i) shall be reduced by the same percentage as the reduction in the pension benefits.

(C) For purposes of this paragraph, severance pay shall include that portion of supplemental unemployment compensation benefits (as described in section 501(c)(17) of title 26 [Internal Revenue Code of 1986]) that—

(i) constitutes additional benefits of up to 52 weeks;

(ii) has the primary purpose and effect of continuing benefits until an individual becomes eligible for an immediate and unreduced pension; and

(iii) is discontinued once the individual becomes eligible for an immediate and unreduced pension.

(D) For purposes of this paragraph and solely in order to make the deduction authorized under this paragraph, the term "retiree health benefits" means benefits provided pursuant to a group health plan covering retirees, for which (determined as of the contingent event unrelated to age)—

(i) the package of benefits provided by the employer for the retirees who are below age 65 is at least comparable to benefits provided under title XVIII of the Social Security Act (42 U.S.C. 1395 et seq.);

(ii) the package of benefits provided by the employer for the retirees who are age 65 and above is at least comparable to that offered under a plan that provides a benefit package with one-fourth the value of benefits provided under title XVIII of such Act; or

(iii) the package of benefits provided by the employer is as described in clauses (i) and (ii). (As amended by P.L. 101-521, eff. Nov. 5, 1990)

(E)(i) If the obligation of the employer to provide retiree health benefits is of limited duration, the value for each individual shall be calculated at a rate of $3,000 per year for benefit years before age 65, and $750 per year for benefit years beginning at age 65 and above.

(ii) If the obligation of the employer to provide retiree health benefits is of un-
limited duration, the value for each individual shall be calculated at a rate of $48,000 for individuals below age 65, and $24,000 for individuals age 65 and above.

(iii) The values described in clauses (i) and (ii) shall be calculated based on the age of the individual as of the date of the contingent event unrelated to age. The values are effective on October 16, 1990, and shall be adjusted on an annual basis, with respect to a contingent event that occurs subsequent to the first year after October 16, 1990, based on the medical component of the Consumer Price Index for all-urban consumers published by the Department of Labor.

(iv) If an individual is required to pay a premium for retiree health benefits, the value calculated pursuant to this subparagraph shall be reduced by whatever percentage of the overall premium the individual is required to pay.

(F) If an employer that has implemented a deduction pursuant to subparagraph (A) fails to fulfill the obligation described in subparagraph (E), any aggrieved individual may bring an action for specific performance of the obligation described in subparagraph (E). The relief shall be in addition to any other remedies provided under Federal or State law.

(3) It shall not be a violation of subsection (a), (b), (c), or (e) of this section solely because an employer provides a bona fide employee benefit plan or plans under which long-term disability benefits received by an individual are reduced by any pension benefits (other than those attributable to employee contributions)—

(A) paid to the individual that the individual voluntarily elects to receive; or

(B) for which an individual who has attained the later of age 62 or normal retirement age is eligible. (Added by the Older Workers Benefit Protection Act, eff. Oct. 16, 1990)

[Editor’s note: The Older Workers Benefit Protection Act, P.L. 101-438, effective October 16, 1990, provided as follows:]

Sec. 104. Rules and Regulations
Notwithstanding section 9 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 628), the Equal Employment Opportunity Commission may issue such rules and regulations as the Commission may consider necessary or appropriate for carrying out this title, and the amendments made by this title, only after consultation with the Secretary of the Treasury and the Secretary of Labor.

Sec. 105. Effective Date
(a) In General.—Except as otherwise provided in this section, this title and the amendments made by this title shall apply only to—

(1) any employee benefit established or modified on or after the date of enactment of this Act; and

(2) other conduct occurring more than 180 days after the date of enactment of this Act.

(b) Collectively Bargained Agreements.—With respect to any employee benefits provided in accordance with a collective bargaining agreement—

(1) that is in effect as of the date of enactment of this Act; or that is a result of pattern collective bargaining in an industry where the agreement setting the pattern was ratified after September 20, 1990, but prior to the date of the enactment, and the final agreement in the industry adhering to the pattern was ratified after the date of enactment, but not later than November 20, 1990;

(2) that terminates after such date of enactment;

(3) any provision of which was entered into by a labor organization (as defined by section 6(d)(4) of the Fair Labor Standards Act of 1938 (29 U.S.C. 206(d)(4))); and

(4) that contains any provision that would be superseded (in whole or part) by this title and the amendments made by this title, but for the operation of this section, this title and the amendments made by this title shall not apply until the termination of such collective bar-
gaining agreement or June 1, 1992,
whichever occurs first.

(c) States and Political Subdivisions—

(1) In general.—With respect to any
employee benefits provided by an em-
ployer—

(A) that is a State or political subdivi-
sion of a State or any agency or instrumentality of a State or political subdivi-
sion of a State; and

(B) that maintained an employee ben-
efit plan at any time between June 23,
1989, and the date of enactment of this
Act that would be superseded (in whole
or part) by this title and the amend-
ments made by this title but for the opera-
tion of this subsection, and which plan may be
modified only through a change in appli-
cable State or local law,

this title and the amendments made by
this title shall not apply until the date
that is 2 years after the date of enact-
ment of this Act.

(2) Election of disability coverage
for employees hired prior to effective
date.—

(A) In general.—An employer that
maintains a plan described in paragraph
(1)(B) may, with regard to disability ben-
efits provided pursuant to such a plan—

(i) following reasonable notice to all
employees, implement new disability
benefits that satisfy the requirements of
the Age Discrimination in Employment
Act of 1967 (as amended by this title); and

(ii) then offer to each employee covered
by a plan described in paragraph (1)(B)
the option to elect such new disability
benefits in lieu of the existing disability
benefits, if—

(I) the offer is made and reasonable
notice provided no later than the date
that is 2 years after the date of enact-
ment of this Act; and

(II) the employee is given up to 180
days after the offer in which to make the
election.

(B) Previous disability benefits.—If the
employee does not elect to be covered by
the new disability benefits, the employer
may continue to cover the employee un-
der the previous disability benefits even
though such previous benefits do not oth-
erwise satisfy the requirements of the
Age Discrimination in Employment Act
of 1967 (as amended by this title).

(C) Abrogation of right to receive bene-
fits.—An election of coverage under the
new disability benefits shall abrogate any
right the electing employee may have
had to receive existing disability benefits.
The employee shall maintain any years
of service accumulated for purposes of
determining eligibility for the new ben-
efits.

(3) State assistance.—The Equal Em-
ployment Opportunity Commission, the
Secretary of Labor, and the Secretary of
the Treasury shall, on request, provide to
States assistance in identifying and se-
curing independent technical advice to
assist in complying with this subsection.

(4) Definitions.—For purposes of this
subsection:

(A) Employer and state.—The terms
"employer" and "State" shall have the re-
spective meanings provided such terms
under subsections (b) and (i) of section
11 of the Age Discrimination in Employ-

(B) Disability benefits.—The term
"disability benefits" means any program for
employees of a State or political subdivi-
sion of a State that provides long-term
disability benefits, whether on an insured
basis in a separate employee benefit plan
or as part of an employee pension benefit
plan.

(C) Reasonable notice.—The term
"reasonable notice" means, with respect
to notice of new disability benefits de-
scribed in paragraph (2)(A) that is given
to each employee, notice that—

(i) is sufficiently accurate and com-pre-
hensive to appraise the employee of the
terms and conditions of the disability
benefits, including whether the employee
is immediately eligible for such benefits; and
(ii) is written in a manner calculated to be understood by the average employee eligible to participate.

(d) Discrimination in Employee Pension Benefit Plans.—Nothing in this title, or the amendments made by this title, shall be construed as limiting the prohibitions against discrimination that are set forth in section 4(j) of the Age Discrimination in Employment Act of 1967 (as redesignated by section 103(2) of this Act).

(e) Continued Benefit Payments.—Notwithstanding any other provision of this section, on and after the effective date of this title and the amendments made by this title (as determined in accordance with subsections (a), (b), and (c)), this title and the amendments made by this title shall not apply to a series of benefit payments made to an individual or the individual's representative that began prior to the effective date and that continue after the effective date pursuant to an arrangement that was in effect on the effective date, except that no substantial modification to such arrangement may be made after the date of enactment of this Act if the intent of the modification is to evade the purposes of this Act.

Sec. 624. Study by Secretary of Labor

(1) The Equal Employment Opportunity Commission shall, not later than 12 months after the date of enactment of this Act (Oct. 31, 1986), enter into an agreement with the National Academy of Sciences for the conduct of a study to analyze the potential consequences of the elimination of mandatory retirement on institutions of higher education.

(2) The study required by paragraph (1) of this subsection shall be conducted under the general supervision of the National Academy of Sciences by a study panel composed of 9 members. The study panel shall consist of—

(A) 4 members who shall be administrators at institutions of higher education selected by the National Academy of Sciences after consultation with the American Council of Education, the Association of American Universities, and the National Association of State Universities and Land Grant Colleges;

(B) 4 members who shall be teachers or retired teachers at institutions of higher education (who do not serve in an administrative capacity at such institutions), selected by the National Academy of Sciences after consultation with the American Federation of Teachers, the National Education Association, the American Association of University Professors, and the American Association of Retired Persons; and

(C) one member selected by the National Academy of Sciences.

(3) The results of the study shall be reported, with recommendations, to the President and to the Congress not later than 5 years after the date of enactment of this Act (Oct. 31, 1986).

(4) The expenses of the study required by this subsection shall be paid from funds available to the Equal Employment Opportunity Commission. (As amended by P.L. 99-592, eff. Oct. 31, 1986)

Sec. 625. Administration

The Secretary shall have the power—

(a) Delegation of functions; appointments of personnel; technical assistance to make delegations, to appoint such agents and employees, and to pay for technical assistance on a fee-for-service basis, as he deems necessary to assist him in the performance of his functions under this chapter;

(b) Cooperation with other agencies, employers, labor organizations, and employment agencies to cooperate with regional, State, local, and other agencies, and to cooperate with and furnish technical assistance to employers, labor organizations, and employment agencies to aid in effectuating the purposes of this chapter.

Sec. 626. Recordkeeping, Investigation, and Enforcement

[Editor's note: The Age Discrimination Claims Assistance Act of 1988, which
extended the statute of limitations for employees whose ADEA claims were jeopardized by EEOC’s failure to process their cases in a timely manner, effective April 7, 1988, was added to the end of this section. See 401:685 for the text of that Act.

(a) Attendance of witnesses; investigations, inspections, records, and homework regulations

The Equal Employment Opportunity Commission shall have the power to make investigations and require the keeping of records necessary or appropriate for the administration of this chapter in accordance with the powers and procedures provided in sections 209 and 211 of this title. [Fair Labor Standards Act of 1938]

(b) Enforcement; prohibition of age discrimination under Fair labor standards; unpaid minimum wages and unpaid overtime compensation; liquidated damages; judicial relief; conciliation, conference, and persuasion

The provisions of this chapter shall be enforced in accordance with the powers, remedies, and procedures provided in sections 211(b), 216 (except for subsection (a) thereof), and 217 of this title [Fair Labor Standards Act of 1938], and subsection (c) of this section. Any act prohibited under section 623 of this title shall be deemed to be a prohibited act under section 215 of this title. Amounts owing to an individual as a result of a violation of this chapter shall be deemed to be unpaid minimum wages or unpaid overtime compensation under this section. Before instituting any action under this section, the Equal Employment Opportunity Commission shall attempt to eliminate the discriminatory practice or practices alleged, and to effect voluntary compliance with the requirements of this chapter through informal methods of conciliation, conference, and persuasion.

(c) Civil actions; persons aggrieved; jurisdiction; judicial relief; termination of individual action upon commencement of action by Commission; jury trial

(1) Any person aggrieved may bring a civil action in any court of competent jurisdiction for such legal or equitable relief as will effectuate the purposes of this chapter. Provided, that the right of any person to bring such action shall terminate upon the commencement of an action by the Equal Employment Opportunity Commission to enforce the right of such person under this chapter.

(2) In an action brought under paragraph (1), a person shall be entitled to a trial by jury of any issue of fact in any such action for recovery of amounts owing as a result of a violation of this chapter, regardless of whether equitable relief is sought by any party in such action.

(d) Filing of charge with Commission; timeliness; conciliation, conference, and persuasion

No civil action may be commenced by an individual under this section until 60 days after a charge alleging unlawful discrimination has been filed with the Equal Employment Opportunity Commission. Such a charge shall be filed—

(1) within 180 days after the alleged unlawful practice occurred; or

(2) in a case to which section 633(b) applies, within 300 days after the alleged unlawful practice occurred, or within 30 days after receipt by the individual of notice of termination of proceedings under State law, whichever is earlier.

Upon receiving such a charge, the Commission shall promptly notify all persons named in such charge as pro-
spective defendants in the action and shall promptly seek to eliminate any alleged unlawful practice by informal methods of conciliation, conference, and persuasion.

(e) Reliance on administrative rulings; notice of dismissal or termination; civil action after receipt of notice

Section 259 of this title [Portal-to-Portal Act of 1947] shall apply to actions under this chapter. If a charge filed with the Commission under this chapter is dismissed or the proceedings of the Commission are otherwise terminated by the Commission, the Commission shall notify the person aggrieved. A civil action may be brought under this section by a person defined in section 630(a) of this title against the respondent named in the charge within 90 days after the date of the receipt of such notice. (As amended by the Civil Rights Act of 1991, eff. Nov. 21, 1991)

[Editor’s note: See 401:15 for the pertinent portions of the Portal-to-Portal Act.]

(f) Waiver

(1) An individual may not waive any right or claim under this chapter unless the waiver is knowing and voluntary. Except as provided in paragraph (2), a waiver may not be considered knowing and voluntary unless at a minimum—

(A) the waiver is part of an agreement between the individual and the employer that is written in a manner calculated to be understood by such individual, or by the average individual eligible to participate;

(B) the waiver specifically refers to rights or claims arising under this chapter;

(C) the individual does not waive rights or claims that may arise after the date the waiver is executed;

(D) the individual waives rights or claims only in exchange for consideration in addition to anything of value to which the individual already is entitled;

(E) the individual is advised in writing to consult with an attorney prior to executing the agreement;

(F)(i) the individual is given a period of at least 21 days within which to consider the agreement; or

(ii) if a waiver is requested in connection with an exit incentive or other employment termination program offered to a group or class of employees, the individual is given a period of at least 45 days within which to consider the agreement;

(G) the agreement provides that for a period of at least 7 days following the execution of such agreement, the individual may revoke the agreement, and the agreement shall not become effective or enforceable until the revocation period has expired;

(H) if a waiver is requested in connection with an exit incentive or other employment termination program offered to a group or class of employees, the employer (at the commencement of the period specified in subparagraph (F)) informs the individual in writing in a manner calculated to be understood by the average individual eligible to participate, as to—

(i) any class, unit, or group of individuals covered by such program, any eligibility factors for such program, and any time limits applicable to such program; and

(ii) the job titles and ages of all individuals eligible or selected for the program, and the ages of all individuals in the same job classification or organizational unit who are not eligible or selected for the program.

(2) A waiver in settlement of a charge filed with the Equal Employment Opportunity Commission, or an action filed in court by the individual or the individual’s representative, alleging age discrimination of a kind prohibited under section 623 or 633a of this title may not be considered knowing and voluntary unless at a minimum—
(A) subparagraphs (A) through (E) of paragraph (1) have been met; and

(B) the individual is given a reasonable period of time within which to consider the settlement agreement.

(3) In any dispute that may arise over whether any of the requirements, conditions, and circumstances set forth in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H) of paragraph (1), or subparagraph (A) or (B) of paragraph (2), have been met, the party asserting the validity of a waiver shall have the burden of proving in a court of competent jurisdiction that a waiver was knowing and voluntary pursuant to paragraph (1) or (2).

(4) No waiver agreement may affect the Commission's rights and responsibilities to enforce this chapter. No waiver may be used to justify interfering with the protected right of an employee to file a charge or participate in an investigation or proceeding conducted by the Commission. (Added by the Older Workers Benefit Protection Act, eff. Oct. 16, 1990)

[Editor's note: The Older Workers Benefit Protection Act, P.L. 101-133, effective October 16, 1990, provided as follows:

Sec. 202. Effective Date
(a) In General.—The amendment made by section 201 [626] shall not apply with respect to waivers that occur before the date of enactment of this Act.

(b) Rule on Waivers.—Effective on the date of enactment of this Act, the rule on waivers issued by the Equal Employment Opportunity Commission and contained in section 1627.16(c) of title 29, Code of Federal Regulations, shall have no force and effect.]

Sec. 627. Notices To Be Posted

Every employer, employment agency, and labor organization shall post and keep posted in conspicuous places upon its premises a notice to be prepared or approved by the Equal Employment Opportunity Commission setting forth information as the Commission deems appropriate to effectuate the purposes of this chapter.

[Editor's note: 29 CFR 1627, at 408:1473, gives posting requirements.]

Sec. 628. Rules and Regulations

In accordance with the provisions of subchapter II of chapter 5 of title 5, United States Code, the Equal Employment Opportunity Commission may issue such rules and regulations as it may consider necessary or appropriate for carrying out this chapter, and may establish such reasonable exemptions to and from any or all provisions of this chapter as it may find necessary and proper in the public interest.

Sec. 629. Criminal Penalties

Whoever shall forcibly resist, oppose, impede, intimidate, or interfere with a duly authorized representative of the Equal Employment Opportunity Commission while it is engaged in the performance of duties under this chapter shall be punished by a fine of not more than $500 or by imprisonment for not more than one year, or by both: Provided, however, That no person shall be imprisoned under this section except when there has been a prior conviction hereunder.

Sec. 630. Definitions

For the purposes of this chapter—
(a) The term "person" means one or more individuals, partnerships, associations, labor organizations, corporations, business trusts, legal representatives, or any organized groups of persons.

(b) The term "employer" means a person engaged in an industry affecting commerce who has twenty or more employees for each working day in each of twenty or more calendar weeks in the current or preceding calendar year: Provided, that prior to June 30, 1968, employers having fewer than fifty employees shall not be considered employers. The term also means (1) any agent of such a person, and (2) a State or political subdivision of a State and any agency or
instrumentality of a State or a political subdivision of a State, and any interstate agency but such term does not include the United States, or a corporation wholly owned by the Government of the United States. (As amended, eff. May 1, 1974)

(c) The term "employment agency" means any person regularly undertaking with or without compensation to procure employees for an employer and includes an agent of such a person; but shall not include an agency of the United States. (As amended, eff. May 1, 1974)

(d) The term "labor organization" means a labor organization engaged in an industry affecting commerce, and any agent of such an organization, and includes any organization of any kind, any agency, or employee representation committee, group, association, or plan so engaged in which employees participate and which exists for the purpose, in whole or in part, of dealing with employers concerning grievances, labor disputes, wages, rates of pay, hours, or other terms or conditions of employment, and any conference, general committee, joint or system board, or joint council so engaged which is subordinate to a national or international labor organization.

(e) A labor organization shall be deemed to be engaged in an industry affecting commerce if (1) it maintains or operates a hiring hall or hiring office which procures employees for an employer or procures for employees opportunities to work for an employer, or (2) the number of its members (or, where it is a labor organization composed of other labor organizations or their representatives, if the aggregate number of the members of such other labor organization is fifty or more prior to July 1, 1968, or twenty-five or more on or after July 1, 1968, and such labor organization —

(1) is the certified representative of employees under the provisions of the National Labor Relations Act, as amended, or the Railway Labor Act, as amended; or

(2) although not certified, is a national or international labor organization or a local labor organization recognized or acting as the representative of employees of an employer or employers engaged in an industry affecting commerce; or

(3) has chartered a local labor organization or subsidiary body which is representing or actively seeking to represent employees of employers within the meaning of paragraph (1) or (2); or

(4) has been chartered by a labor organization representing or actively seeking to represent employees within the meaning of paragraph (1) or (2) as to local or subordinate body through which such employees may enjoy membership or become affiliated with such labor organization; or

(5) is a conference, general committee, joint or system board or joint council subordinate to a national or international labor organization, which includes a labor organization engaged in an industry affecting commerce within the meaning of any of the preceding paragraphs of this subsection.

(f) The term "employee" means any individual employed by an employer except that the term "employee" shall not include any person elected to public office in any State or political subdivision of any State by the qualified voters thereof, or any person chosen by such officer to be on such officer’s personal staff, or an appointee on the policy-making level or an immediate adviser with respect to the exercise of the constitutional or legal powers of the office. The exemption set forth in the preceding sentence shall not include employees subject to the civil service laws of a State government, governmental agency, or political subdivision. The term "employee" includes any individual who is a citizen of the United States employed by an employer in a workplace in a foreign country. (As amended by P.L. 98-459, eff. Oct. 9, 1984)

(g) The term "commerce" means trade, traffic, commerce, transportation, transmission, or communication among the
several States, or between a State and any place outside thereof; or within the District of Columbia, or a possession of the United States, or between points in the same State but through a point outside thereof.

(h) The term “industry affecting commerce” means any activity, business, or industry in commerce or in which a labor dispute would hinder or obstruct commerce or the free flow of commerce and includes any activity or industry “affecting commerce” within the meaning of the Labor-Management Reporting and Disclosure Act of 1959.

(i) The term “State” includes a State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, American Samoa, Guam, Wake Island, the Canal Zone, and Outer Continental Shelf Lands defined in the Outer Continental Shelf Lands Act.

(j) The term “firefighter” means an employee, the duties of whose position are primarily to perform work directly connected with the control and extinguishment of fires or the maintenance and use of firefighting apparatus and equipment, including an employee engaged in this activity who is transferred to a supervisory or administrative position.

(k) The term “law enforcement officer” means an employee, the duties of whose position are primarily the investigation, apprehension, or detention of individuals suspected or convicted of offenses against the criminal laws of a State, including an employee engaged in this activity who is transferred to a supervisory or administration position. For the purpose of this subsection, “detention” includes the duties of employees assigned to individuals incarcerated in any penal institution. (Sections 11(j) and (k) were added by P.L. 99-592, eff. Jan. 1, 1987, but do not apply to any causes of action arising under ADEA as in effect before Jan. 1, 1987.)

(l) The term “compensation, terms, conditions, or privileges of employment” encompasses all employee benefits, including such benefits provided pursuant to a bona fide employee benefit plan. (Added by the Older Workers Benefit Protection Act, eff. Oct. 16, 1990)

Sec. 631. Age Limits

(a) Individuals at least 40 years of age

The prohibitions in this chapter shall be limited to individuals who are at least 40 years of age. (As amended by P.L. 101-239, eff. Dec. 19, 1989)

(b) Employees or applicants for employment in Federal Government

In the case of any personnel action affecting employees or applicants for employment which is subject to the provisions of section 633a of this title, the prohibitions established in section 633a of this title shall be limited to individuals who are at least 40 years of age.

(c) Bona fide executives or high policymakers

(1) Nothing in this chapter shall be construed to prohibit compulsory retirement of any employee who has attained 65 years of age, and who, for the two-year period immediately before retirement, is employed in a bona fide executive or a high policymaking position, if such employee is entitled to an immediate nonforfeitable annual retirement benefit from a pension, profit-sharing, savings, or deferred compensation plan, or any combination of such plans, of the employer of such employee, which equals, in aggregate, at least $44,000 (As amended by P.L. 99-592, eff. Jan. 1, 1987)

(2) In applying the retirement benefit test of paragraph (1) of this subsection, if any such retirement benefit is in a form other than a straight life annuity (with no ancillary benefits), or if employees contribute to any such plan or make rollover contributions, such benefit shall be adjusted in accordance with regulations prescribed by the Equal Employment Opportunity Commission, after consultation with the Secretary of the treasury, so that the benefit is the equivalent of a straight life annuity (with no ancillary benefits) under a plan to which
employees do not contribute and under which no rollover contributions are made.

(d) Tenured employee at institution of higher learning

Nothing in this chapter shall be construed to prohibit compulsory retirement of any employee who has attained 70 years of age, and who is serving under a contract of unlimited tenure (or similar arrangement providing for unlimited tenure) at an institution of higher education (as defined by section 1141(a) of title 20 [Higher Education Act of 1965].) (Added by P.L. 99-592, eff. Jan. 1, 1987 through Dec. 31, 1993. For section 6 of P.L. 99-592, see Sec. 624)

[Editor's note on history of amendments: This section was amended in 1978 to raise the age of coverage of the Act from 65 to 70 in 1978. In 1987, the section was amended by P.L. 99-592, eff. Jan. 1, 1987, which removed the age-70 upper limit. Section 12(d) was added, establishing a seven-year exemption from the ban on mandatory retirement for tenured college professors aged 70 and older. An exception to the Jan. 1, 1987, effective date was made for collective bargaining agreements which were in effect on June 30, 1986, and which terminate after Jan. 1, 1987. The 1987 amendments do not apply to those agreements until they terminate or Jan. 1, 1990, whichever occurs first.]

Sec. 632. Annual Report to Congress

The Equal Employment Opportunity Commission shall submit annually in January a report to the Congress covering its activities for the preceding year and including such information, data, and recommendations for further legislation in connection with the matters covered by this chapter as it may find advisable. Such report shall contain an evaluation and appraisal by the Commission of the effect of the minimum and maximum ages established by this chapter, together with its recommendation to the Congress. In making such evaluation and appraisal, the Commis-

sion shall take into consideration any changes which may have occurred in the general age level of the population, the effect of the chapter upon workers not covered by its provisions, and such other factors as it may deem pertinent.

Sec. 633. Federal-State Relationship

(a) Federal action superseding State action

Nothing in this chapter shall affect the jurisdiction of any agency of any State performing like functions with regard to discriminatory employment practices on account of age except that upon commencement of an action under this chapter such action shall supersede any State action.

(b) Limitation of Federal action upon commencement of State proceedings

In the case of an alleged unlawful practice occurring in a State which has a law prohibiting discrimination in employment because of age and establishing or authorizing a State authority to grant or seek relief from such discriminatory practice, no suit may be brought under section 626 of this title before the expiration of sixty days after proceedings have been commenced under the State law, unless such proceedings have been earlier terminated: Provided, That such sixty-day period shall be extended to one hundred any twenty days during the first year after the effective date of such State law. If any requirement for the commencement of such proceedings is imposed by a State authority other than a requirement of the filing of a written and signed statement of the facts upon which the proceeding is based, the proceeding shall be deemed to have been commenced for the purposes of this subsection at the time such statement is sent by registered mail to the appropriate State authority.

Sec. 633a. Nondiscrimination on Account of Age in Federal Government Employment

(a) Federal agencies affected

All personnel actions affecting employees or applicants for employment who
are at least 40 years of age (except personnel actions with regard to aliens employed outside the limits of the United States) in military departments as defined in section 102 of title 5, in executive agencies as defined in section 105 of title 5, (including employees and applicants for employment who are paid from non-appropriated funds), in the United States Postal Service and the Postal Rate Commission, in those units in the government of the District of Columbia having positions in the competitive service, and in those units of the legislative and judicial branches of the Federal Government having positions in the competitive service, and in the Library of Congress shall be made free from any discrimination based on age.

(b) Enforcement by Equal Employment Opportunity Commission and by Librarian of Congress in Library of Congress; remedies; rules, regulations, orders, and instructions of Commission: compliance by Federal agencies; powers and duties of Commission; notification of final action on complaint of discrimination; exemptions: bona fide occupational qualification

Except as otherwise provided in this subsection, the Equal Employment Opportunity Commission is authorized to enforce the provisions of subsection (a) of this section through appropriate remedies, including reinstatement or hiring of employees with or without backpay, as will effectuate the policies of this section. The Equal Employment Opportunity Commission shall issue such rules, regulations, orders, and instructions as it deems necessary and appropriate to carry out its responsibilities under this section. The Equal Employment Opportunity Commission shall—

(1) be responsible for the review and evaluation of the operation of all agency programs designed to carry out the policy of this section, periodically obtaining and publishing (on at least a semiannual basis) progress reports from each department, agency, or unit referred to in subsection (a) of this section;

(2) consult with and solicit the recommendations of interested individuals, groups, and organizations relating to nondiscrimination in employment on account of age; and

(3) provide for the acceptance and processing of complaints of discrimination in Federal employment on account of age.

The head of each such department, agency, or unit shall comply with such rules, regulations, orders, and instructions of the Equal Employment Opportunity Commission which shall include a provision that an employee or applicant for employment shall be notified of any final action taken on any complaint or discrimination filed by him thereunder. Reasonable exemptions to the provisions of this section may be established by the Commission but only when the Commission has established a maximum age requirement on the basis of a determination that age is a bona fide occupational qualification necessary to the performance of the duties of the position. With respect to employment in the Library of Congress, authorities granted in this subsection to the Equal Employment Opportunity Commission shall be exercised by the Librarian of Congress.

(c) Civil actions; jurisdiction; relief

Any person aggrieved may bring a civil action in any Federal district court of competent jurisdiction for such legal or equitable relief as will effectuate the purposes of this chapter.

(d) Notice to Commission; time of notice; Commission notification of prospective defendants; Commission elimination of unlawful practices

When the individual has not filed a complaint concerning age discrimination with the Commission, no civil action may be commenced by any individual under this section until the individual has given the Commission not less than thirty days notice of an intent to file such action. Such notice shall be filed within one
hundred and eighty days after the alleged unlawful practice occurred. Upon receiving a notice of intent to sue, the Commission shall promptly notify all persons named therein as prospective defendants in the action and take any appropriate action to assure the elimination of any unlawful practice.

(e) Duty of Government agency or official

Nothing contained in this section shall relieve any Government agency or official of the responsibility to assure non-discrimination on account of age in employment as required under any provision of Federal law.

(f) Applicability of statutory provisions to personnel action of Federal departments, etc.

Any personnel action of any department, agency, or other entity referred to in subsection (a) of this section shall not be subject to, or affected by, any provision of this chapter, other than the provisions of section 631(b) of this title and the provisions of this section.

(g) Study and report to President and Congress by Equal Employment Opportunity Commission; scope

(1) The Equal Employment Opportunity Commission shall undertake a study relating to the effects of the amendments made to this section by the Age Discrimination in Employment Act Amendments of 1978, and the effects of section 631(b) of this title.

(2) The Equal Employment Opportunity Commission shall transmit a report to the President and to the Congress containing the findings of the Commission resulting from the study of the Commission under paragraph (1) of this subsection. Such report shall be transmitted no later than January 1, 1980.
EEOC: Interpretations of the Age Discrimination in Employment Act

Following is the text of EEOC's Interpretations of the Age Discrimination in Employment Act, codified as 29 CFR Part 1625, which reads as amended at 53 FR 5972, Feb. 29, 1988, and corrected at 53 FR 15673, May 3, 1988. Effective June 25, 1987, the Department of Labor's Interpretative Bulletin on Employee Benefit Plans, formerly designated as 29 CFR 860.120, was redesignated by EEOC as Section 1625.10 of these ADEA interpretations. Part (f)(1)(iv)(B) of Section 1625.10, which allowed employers to discontinue pension accruals for employees who work beyond normal retirement age, was rescinded by the commission, pursuant to court order, at 52 FR 8448, March 18, 1987.

PART 1625—AGE DISCRIMINATION IN EMPLOYMENT ACT

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Subpart A—Interpretations

Sec. 1625.1. Definitions

The Equal Employment Opportunity Commission is hereinafter referred to as the "Commission". The terms "person", "employer", "employment agency", "labor organization", and "employee" shall have the meanings set forth in Section 11 of the Age Discrimination in Employment Act of 1967, as amended, 29 U.S.C. 621, et seq., hereinafter referred to as the "Act". References to "employers" in this part state principles that are applicable not only to employers but also to labor organizations and to employment agencies.

Sec. 1625.2. Discrimination Between Individuals Protected by the Act

(a) It is unlawful in situations where this Act applies, for an employer to discriminate in hiring or in any other way by giving preference because of age between individuals 40 and over. Thus, if two people apply for the same position, and one is 42 and the other 52, the employer may not lawfully turn down either one on the basis of age, but must make such decision on the basis of some other factor.

(b) The extension of additional benefits, such as increased severance pay, to older employees within the protected group may be lawful if an employer has a reasonable basis to conclude that those benefits will counteract problems related to age discrimination. The extension of those additional benefits may not be used as a means to accomplish practices otherwise prohibited by the Act. (As amended by 53 FR 5972, eff. Jan. 1, 1987)

Sec. 1625.3. Employment Agency

(a) As long as an employment agency regularly procures employees for at least one covered employer, it qualifies under section 11(c) of the Act as an employment agency with respect to all of its activities whether or not such activities are for employers covered by the act.

(b) The prohibitions of section 4(b) of the Act apply not only to the referral
activities of a covered employment agency, but also to the agency's own employment practices, regardless of the number of employees the agency may have.

Sec. 1625.4. Help Wanted Notices or Advertisements
(a) When help wanted notices or advertisements contain terms and phrases such as "age 25 to 35," "young," "college student," "recent college graduate," "boy," "girl," or others of a similar nature, such a term or phrase deters the employment of older persons and is a violation of the Act, unless one of the exceptions applies. Such phrases as "age 40 to 50," "age over 65," "retired person," or "supplement your pension" discriminate against others within the protected group and, therefore, are prohibited unless one of the exceptions applies.

(b) The use of the phrase "state age" in help wanted notices or advertisements is not, in itself, a violation of the Act. But because the request that an applicant state his age may tend to deter older applicants or otherwise indicate discrimination based on age, employment notices or advertisements which include the phrase "state age," or any similar term, will be closely scrutinized to assure that the request is for a lawful purpose.

Sec. 1625.5. Employment Applications
A request on the part of an employer for information such as "Date of Birth" or "State Age" on an employment application form is not, in itself, a violation of the Act. But because the request that an applicant state his age may tend to deter older applicants or otherwise indicate discrimination based on age, employment application forms which request such information will be closely scrutinized to assure that the request is for a permissible purpose and not for purposes proscribed by the Act. That the purpose is not one proscribed by the statute should be made known to the applicant, either by a reference on the application form to the statutory prohibition in language to the following effect:

"The Age Discrimination in Employment Act of 1967 prohibits discrimination on the basis of age with respect to individuals who are at least 40 years of age," or by other means. The term "Employment applications" refers to all written inquiries about employment or applications for employment or promotion including, but not limited to, resumes or other summaries of the applicant's background. It relates not only to written preemployment inquiries, but to inquiries by employees concerning terms, conditions, or privileges of employment as specified in section 4 of the Act. (As amended by 53 FR 5972, eff. Jan. 1, 1987)

Sec. 1625.6. Bona Fide Occupational Qualifications
(a) Whether occupational qualifications will be deemed to be "bona fide" to a specific job and "reasonably necessary to the normal operation of the particular business," will be determined on the basis of all the pertinent facts surrounding each particular situation. It is anticipated that this concept of a bona fide occupational qualification will have limited scope and application. Further, as this is an exception to the Act it must be narrowly construed.

(b) An employer asserting a BFOQ defense has the burden of proving that (1) the age limit is reasonably necessary to the essence of the business, and either (2) that all or substantially all individuals excluded from the job involved are in fact disqualified, or (3) that some of the individuals so excluded possess a disqualifying trait that cannot be ascertained except by reference to age. If the employer's objective in asserting a BFOQ is the goal of public safety, the employer must prove that the challenged practice does indeed effectuate that goal and that there is no acceptable alternative which would better advance it or equally advance it with less discriminatory impact.

(c) Many State and local governments have enacted laws or administrative regulations which limit employment opportunities based on age. Unless these laws meet the standards for the establishment of a valid bona fide occupational qualification under section 4(f)(1) of the Act, they will be considered in conflict with and effectively superseded by the ADEA.
Sec. 1625.7. Differentiations Based on Reasonable Factors Other Than Age

(a) Section 4(f)(1) of the Act provides that

"* * * it shall not be unlawful for an employer, employment agency, or labor organization * * * to take any action otherwise prohibited under paragraphs (a), (b), (c), or (e) of this section * * * where the differentiation is based on reasonable factors other than age * * *

(b) No precise and unequivocal determination can be made as to the scope of the phrase "differentiation based on reasonable factors other than age." Whether such differentiations exist must be decided on the basis of all the particular facts and circumstances surrounding each individual situation.

(c) When an employment practice uses age as a limiting criterion, the defense that the practice is justified by a reasonable factor other than age is unavailable.

(d) When an employment practice, including a test, is claimed as a basis for different treatment of employees or applicants for employment on the grounds that it is a "factor other than" age, and such a practice has an adverse impact on individuals within the protected age group, it can only be justified as a business necessity. Tests which are asserted as "reasonable factors other than age" will be scrutinized in accordance with the standards set forth at Part 1607 of this title.

(e) When the exception of "a reasonable factor other than age" is raised against an individual claim of discriminatory treatment, the employer bears the burden of showing that the "reasonable factor other than age" exists factually.

(f) A differentiation based on the average cost of employing older employees as a group is unlawful except with respect to employee benefit plans which qualify for the section 4(f)(2) exception to the Act.

Sec. 1625.8. Bona Fide Seniority Systems

Section 4(f)(2) of the Act provides that

"* * * It shall not be unlawful for an employer, employment agency, or labor organization * * * to observe the terms of a bona fide seniority system * * * which is not a subterfuge to evade the purposes of this Act except that no such seniority system * * * shall require or permit the involuntary retirement of any individual specified by section 12(a) of this Act because of the age of such individual. * * *"

(As corrected at 53 FR 15673, May 3, 1988)

(a) Though a seniority system may be qualified by such factors as merit, capacity, or ability, any bona fide seniority system must be based on length of service as the primary criterion for the equitable allocation of available employment opportunities and prerogatives among younger and older workers.

(b) Adoption of a purported seniority system which gives those with longer service lesser rights, and results in discharge or less favored treatment to those within the protection of the Act, may, depending upon the circumstances, be a "subterfuge to evade the purposes" of the Act.

(c) Unless the essential terms and conditions of an alleged seniority system have been communicated to the affected employees and can be shown to be applied uniformly to all of those affected, regardless of age, it will not be considered a bona fide seniority system within the meaning of the Act.

(d) It should be noted that seniority systems which segregate, classify, or otherwise discriminate against individuals on the basis of race, color, religion, sex, or national origin, are prohibited under Title VII of the Civil Rights Act of 1964, where that Act otherwise applies. The "bona fides" of such a system will be closely scrutinized to ensure that such a system is, in fact, bona fide under the ADEA.
Sec. 1625.9. Prohibition of Involuntary Retirement

(a)(1) As originally enacted in 1967, section 4(f)(2) of the Act provided: “It shall not be unlawful * * * to observe the terms of a bona fide seniority system or any bona fide employee benefit plan such as a retirement, pension, or insurance plan, which is not a subterfuge to evade the purposes of this Act, except that no such employee benefit plan shall excuse the failure to hire any individual * * *.” The Department of Labor interpreted the provisions as “Authoriz[ing] involuntary retirement irrespective of age: Provided, That such retirement is pursuant to the terms of a retirement or pension plan meeting the requirements of section 4(f)(2).” See 34 FR 9709 (June 21, 1969).

The Department took the position that in order to meet the requirements of section 4(f)(2), the involuntary retirement provision had to be (i) contained in a bona fide pension or retirement plan, (ii) required by the terms of the plan and not optional, and (iii) essential to the plan’s economic survival or to some other legitimate business purpose—i.e., the provision was not in the plan as the result of arbitrary discrimination on the basis of age.

(2) As revised by the 1978 amendments, section 4(f)(2) was amended by adding the following clause at the end: “and no such seniority system or employee benefit plan shall require or permit the involuntary retirement of any individual specified by section 12(a) of this Act because of the age of such individual * * *.” The Conference Committee Report expressly states that this amendment is intended “to make absolutely clear one of the original purposes of this provision, namely, that the exception does not authorize an employer to require or permit involuntary retirement of an employee within the protected age group on account of age” (H.R. Rept. No. 95-950, p. 8)

(b)(1) The amendment applies to all new and existing seniority systems and employee benefit plans. Accordingly, any system or plan provision requiring or permitting involuntary retirement is unlawful, regardless of whether the provision antedates the 1967 Act or the 1978 amendments.

(2) Where lawsuits pending on the date of enactment (April 6, 1978) or filed thereafter challenge involuntary retirements which occurred either before or after that date, the amendment applies.

(c)(1) The amendment protects all individuals covered by section 12(a) of the Act. Section 12(a) was amended in October of 1986 by the Age Discrimination in Employment Amendments of 1986, Pub. L. 99-592, 100 Stat. 3342 (1986), which removed the age 70 limit. Section 12(a) provides that the Act’s prohibitions shall be limited to individuals who are at least forty years of age. Accordingly, unless a specific exemption applies, an employer can no longer force retirement or otherwise discriminate on the basis of age against an individual because (s)he is 70 or older.

(2) The amendment to section 12(a) of the Act became effective on January 1, 1987, except with respect to any employee subject to a collective bargaining agreement containing a provision that would be superseded by such amendment that was in effect on June 30, 1986, and which terminates after January 1, 1987. In that case, the amendment is effective on the termination of the agreement or January 1, 1990, whichever comes first.

(d) Neither section 4(f)(2) nor any other provision of the Act makes it unlawful for a plan to permit individuals to elect early retirement at a specified age at their own option. Nor is it unlawful for a plan to require early retirement for reasons other than age. (As amended by 53 FR 5973, eff. Jan. 1, 1987)
Sec. 1625.10. Costs and Benefits
Under Employee Benefit Plans

[Editor's note: The following section, formerly designated as 29 CFR 560.120, was redesignated by EEOC as 29 CFR 1625.10, effective June 25, 1987 (52 FR 23812). However, Part (f)(1)(iv)(B) of the section, which allowed employers to cease pension accruals for employees who continue working beyond normal retirement age, was rescinded by EEOC on March 18, 1987, pursuant to court order (See 52 FR 8448). Part (f)(1)(iv)(B) is, therefore, rendered obsolete, and has been removed from the CFR.]

(a)(1) General. Section 4(f)(2) of the Act provides that it is not unlawful for an employer, employment agency, or labor organization “to observe the terms of *** any bona fide employee benefit plan such as retirement, pension, or insurance plan, which is not subterfuge to evade the purposes of this Act, except that no such employee benefit plan shall excuse the failure to hire any individual, and no such *** employee benefit plan shall require or permit the involuntary retirement of any individual specified by section 12(a) of this Act because of the age of such individuals.” The legislative history of this provision indicates that its purpose is to permit age-based reductions in employee benefit plans where such reductions are justified by significant cost considerations. Accordingly, section 4(f)(2) does not apply, for example, to paid vacations and uninsured paid sick leave, since reductions in these benefits would not be justified by significant cost considerations. Where employee benefit plans do meet the criteria in section 4(f)(2), benefit levels for older workers may be reduced to the extent necessary to achieve approximate equivalency in cost for older and younger workers. A benefit plan will be considered in compliance with the statute where the actual amount of payment made, or cost incurred, in behalf of an older worker is equal to that made or incurred in behalf of a younger worker, even though the older worker may thereby receive a lesser amount of benefits or insurance coverage. Since section 4(f)(2) is an exception from the general non-discrimination provisions of the Act, the burden is on the one seeking to invoke the exception to show that every element has been clearly and unmistakably met. The exception must be narrowly construed. The following sections explain three key elements of the exception: (i) What a “bona fide employee benefit plan” is; (ii) what it means to “observe the terms” of such a plan; and (iii) what kind of plan, or plan provision; would be considered “a subterfuge to evade the purposes of [the] Act.” There is also a discussion of the application of the general rules governing all plans with respect to specific kinds of employee benefit plans.

(2) Relation of section 4(f)(2) to sections 4(a), 4(b), and 4(c). Sections 4(a), 4(b), and 4(c) prohibit specified acts of discrimination on the basis of age. Section 4(a) in particular makes it unlawful for an employer to “discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual’s age***.” Section 4(f)(2) is an exception to this general prohibition. Where an employer under an employee benefit plan provides the same level of benefits to older workers as to younger workers, there is no violation of section 4(a), and accordingly the practice does not have to be justified under section 4(f)(2).

(b) “Bona fide employee benefit plan.” Section 4(f)(2) applies only to bona fide employee benefit plans. A plan is considered “bona fide” if its terms (including cessation of contributions or accruals in the case of retirement income plans) have been accurately described in writing to all employees and if it actually provides the benefits in accordance with the terms of the plan. Notifying employees promptly of the provisions and changes in an employee benefit plan is essential if they are to know how the
plan affects them. For these purposes, it would be sufficient under the ADEA for employers to follow the disclosure requirements of ERISA and the regulations thereunder. The plan must actually provide the benefits its provisions describe, since otherwise the notification of the provisions to employees is misleading and inaccurate. An “employee benefit plan” is a plan, such as a retirement, pension, or insurance plan, which provides employees with what are frequently referred to as “fringe benefits.” The term does not refer to wages or salary in cash; neither section 4(f)(2) nor any other section of the Act excuses the payment of lower wages or salary to older employees on account of age. Whether or not any particular employee benefit plan may lawfully provide lower benefits to older employees on account of age depends on whether all of the elements of the exception have been met. An “employee-pay-all” employee benefit plan is one of the “terms, conditions, or privileges of employment” with respect to which discrimination on the basis of age is forbidden under section 4(a)(1). In such a plan, benefits for older workers may be reduced only to the extent and according to the same principles as apply to other plans under section 4(f)(2).

(c) “To observe the terms” of a plan. In order for a bona fide employee benefit plan which provides lower benefits to older employees on account of age to be within the section 4(f)(2) exception, the lower benefits must be provided in “observ[ance of] the terms of” the plan. As this statutory text makes clear, the section 4(f)(2) exception is limited to otherwise discriminatory actions which are actually prescribed by the terms of a bona fide employee benefit plan. Where the employer, employment agency, or labor organization is not required by the express provisions of the plan to provide lesser benefits to older workers, section 4(f)(2) does not apply. Important purposes are served by this requirement. Where a discriminatory policy is an express term of a benefit plan, employees presumably have some opportunity to know of the policy and to plan (or protest) accordingly. Moreover, the requirement that the discrimination actually be prescribed by a plan assures that the particular plan provision will be equally applied to all employees of the same age. Where a discriminatory provision is an optional term of the plan, it permits individual, discretionary acts of discrimination, which do not fall within the section 4(f)(2) exception.

(d) “Subterfuge.” In order for a bona fide employee benefit plan which prescribes lower benefits for older employees on account of age to be within the section 4(f)(2) exception, it must not be “a subterfuge to evade the purposes of [the] Act.” In general, a plan or plan provision which prescribes lower benefits for older employees on account of age is not a “subterfuge” within the meaning of section 4(f)(2), provided that the lower level of benefits is justified by age-related cost considerations. (The only exception to this general rule is with respect to certain retirement plans. See paragraph (f)(4) of this section.) There are certain other requirements that must be met in order for a plan not to be a subterfuge. These requirements are set forth below.

(1) Cost data—general. Cost data used in justification of a benefit plan which provides lower benefits to older employees on account of age must be valid and reasonable. This standard is met where an employer has cost data which show the actual cost to it of providing the particular benefit (or benefits) in question over a representative period of years. An employer may rely in cost data for its own employees over such a period, or on cost data for a larger group of similarly situated employees. Sometimes, as a result of experience rating or other causes, an employer incurs costs that differ significantly from costs for a group of similarly situated employees. Such an employer may not rely on cost data for the similarly situated employees where such
reliance would result in significantly lower benefits for its own older employees. Where reliable cost information is not available, reasonable projections made from existing cost data meeting the standards set forth above will be considered acceptable.

(2) Cost data—Individual benefit basis and "benefit package" basis. Cost comparisons and adjustments under section 4(f)(2) must be made on a benefit-by-benefit basis or on a "benefit package" basis, as described below.

(i) Benefit-by-benefit basis. Adjustments made on a benefit-by-benefit basis must be made in the amount or level of a specific form of benefit for a specific event or contingency. For example, higher group term life insurance costs for older workers would justify a corresponding reduction in the amount of group term life insurance coverage for older workers, on the basis of age. However, a benefit-by-benefit approach would not justify the substitution of one form of benefit for another, even though both forms of benefit are designed for the same contingency, such as death. See paragraph (f)(1) of this section.

(ii) "Benefit package" basis. As an alternative to the benefit-by-benefit basis, cost comparisons and adjustments under section 4(f)(2) may be made on a limited "benefit package" basis. Under this approach, subject to the limitations described below, cost comparisons and adjustments can be made with respect to section 4(f)(2) plans in the aggregate. This alternative basis provides greater flexibility than a benefit-by-benefit basis in order to carry out the declared statutory purpose "to help employers and workers find ways of meeting problems arising from the impact of age on employment." A "benefit package" approach is an alternative approach consistent with this purpose and with the general purpose of section 4(f)(2) only if it is not used to reduce the cost to the employer or the favorability to the employees of overall employee benefits for older employees. A "benefit package" approach used for either of these purposes would be a subterfuge to evade the purposes of the Act. In order to assure that such a "benefit package" approach is not abused and is consistent with the legislative intent, it is subject to the limitations described in paragraph (f), which also includes a general example.

(3) Cost data—five year maximum basis. Cost comparisons and adjustments under section 4(f)(2) may be made on the basis of age brackets of up to 5 years. Thus a particular benefit may be reduced for employees of any age within the protected age group by an amount no greater than that which could be justified by the additional cost to provide them with the same level of the benefit as younger employees within a specified five-year age group immediately preceding theirs. For example, where an employer chooses to provide unreduced group term life insurance benefits until age 60, benefits for employees who are between 60 and 65 years of age may be reduced only to the extent necessary to achieve approximate equivalency in costs with employees who are 55 to 60 years old. Similarly, any reductions in benefit levels for 65 to 70 year old employees cannot exceed an amount which is proportional to the additional costs for their coverage over 60 to 65 year old employees.

(4) Employee contributions in support of employee benefit plans—(i) As a condition of employment. An older employee within the protected age group may not be required as a condition of employment to make greater contributions than a younger employee in support of an employee benefit plan. Such a requirement would be in effect a mandatory reduction in take-home pay, which is never authorized by section 4(f)(2), and would impose an impediment to employment in violation of the specific restrictions in section 4(f)(2).

(ii) As a condition of participation in a voluntary employee benefit plan. An old-
employee within the protected age group may be required as a condition of participation in a voluntary employee benefit plan to make a greater contribution than a younger employee only if the older employee is not thereby required to bear a greater proportion of the total premium cost (employer-paid and employee-paid) than the younger employee. Otherwise the requirement would discriminate against the older employee by making compensation in the form of an employer contribution available on less favorable terms than for the younger employee and denying that compensation altogether to an older employee unwilling or unable to meet the less favorable terms. Such discrimination is not authorized by section 4(f)(2). This principle applies to three different contribution arrangements as follows:

(A) Employee-pay-all plans. Older employees, like younger employees, may be required to contribute as a condition of participation up to the full premium cost for their age.

(B) Non-contributory ("employer-pay-all") plans. Where younger employees are not required to contribute any portion of the total premium cost, older employees may not be required to contribute any portion.

(C) Contributory plans. In these plans employers and participating employees share the premium cost. The required contributions of participants may increase with age so long as the proportion of the total premium required to be paid by the participants does not increase with age.

(iii) As an option in order to receive an unreduced benefit. An older employee may be given the option, as an individual, to make the additional contribution necessary to receive the same level of benefits as a younger employee (provided that the contemplated reduction in benefits is otherwise justified by section 4(f)(2)).

(5) Forfeiture clauses. Clauses in employee benefit plans which state that litigation or participation in any manner in a formal proceeding by an employee will result in the forfeiture of his rights are unlawful insofar as they may be applied to those who seek redress under the Act. This is by reason of section 4(d) which provides that it is unlawful for an employer, employment agency, or labor organization to discriminate against any individual because such individual "has made a charge, testified, assisted, or participated in any manner in an investigation, proceeding, or litigation under this Act."

(6) Refusal to hire clauses. Any provision of an employee benefit plan which requires or permits the refusal to hire an individual specified in section 12(a) of the Act on the basis of age is a subterfuge to evade the purposes of the Act and cannot be excused under section 4(f)(2).

(7) Involuntary retirement clauses. Any provision of an employee benefit plan which requires or permits the involuntary retirement of any individual specified in section 12(a) of the Act on the basis of age is a subterfuge to evade the purpose of the Act and cannot be excused under section 4(f)(2).

(e) Benefits provided by the Government. An employer does not violate the Act by permitting certain benefits to be provided by the Government, even though the availability of such benefits may be based on age. For example, it is not necessary for an employer to provide health benefits which are otherwise provided to certain employees by Medicare. However, the availability of benefits from the Government will not justify a reduction in employer-provided benefits if the result is that, taking the employer-provided and Government-provided benefits together, an older employee is entitled to a lesser benefit of any type (including coverage for family and/or dependents) than a similarly situated younger employee. For example, the availability of certain benefits to an older employee under Medicare will not justify denying an older employee a benefit...
which is provided to younger employees and is not provided to the older employee by Medicare.

(f) Application of section 4(f)(2) to various employee benefit plans—(1) Benefit-by-benefit approach. This portion of the interpretation discusses how a benefit-by-benefit approach would apply to four of the most common types of employee benefit plans.

(i) **Life insurance.** It is not uncommon for life insurance coverage to remain constant until a specified age, frequently 65, and then be reduced. This practice will not violate the Act (even if reductions start before age 65), provided that the reduction for an employee of a particular age is no greater than is justified by the increased cost of coverage for that employee's specific age bracket encompassing no more than five years. It should be noted that a total denial of life insurance, on the basis of age, would not be justified under a benefit-by-benefit analysis. However, it is not unlawful for life insurance coverage to cease upon separation from service.

(ii) **Long-term disability.** Under a benefit-by-benefit approach, where employees who are disabled at younger ages are entitled to long-term disability benefits, there is no cost-based justification for denying such benefits altogether, on the basis of age, to employees who are disabled at older ages. It is not unlawful to cut off long-term disability benefits and coverage on the basis of some non-age factor, such as recovery from disability. Reductions on the basis of age in the level or duration of benefits available for disability are justifiable only on the basis of age-related cost considerations as set forth elsewhere in this section. An employer which provides long-term disability coverage to all employees may avoid any increases in the cost to it that such coverage for older employees would entail by reducing the level of benefits available to older employees. An employer may also avoid such cost increases by reducing the duration of benefits available to employees who become disabled at older ages, without reducing the level of benefits. In this connection, the Department would not assert a violation where the level of benefits is not reduced and the duration of benefits is reduced in the following manner:

(A) With respect to disabilities which occur at age 60 or less, benefits cease at age 65.

(B) With respect to disabilities which occur after age 60, benefits cease 5 years after disablement. Cost data may be produced to support other patterns of reduction as well.

(iii) **Retirement plans — (A) Participation.** No employee hired prior to normal retirement age may be excluded from a defined contribution plan. With respect to defined benefit plans not subject to the Employee Retirement Income Security Act (ERISA), Pub. L. 93–406, 29 U.S.C. 1001, 1003(a) and (b), an employee hired at an age more than 5 years prior to normal retirement age may not be excluded from such a plan unless the exclusion is justifiable on the basis of cost considerations as set forth elsewhere in this section. With respect to defined benefit plans subject to ERISA, such an exclusion would be unlawful in any case. An employee hired less than 5 years prior to normal retirement age may be excluded from a defined benefit plan, regardless of whether or not the plan is covered by ERISA. Similarly, any employee hired after normal retirement age may be excluded from a defined benefit plan. (As amended by 53 FR 5973, eff. Jan. 1, 1987)

(2) **"Benefit package" approach.** A "benefit package" approach to compliance under section 4(f)(2) offers greater flexibility than a benefit-by-benefit approach by permitting deviations from a benefit-by-benefit approach so long as the overall result is no lesser cost to the employer and no less favorable benefits for employees. As previously noted, in order to assure that such an approach is used for the benefit of older workers and
not to their detriment, and is otherwise consistent with the legislative intent, it is subject to limitations as set forth below:

(i) A benefit package approach shall apply only to employee benefit plans which fall within section 4(f)(2).

(ii) A benefit package approach shall not apply to a retirement or pension plan. The 1978 legislative history sets forth specific and comprehensive rules governing such plans, which have been adopted above. These rules are not tied to actuarially significant cost considerations but are intended to deal with the special funding arrangements of retirement or pension plans. Variations from these special rules are therefore not justified by variations from the cost-based benefit-by-benefit approach in other benefits plans, nor may variations from the special rules governing pension and retirement plans justify variations from the benefit-by-benefit approach in other benefit plans.

(iii) A benefit package approach shall not be used to justify reductions in health benefits greater than would be justified under a benefit-by-benefit approach. Such benefits appear to be of particular importance to older workers in meeting "problems arising from the impact of age" and were of particular concern to Congress. Therefore, the "benefit package" approach may not be used to reduce health insurance benefits by more than is warranted by the increase in the costs to the employer of those benefits alone. Any greater reduction would be a subterfuge to evade the purpose of the Act.

(iv) A benefit reduction greater than would be justified under a benefit-by-benefit approach must be prepared to produce data to show that those reductions are fully justified. Thus employers must be able to show that deviations from a benefit-by-benefit approach do not result in lesser cost to them or less favorable benefits to their employees. A general example consistent with these limitations may be given. Assume two employee benefit plans, providing Benefit "A" and Benefit "B." Both plans fall within section 4(f)(2), and neither is a retirement or pension plan subject to special rules. Both benefits are available to all employees. Age-based cost increases would justify a 10% decrease in both benefits on a benefit-by-benefit basis. The affected employees would, however, find it more favorable—that is, more consistent with meeting their needs—for no reduction to be made in Benefit "A" and a greater reduction to be made in Benefit "B." This "trade-off" would not result in a reduction in health benefits. The "trade-off" may therefore be made. The details of the "trade-off" depend on data on the relative cost to the employer of the two benefits. If the data show that Benefit "A" and Benefit "B" cost the same, Benefit "B" may be reduced up to 20%, if Benefit "A" is unreduced. If the data show that Benefit "A" costs only half as much as Benefit "B", however, Benefit "B" may be reduced up to only 15% if Benefit "A" is unreduced, since a greater reduction in Benefit "B" would result in an impermissible reduction in total benefit costs.

(g) Relation of ADEA to State laws. The ADEA does not preempt State age discrimination in employment laws. However, the failure of the ADEA to preempt such laws does not affect the issue of whether section 514 of the Employee Retirement Income Security Act (ERISA) preempts State laws which related to employee benefit plans.
Sec. 1625.11. Exemption for Employees Serving Under a Contract of Unlimited Tenure

(a)(1) Section 12(d) of the Act, added by the 1986 amendments, provides:

"Nothing in this Act shall be construed to prohibit compulsory retirement of any employee who has attained 70 years of age, and who is serving under a contract of unlimited tenure (or similar arrangement providing for unlimited tenure) at an institution of higher education (as defined by section 1201(a) of the Higher Education Act of 1965)."

(2) This exemption from the Act's protection of covered individuals took effect on January 1, 1987, and is repealed on December 31, 1993 (see section 6 of the Age Discrimination in Employment Act Amendments of 1986, Pub. L. No. 99-592, 100 Stat. 3342). The Equal Employment Opportunity Commission is required to enter into an agreement with the National Academy of Sciences, for the conduct of a study to analyze the potential consequences of the elimination of mandatory retirement on institutions of higher education. (As amended by 53 FR 5973, eff. Jan. 1, 1987)

(b) Since section 12(d) is an exemption from the nondiscrimination requirements of the Act, the burden is on the one seeking to invoke the exemption to show that every element has been clearly and unmistakably met. Moreover, as with other exemptions from the ADEA, this exemption must be narrowly construed.

(c) Section 1201(a) of the Higher Education Act of 1965, as amended, and set forth in 20 U.S.C. 1141(a), provides in pertinent part:

The term "institution of higher education" means an educational institution in any State which (1) admits as regular students only persons having a certificate of graduation from a school providing secondary education, or the recognized equivalent of such a certificate (2) is legally authorized within such State to provide a program of education beyond secondary education, (3) provides an educational program for which it awards a bachelor's degree or provides not less than a two-year program which is acceptable for full credit toward such a degree, (4) is a public or other nonprofit institution, and (5) is accredited by a nationally recognized accrediting agency or association or, if not so accredited, (A) is an institution with respect to which the Commissioner has determined that there is satisfactory assurance, considering the resources available to the institution, the period of time, if any, during which it has operated, the effort it is making to meet accreditation standards, and the purpose for which this determination is being made, that the institution will meet the accreditation standards of such an agency or association within a reasonable time, or (B) is an institution whose credits are accepted, on transfer, by not less than three institutions which are so accredited, for credit on the same basis as if transferred from an institution so accredited.

The definition encompasses almost all public and private universities and two- and four-year colleges. The omitted portion of the text of section 1201(a) refers largely to one-year technical schools, which generally do not grant tenure to employees, but which, if they do, are also eligible to claim the exemption.

(d)(1) Use of the term "any employee" indicates that application of the exemption is not limited to teachers, who are traditional recipients of tenure. The exemption may also be available with respect to other groups, such as academic deans, scientific researchers, professional librarians and counseling staff, who frequently have tenured status.

(2) The Conference Committee Report on the 1978 amendments expressly states that the exemption does not apply to Federal employees covered by section 15 of the Act (H.R. Rept. No. 95-950, p. 10).

(e)(1) The phrase "unlimited tenure" is not defined in the Act. However, the almost universally accepted definition of academic "tenure" is an arrangement under which certain appointments in an institution of higher education are continued until retirement for age or physical disability, subject to dismissal for adequate cause or under extraordinary circumstances on account of financial exigency or change of institutional program. Adopting that definition, it is evident that the word "unlimited" refers to the duration of tenure. Therefore, a contract (or other similar arrangement) which is limited to a specific term (for example, one year or 10 years) will not meet the requirements of the exemption.

(2) The legislative history shows that Congress intended the exemption to ap-
ply only where the minimum rights and privileges traditionally associated with tenure are guaranteed to an employee by contract or similar arrangement. While tenure policies and practices vary greatly from one institution to another, the minimum standards set forth in the 1940 Statement of Principles on Academic Freedom and Tenure, jointly developed by the Association of American Colleges and the American Association of University Professors, have enjoyed widespread adoption or endorsement. The 1940 Statement of Principles on academic tenure provides as follows:

(a) After the expiration of a probationary period, teachers or investigators should have permanent or continuous tenure, and their service should be terminated only for adequate cause, except in the case of retirement for age, or under extraordinary circumstances because of financial exigencies.

In the interpretation of this principle it is understood that the following represents acceptable academic practice:

(1) The precise terms and conditions of every appointment should be stated in writing and be in the possession of both institution and teacher before the appointment is consummated.

(2) Beginning with appointment to the rank of full-time instructor or a higher rank, the probationary period should not exceed seven years, including within this period full-time service in all institutions of higher education; but subject to the proviso that when, after a term of probationary service of more than three years in one or more institutions, a teacher is called to another institution it may be agreed in writing that his new appointment is for a probationary period of not more than four years, even though thereby the person's total probationary period in the academic profession is extended beyond the normal maximum of seven years. Notice should be given at least one year prior to the expiration of the probationary period if the teacher is not to be continued in service after the expiration of that period.

(3) During the probationary period a teacher should have the academic freedom that all other members of the faculty have.

(4) Termination for cause of a continuous appointment, or the dismissal for cause of a teacher previous to the expiration of a term appointment, should, if possible, be considered by both a faculty committee and the governing board of the institution. In all cases where the facts are in dispute, the accused teacher should be informed before the hearing in writing of the charges against him and should have the opportunity to be heard in his own defense by all bodies that pass judgment upon his case. He should be permitted to have with him an advisor of his own choosing who may act as counsel. There should be a full stenographic record of the hearing available to the parties concerned. In the hearing of charges of incompetence, the testimony should include that of teachers and other scholars, either from his own or from other institutions. Teachers on continuous appointment who are dismissed for reasons not involving moral turpitude should receive their salaries for at least a year from the date of notification of dismissal whether or not they are continued in their duties at the institution.

(5) Termination of a continuous appointment because of financial exigency should be demonstrably bona fide.

(3) A contract or similar arrangement which meets the standards in the 1940 Statement of Principles will satisfy the tenure requirements of the exemption. However, a tenure arrangement will not be deemed inadequate solely because it fails to meet these standards in every respect. For example, a tenure plan will not be deemed inadequate solely because it includes a probationary period somewhat longer than seven years. Of course, the greater the deviation from the standards in the 1940 Statement of Principles, the less likely it is that the employee in question will be deemed subject to "unlimited tenure" within the meaning of the exemption. Whether or not a tenure arrangement is adequate to satisfy the requirements of the exemption must be determined on the basis of the facts of each case.

(f) Employees who are not assured of a continuing appointment either by contract of unlimited tenure or other similar arrangement (such as a state statute) would not, of course, be exempted from the prohibitions against compulsory retirement, even if they perform functions identical to those performed by employees with appropriate tenure.

(g) An employee within the exemption can lawfully be forced to retire on account of age at age 70 (see (a)(1) above). In addition, the employer is free to retain such employees, either in the same position or status or in a different position or status: Provided, That the employee voluntarily accepts this new position or status. For example, an employee who falls within the exemption may be offered a nontenured position or part-time employment. An employee who accepts a
Sec. 1625.12. Exemption for Bona Fide Executive or High Policymaking Employees

(a) Section 12(c)(1) of the Act, added by the 1978 amendments and as amended in 1984 and 1986, provides: "Nothing in this Act shall be construed to prohibit compulsory retirement of any employee who has attained 65 years of age, and who, for the 2-year period immediately before retirement, is employed in a bona fide executive or higher policymaking position, if such employee is entitled to an immediate nonforfeitable annual retirement benefit from a pension, profit-sharing, savings, or deferred compensation plan, or any combination of such plans, of the employer of such employee which equals, in the aggregate, at least $44,000." (As amended by 53 FR 5973, eff. Jan. 1, 1987)

(b) Since this provision is an exemption from the non-discrimination requirements of the Act, the burden is on the one seeking to invoke the exemption to show that every element has been clearly and unmistakably met. Moreover, as with other exemptions from the Act, this exemption must be narrowly construed.

(c) An employee within the exemption can lawfully be forced to retire on account of age at age 65 or above. In addition, the employer is free to retain such employees, either in the same position or status or in a different position or status. For example, an employee who falls within the exemption may be offered a position of lesser status or a part-time position. An employee who accepts such a new status or position, however, may not be treated any less favorably, on account of age, than any similarly situated younger employee.

(d)(1) In order for an employee to qualify as a "bona fide executive," the employer must initially show that the employee satisfies the definition of a bona fide executive set forth in §541.1 of this chapter. Each of the requirements in paragraphs (a) through (e) of §541.1 must be satisfied, regardless of the level of the employee's salary or compensation.

[Editor's note: Section 541.1 appears at 29 CFR Part 541, the Labor Department's Wage and Hour regulations. The section reads as follows:]

Sec. 541.1. Executive.

The term "employee employed in a bona fide executive ... capacity" in section 13(a)(1) of the act shall mean any employee:

(a) Whose primary duty consists of the management of the enterprise in which he is employed or of a customarily recognized department of subdivision thereof;

(b) Who customarily and regularly directs the work of two or more other employees therein; and

(c) Who has the authority to hire or fire other employees or whose suggestions and recommendations as to the hiring or firing and as to the advancement and promotion or any other change of status of other employees will be given particular weight; and

(d) Who customarily and regularly exercises discretionary powers; and

(e) Who does not devote more than 20 percent, or, in the case of an employee of a retail or service establishment who does not devote as much as 40 percent, of his hours of work in the workweek to activities which are not directly and closely related to the performance of the work described in paragraphs (a) through (d) of this section: Provided, That this paragraph shall not apply in the case of an employee who is in sole charge of an independent establishment or a physically separated branch estab-
lishment, or who owns at least a 20-per-
cent interest in the enterprise in which
he is employed; and
(1) Who is compensated for his services
on a salary basis at a rate of not less than
$155 per week (or $130 per week, if em-
ployed by other than the Federal Govern-
ment in Puerto Rico, the Virgin Islands,
or American Samoa), exclusive of board,
lodging, or other facilities; Provided,
That an employee who is compensated on
a salary basis at a rate of not less than
$250 per week (or $200 per week, if em-
ployed by other than the Federal Govern-
ment in Puerto Rico, the Virgin Islands
or American Samoa), exclusive of board,
lodging, or other facilities, and whose
primary duty consists of the manage-
ment of the enterprise in which the
employee is employed or of a customarily
recognized department or subdivision
thereof, and includes the customary and
regular direction of the work of two or
more other employees therein, shall be
deemed to meet all the requirements of
this section. (33 FR 11390, May 7, 1973,
as amended at 40 FR 7092, Feb. 19,
1975) ]

(2) Even if an employee qualifies as an
executive under the definition in §541.1 of
this chapter, the exemption from the
ADEA may not be claimed unless the
employee also meets the further criteria
specified in the Conference Committee
Report in the form of examples (see H.R.
Rept. No. 95-950, p.9). The examples are
intended to make clear that the exemp-
tion does not apply to middle-manage-
ment employees, no matter how great
their retirement income, but only to a
very few top level employees who exercise
substantial executive authority over a
significant number of employees and a
large volume of business. As stated in
the Conference Report (H.R. Rept. No.
95-950, p. 9):

Typically the head of a significant and substantial
local or regional operation of a corporation [or other
business organization] such as a major production
facility or retail establishment, but not the head of a
minor branch, warehouse or retail store, would be
covered by the term "bona fide executive." Individu-
als at higher levels in the corporate organizational
structure who possess comparable or greater levels
of responsibility and authority as measured by es-
blished and recognized criteria would also be cov-
ered.

The heads of major departments or divisions of
corporations [or other business organizations] are
usually located at corporate or regional headquar-
ters. With respect to employees whose duties are as
associated with corporate headquarters operations,
such as finance, marketing, legal, production and
manufacturing (or in a corporation organized on a
product line basis, the management of product lines),
the definition would cover employees who head those
divisions.

In a large organization, the immediate subordi-
nates of the heads of these divisions sometimes also
exercise executive authority, within the meaning of
this exemption. The conferees intend the definition to
cover such employees if they possess responsibility
which is comparable to or greater than that pos-
sessed by the head of a significant and substantial
local operation who meets the definition.

(e) The phrase "high policymaking posi-
tion," according to the Conference Re-
port (H.R. Rept. No. 95-950, p. 10), is
limited to "***certain top level employees
who are not 'bona fide executives'***." Spe-
cifically, these are:

***individuals who have little or no line authority
but whose position and responsibility are such that
they play a significant role in the development of
corporate policy and effectively recommend the im-
plementation thereof.

For example, the chief economist or the chief re-
search scientist of a corporation typically has little
line authority. His duties would be primarily intel-
lectual as opposed to executive or managerial. His
responsibility would be to evaluate significant eco-
nomic or scientific trends and issues, to develop and
recommend policy direction to the top executive of-
icers of the corporation, and he would have a signifi-
cant impact on the ultimate decision on such policies
by virtue of his expertise and direct access to the
decisionmakers. Such an employee would meet the
definition of a "high policymaking" employee.

On the other hand, as this description
makes clear, the support personnel of a
"high policymaking" employee would not
be subject to the exemption even if they
supervise the development, and draft the
recommendation, of various policies sub-
mitted by their supervisors.

(f) In order for the exemption to apply
to a particular employee, the employee
must have been in a "bona fide executive
or high policymaking position," as those
terms are defined in this section, for the
two-year period immediately before re-
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retirement. Thus, an employee who holds two or more different positions during the two-year period is subject to the exemption only if each such job is an executive or high policymaking position.

(g) The Conference Committee Report expressly states that the exemption is not applicable to Federal employees covered by section 15 of the Act (H.R. Rept. No. 95-950, p. 10).

(h) The "annual retirement benefit," to which covered employees must be entitled, is the sum of amounts payable during each one-year period from the date on which such benefits first become receivable by the retiree. Once established, the annual period upon which calculations are based may not be changed from year to year.

(i) The annual retirement benefit must be immediately available to the employee to be retired pursuant to the exemption. For purposes of determining compliance, "immediate" means that the payment of plan benefits (in a lump sum or the first of a series of periodic payments) must occur not later than 60 days after the effective date of the retirement in question. The fact that an employee will receive benefits only after expiration of the 60-day period will not preclude his retirement pursuant to the exemption, if the employee could have elected to receive benefits within that period.

(j)(1) The annual retirement benefit must equal, in the aggregate, at least $44,000. The manner of determining whether this requirement has been satisfied is set forth in §1627.17(c).

(2) In determining whether the aggregate annual retirement benefit equals at least $44,000, the only benefits which may be counted are those authorized by and provided under the terms of a pension, profit-sharing, savings, or deferred compensation plan. (Regulations issued pursuant to section 12(c)(2) of the Act, regarding the manner of calculating the amount of qualified retirement benefits for purposes of the exemption, are set forth in §1627.17 of this chapter.)

(k)(1) The annual retirement benefit must be "nonforfeitable." Accordingly, the exemption may not be applied to any employee subject to plan provisions which could cause the cessation of payments to a retiree or result in the reduction of benefits to less than $44,000 in any one year. For example, where a plan contains a provision under which benefits would be suspended if a retiree engages in litigation against the former employer, or obtains employment with a competitor of the former employer, the retirement benefit will be deemed to be forfeitable. However, retirement benefits will not be deemed forfeitable solely because the benefits are discontinued or suspended for reasons permitted under section 411(a)(3) of the Internal Revenue Code.

(2) An annual retirement benefit will not be deemed forfeitable merely because the minimum statutory benefit level is not guaranteed against the possibility of plan bankruptcy or is subject to benefit restrictions in the event of early termination of the plan in accordance with Treasury Regulation 1.401—4(c). However, as of the effective date of the retirement in question, there must be at least a reasonable expectation that the plan will meet its obligations.

Sec. 1625.13. Apprenticeship Programs

Age limitations for entry into bona fide apprenticeship programs were not intended to be affected by the Act. Entry into most apprenticeship programs has traditionally been limited to youths under specified ages. This is in recognition of the fact that apprenticeship is an extension of the educational process to prepare young men and women for skilled employment. Accordingly, the prohibitions contained in the Act will not be applied to bona fide apprenticeship programs which meet the standards specified in §§521.2 and 521.3 of this chapter.

[Editor's note: Sections 521.2 and 521.3 appear at 29 CFR Part 521, the La-
Sec. 521.2 Definitions.

As used in this part:

(a) "Apprentice" means a worker at least sixteen years of age, except where a higher minimum age standard is otherwise fixed by law, who is employed to learn a skilled trade as defined in §521.4, and in conformity with or substantial conformity with the standards of apprenticeship as set forth in §521.3.

(b) "Apprenticeship agreement" means a written agreement between an apprentice and either his employer or a joint apprenticeship committee, which contains the terms and conditions of the employment and training of the apprentice, and which conforms or substantially conforms with the standards of apprenticeship as set forth in §521.3.

(c) "Apprenticeship program" means a complete plan of terms and conditions for the employment and training of apprentices which conforms or substantially conforms with the standards of apprenticeship, as set forth in §521.3.

(d) "Joint apprenticeship committee" means a local committee, equally representative of employers and employees, which has been established by a group of employers and a bona fide bargaining agent or agents, to direct the training of apprentices with whom it has made agreements. This term does not include a joint apprenticeship committee established for an individual plant.

(e) "Recognized apprenticeship agency" means either (1) a state apprenticeship agency recognized by the Bureau of Apprenticeship, United States Department of Labor, or (2) if no such apprenticeship agency exists in the state, the Bureau of Apprenticeship, United States Department of Labor.

(f) "Registration" means the approval by a recognized apprenticeship agency of an apprenticeship program or agreement as meeting the basic standards adopted by the Bureau of Apprenticeship, United States Department of Labor, upon the recommendation of the Federal Committee on Apprenticeship.

(g) "State" means any state of the United States or the District of Columbia or any territory or possession of the United States.

Sec. 521.3. Standards of Apprenticeship

An apprenticeship program must conform with or substantially conform with the following standards of apprenticeship before the Administrator or his authorized representative will issue a special certificate authorizing employment of an apprentice under such program at wages lower than the minimum wages applicable under section 6 of the act:

(a) Employment and training of the apprentice in a skilled trade. A skilled trade is an apprenticeable occupation which satisfies the criteria set forth in §521.4.

(b) One year or more (2,000 or more hours) of work experience.

(c) A progressively increasing schedule of wages to be paid the apprentice which averages at least 50 percent of the journeyman's rate over the period of apprenticeship.

(d) A schedule of work processes or operations in which experience is to be given the apprentice on the job.

(e) Submission of the apprenticeship program and the apprenticeship agreement to the recognized apprenticeship agency for registration as provided in §521.5.

(f) Joint agreement to the apprenticeship program by the employer and the bona fide bargaining agent, where a bargaining agent exists.

(g) An indication that the number of apprentices to be employed conforms to the needs and practices in the community.

(h) Adequate facilities for training and supervision of the apprentice and the keeping of appropriate records concerning his progress.

(i) Related instruction, if available, (144 hours a year is normally considered...
necessary. Related instruction means an organized and systematic form of instruction which is designed to provide the apprentice with knowledge of the theoretical and technical subjects related to his trade. Such instruction may be given in a classroom, through correspondence courses, or other forms of self-study.)
Worker Adjustment And Retraining Notification Act

Following is the text of The Worker Adjustment and Retraining Notification Act, which, with some exceptions, requires employers to provide 60 days' advance notice of plant closings and layoffs. The law (PL 100-379, 102 Stat 890, 29 USC §§2101-2109) automatically became law on Aug. 4, 1988, without the president's signature, and took effect, except where noted, on Feb. 4, 1989.

29 U.S.C. s 2101
TITLE 29—LABOR
CHAPTER 23—WORKER ADJUSTMENT AND RETRAINING NOTIFICATION

Sec. 2101. Definitions; exclusions from definition of loss of employment

(a) Definitions. As used in this chapter—

(1) the term "employer" means any business enterprise that employs—

(A) 100 or more employees, excluding part-time employees; or

(B) 100 or more employees who in the aggregate work at least 4,000 hours per week (exclusive of hours of overtime);

(2) the term "plant closing" means the permanent or temporary shutdown of a single site of employment, or one or more facilities or operating units within a single site of employment, if the shutdown results in an employment loss at the single site of employment during any 30-day period for 50 or more employees excluding any part-time employees;

(3) the term "mass layoff" means a reduction in force which—

(A) is not the result of a plant closing; and

(B) results in an employment loss at the single site of employment during any 30-day period for—

(i)(I) at least 33 percent of the employees (excluding any part-time employees); and

(ii) at least 50 employees (excluding any part-time employees); or

(ii) at least 500 employees (excluding any part-time employees);

(4) the term "representative" means an exclusive representative of employees within the meaning of section 159(a) or 158(f) of this title or section 152 of Title 45;

(5) the term "affected employees" means employees who may reasonably be expected to experience an employment loss as a consequence of a proposed plant closing or mass layoff by their employer;

(6) subject to subsection (b) of this section, the term "employment loss" means (A) an employment termination, other than a discharge for cause, voluntary departure, or retirement, (B) a layoff exceeding 6 months, or (C) a reduction in hours of work of more than 50 percent during each month of any 6-month period;

(7) the term "unit of local government" means any general purpose political subdivision of a State which has the power to levy taxes and spend funds, as well as general corporate and police powers; and
(8) the term “part-time employee” means an employee who is employed for an average of fewer than 20 hours per week or who has been employed for fewer than 6 of the 12 months preceding the date on which notice is required.

(b) Exclusions from definition of employment loss. (1) In the case of a sale of part or all of an employer's business, the seller shall be responsible for providing notice for any plant closing or mass layoff in accordance with section 2102 of this title, up to and including the effective date of the sale. After the effective date of the sale of part or all of an employer’s business, the purchaser shall be responsible for providing notice for any plant closing or mass layoff in accordance with section 2102 of this title. Notwithstanding any other provision of this chapter, any person who is an employee of the seller (other than a part-time employee) as of the effective date of the sale shall be considered an employee of the purchaser immediately after the effective date of the sale.

(2) Notwithstanding subsection (a)(6) of this section, an employee may not be considered to have experienced an employment loss if the closing or layoff is the result of the relocation or consolidation of part or all of the employer's business and, prior to the closing or layoff—

(A) the employer offers to transfer the employee to a different site of employment within a reasonable commuting distance with no more than a 6-month break in employment; or

(B) the employer offers to transfer the employee to any other site of employment regardless of distance with no more than a 6-month break in employment, and the employee accepts within 30 days of the offer or of the closing or layoff, whichever is later.

Sec. 2102. Notice required before plant closings and mass layoffs

(a) Notice to employees, state dislocated worker units, and local governments. An employer shall not order a plant closing or mass layoff until the end of a 60-day period after the employer serves written notice of such an order—

(1) to each representative of the affected employees as of the time of the notice or, if there is no such representative at that time, to each affected employee; and

(2) to the State dislocated worker unit (designated or created under title III of the Job Training Partnership Act [29 U.S.C.A. s 1651 et seq.]) and the chief elected official of the unit of local government within which such closing or layoff is to occur.

If there is more than one such unit, the unit of local government which the employer shall notify is the unit of local government to which the employer pays the highest taxes for the year preceding the year for which the determination is made.

(b) Reduction of notification period. (1) An employer may order the shutdown of a single site of employment before the conclusion of the 60-day period if as of the time that notice would have been required the employer was actively seeking capital or business which, if obtained, would have enabled the employer to avoid or postpone the shutdown and the employer reasonably and in good faith believed that giving the notice required would have precluded the employer from obtaining the needed capital or business.

(2)(A) An employer may order a plant closing or mass layoff before the conclusion of the 60-day period if the closing or mass layoff is caused by business circumstances that were not
reasonably foreseeable as of the time that notice would have been required.

(B) No notice under this chapter shall be required if the plant closing or mass layoff is due to any form of natural disaster, such as a flood, earthquake, or the drought currently ravaging the farmlands of the United States.

(3) An employer relying on this subsection shall give as much notice as is practicable and at that time shall give a brief statement of the basis for reducing the notification period.

(c) Extension of layoff period. A layoff of more than 6 months which, at its outset, was announced to be a layoff of 6 months or less, shall be treated as an employment loss under this chapter unless—

(1) the extension beyond 6 months is caused by business circumstances (including unforeseeable changes in price or cost) not reasonably foreseeable at the time of the initial layoff; and

(2) notice is given at the time it becomes reasonably foreseeable that the extension beyond 6 months will be required.

(d) Determinations with respect to employment loss. For purposes of this section, in determining whether a plant closing or mass layoff has occurred or will occur, employment losses for 2 or more groups at a single site of employment, each of which is less than the minimum number of employees specified in section 2101(a)(2) or (3) of this title but which in the aggregate exceed that minimum number, and which occur within any 90-day period shall be considered to be a plant closing or mass layoff unless the employer demonstrates that the employment losses are the result of separate and distinct actions and causes and are not an attempt by the employer to evade the requirements of this chapter.

Sec. 2103. Exemptions.
This chapter shall not apply to a plant closing or mass layoff if—

(1) the closing is of a temporary facility or the closing or layoff is the result of the completion of a particular project or undertaking, and the affected employees were hired with the understanding that their employment was limited to the duration of the facility or the project or undertaking; or

(2) the closing or layoff constitutes a strike or constitutes a lockout not intended to evade the requirements of this chapter. Nothing in this chapter shall require an employer to serve written notice pursuant to section 2102 (a) of this title when permanently replacing a person who is deemed to be an economic striker under the National Labor Relations Act: [29 U.S.C.A. s 151 et seq.] Provided, That nothing in this chapter shall be deemed to validate or invalidate any judicial or administrative ruling relating to the hiring of permanent replacements for economic strikers under the National Labor Relations Act.

Sec. 2104. Administration and enforcement of requirements.
(a) Civil actions against employers.
(1) Any employer who orders a plant closing or mass layoff in violation of section 2102 of this title shall be liable to each aggrieved employee who suffers an employment loss as a result of such closing or layoff for—

(A) back pay for each day of violation at a rate of compensation not less than the higher of—

(i) the average regular rate received by such employee during the last 3 years of the employee's employment; or

(ii) the final regular rate received by such employee; and

(B) benefits under an employee bene-
fit plan described in section 1002(3) of this title, including the cost of medical expenses incurred during the employment loss which would have been covered under an employee benefit plan if the employment loss had not occurred.

Such liability shall be calculated for the period of the violation, up to a maximum of 60 days, but in no event for more than one-half the number of days the employee was employed by the employer.

(2) The amount for which an employer is liable under paragraph (1) shall be reduced by—

(A) any wages paid by the employer to the employee for the period of the violation;

(B) any voluntary and unconditional payment by the employer to the employee that is not required by any legal obligation; and

(C) any payment by the employer to a third party or trustee (such as premiums for health benefits or payments to a defined contribution pension plan) on behalf of and attributable to the employee for the period of the violation.

In addition, any liability incurred under paragraph (1) with respect to a defined benefit pension plan may be reduced by crediting the employee with service for all purposes under such a plan for the period of the violation.

(3) Any employer who violates the provisions of section 2102 of this title with respect to a unit of local government shall be subject to a civil penalty of not more than $500 for each day of such violation, except that such penalty shall not apply if the employer pays to each aggrieved employee the amount for which the employer is liable to that employee within 3 weeks from the date the employer orders the shutdown or layoff.

(4) If an employer which has violated this chapter proves to the satisfaction of the court that the act or omission that violated this chapter was in good faith and that the employer had reasonable grounds for believing that the act or omission was not a violation of this chapter the court may, in its discretion, reduce the amount of the liability or penalty provided for in this section.

(5) A person seeking to enforce such liability, including a representative of employees or a unit of local government aggrieved under paragraph (1) or (3), may sue either for such person or for other persons similarly situated, or both, in any district court of the United States for any district in which the violation is alleged to have occurred, or in which the employer transacts business.

(6) In any such suit, the court, in its discretion, may allow the prevailing party a reasonable attorney’s fee as part of the costs.

(7) For purposes of this subsection, the term, “aggrieved employee” means an employee who has worked for the employer ordering the plant closing or mass layoff and who, as a result of the failure by the employer to comply with section 2102 of this title did not receive timely notice either directly or through his or her representative as required by section 2102 of this title.

(b) Exclusivity of remedies.

The remedies provided for in this section shall be the exclusive remedies for any violation of this chapter. Under this chapter, a Federal court shall not have authority to enjoin a plant closing or mass layoff.

Sec. 2105. Procedures in addition to other rights of employees.

The rights and remedies provided to employees by this chapter are in addition to, and not in lieu of, any other contractual or statutory rights and
remedies of the employees, and are not intended to alter or affect such rights and remedies, except that the period of notification required by this chapter shall run concurrently with any period of notification required by contract or by any other statute.

Sec. 2106. Procedures encouraged where not required.

It is the sense of Congress that an employer who is not required to comply with the notice requirements of section 2102 of this title should, to the extent possible, provide notice to its employees about a proposal to close a plant or permanently reduce its workforce.

Sec. 2107. Authority to prescribe regulations.

(a) The Secretary of Labor shall prescribe such regulations as may be necessary to carry out this chapter. Such regulations shall, at a minimum, include interpretative regulations describing the methods by which employers may provide for appropriate service of notice as required by this chapter.

(b) The mailing of notice to an employee's last known address or inclusion of notice in the employee's paycheck will be considered acceptable methods for fulfillment of the employer's obligation to give notice to each affected employee under this chapter.

Sec. 2108. Effect on other laws.

The giving of notice pursuant to this chapter, if done in good faith compliance with this chapter, shall not constitute a violation of the National Labor Relations Act [29 U.S.C.A. ss 151 et seq.] or the Railway Labor Act.

Sec. 2109. Report on employment and international competitiveness.

Two years after Aug. 4, 1988, the Comptroller General shall submit to the Committee on Small Business of both the House and Senate, the Committee on Labor and Human Resources, and the Committee on Education and Labor a report containing a detailed and objective analysis of the effect of this chapter on employers (especially small-and medium-sized businesses), the economy (international competitiveness), and employees (in terms of levels and conditions of employment). The Comptroller General shall assess both costs and benefits, including the effect on productivity, competitiveness, unemployment rates and compensation, and worker retraining and readjustment. (Effective February 4, 1989, expect that the authority of the Secretary of Labor under Sec. 2107 took effect August 4, 1988.)
Final Rule

Accordingly, Chapter V of Title 20, Code of Federal Regulations, is amended by Revising Part 639, to read as follows:

PART 639 — WORKER ADJUSTMENT AND RETRAINING NOTIFICATION

Sec.
639.1 Purpose and scope.
639.2 What does WARN require?
639.3 Definitions.
639.4 Who must give notice?
639.5 When must notice be given?

§639.1 Purpose and scope.

(a) Purpose of WARN.
The Worker Adjustment and Retraining Notification Act (WARN or the Act) provides protection to workers, their families and communities by requiring employers to provide notification 60 calendar days in advance of plant closings and mass layoffs. Advance notice provides workers and their families some transition time to adjust to the prospective loss of employment, to seek and obtain alternative jobs and, if necessary, to enter skill training or retraining that will allow these workers to successfully compete in the job market. WARN also provides for notice to State dislocated worker units so that dislocated worker assistance can be promptly provided.

(b) Scope of these regulations.
These regulations establish basic definitions and rules for giving notice, implementing the provisions of WARN. The Department's objective is to establish clear principles and broad guidelines which can be applied in specific circumstances. However, the Department recognizes that Federal rulemaking cannot address the multitude of industry and company-specific situations in which advance notice will be given.

(c) Notice encouraged where not required.
Section 7 of the Act states:
It is the sense of Congress that an employer who is not required to comply with the notice requirements of section 3 should, to the extent possible, provide notice to its employees about a proposal to close a plant or permanently reduce its workforce.
(d) WARN enforcement.
Enforcement of WARN will be through the courts, as provided in §5 of the statute. Employees, their representatives and units of local government may initiate civil actions against employers believed to be in violation of §3 of the Act. The Department of Labor has no legal standing in any enforcement action and, therefore, will not be in a position to issue advisory opinions on specific cases. The Department will provide assistance in understanding these regulations and may revise them from time to time as may be necessary.

(e) Notice in ambiguous situations.
It is civically desirable and it would appear to be good business practice for an employer to provide advance notice to its workers or unions, local government and the State when terminating a significant number of employees. In practical terms, there are some questions and ambiguities of interpretation inherent in the application of WARN to business, practices in the market economy that cannot be addressed in these regulations. It is therefore prudent for employers to weigh the desirability of advance notice against the possibility of expensive and time-consuming litigation to resolve disputes where notice has not been given. The Department encourages employers to give notice in all circumstances.

(f) Coordination with job placement and retraining programs.
The Department, through these regulations and through the Trade Adjustment Assistance Program (TAA) and Economic Dislocation and Worker Adjustment Assistance Act (EDWAA) regulations, encourages maximum coordination of the actions and activities of these programs to assure that the negative impact of dislocation on workers is lessened to the extent possible. By providing for notice to the State dislocated worker unit, WARN notice begins the process of assisting workers who will be dislocated.

(g) WARN not to supersede other laws and contracts.
The provisions of WARN do not supersede any laws or collective bargaining agreements that provide for additional notice or additional rights and remedies. If such law or agreement provides for a longer notice period, WARN notice shall run concurrently with that additional notice period. Collective bargaining agreements may be used to clarify or amplify the terms and conditions of WARN, but may not reduce WARN rights.

§639.2 What does WARN require?
WARN requires employers who are planning a plant closing or a mass layoff to give affected employees at least 60 days' notice of such an employment action. While the 60-day period is the minimum for advance notice, this provision is not intended to discourage employers from voluntarily providing longer periods of advance notice. Not all plant closings and layoffs are subject to the Act, and certain employment thresholds must be reached before the Act applies. WARN sets out specific exemptions, and provides for a reduction in the notification period in particular circumstances. Damages and civil penalties can be assessed against employers who violate the Act.

§639.3 Definitions.
(a) Employer. (1) The term "employer" means any business enterprise that employs —
   (i) 100 or more employees, excluding part-time employees; or
   (ii) 100 or more employees, including part-time employees, who in the aggregate work at least 4,000 hours
per week, exclusive of hours of overtime.

Workers on temporary layoff or on leave who have a reasonable expectation of recall are counted as employees. An employee has a "reasonable expectation of recall" when he/she understands, through notification or through industry practice, that his/her employment with the employer has been temporarily interrupted and that he/she will be recalled to the same or to a similar job. The term "employer" includes non-profit organizations of the requisite size. Regular Federal, State, local and federally recognized Indian tribal governments are not covered. However, the term "employer" includes public and quasi-public entities which engage in business (i.e., take part in a commercial or industrial enterprise, supply a service or good on a mercantile basis, or provide independent management of public assets, raising revenue and making desired investments), and which are separately organized from the regular government, which have their own governing bodies and which have independent authority to manage their personnel and assets.

(2) Under existing legal rules, independent contractors and subsidiaries which are wholly or partially owned by a parent company are treated as separate employers or as a part of the parent or contracting company depending upon the degree of their independence from the parent. Some of the factors to be considered in making this determination are (i) common ownership, (ii) common directors and/or officers, (iii) de facto exercise of control, (iv) unity of personnel policies emanating from a common source, and (v) the dependency of operations.

(3) Workers, other than part-time workers, who are exempt from notice under §4 of WARN are nonetheless counted as employees for purposes of determining coverage as an employer.

(4) An employer may have one or more sites of employment under common ownership or control. An example would be a major auto maker which has dozens of automobile plants throughout the country. Each plant would be considered a site of employment, but there is only one "employer," the auto maker.

(b) Plant closing. The term "plant closing" means the permanent or temporary shutdown of a "single site of employment," or one or more "facilities or operating units" within a single site of employment, if the shutdown results in an "employment loss" during any 30-day period at the single site of employment for 50 or more employees, excluding any part-time employees. An employment action that results in the effective cessation of production or the work performed by a unit, even if a few employees remain, is a shutdown. A "temporary shutdown" triggers the notice requirement only if there are a sufficient number of terminations, layoffs exceeding 6 months, or reductions in hours of work as specified under the definition of "employment loss."

(c) Mass layoff. (1) The term "mass layoff" means a reduction in force which first, is not the result of a plant closing, and second, results in an employment loss at the single site of employment during any 30-day period for:

(i) at least 33 percent of the active employees, excluding part-time employees, and

(ii) at least 50 employees, excluding part-time employees.

Where 500 or more employees (excluding part-time employees) are affected, the 33% requirement does not apply, and notice is required if the other criteria are met. Plant closings involve
employment loss which results from the shutdown of one or more distinct units within a single site or the entire site. A mass layoff involves employment loss, regardless of whether one or more units are shut down at the site.

(2) Workers, other than part-time workers, who are exempt from notice under §4 of WARN are nonetheless counted as employees for purposes of determining coverage as a plant closing or mass layoff. For example, if an employer closes a temporary project on which 10 permanent and 40 temporary workers are employed, a covered plant closing has occurred although only 10 workers are entitled to notice.

(d) Representative. The term “representative” means an exclusive representative of employees within the meaning of §9(a) or 8(f) of the National Labor Relations Act or §2 of the Railway Labor Act.

(e) Affected employees. The term “affected employees” means employees who may reasonably be expected to experience an employment loss as a consequence of a proposed plant closing or mass layoff by their employer. This includes individually identifiable employees who will likely lose their jobs because of bumping rights or other factors, to the extent that such individual workers reasonably can be identified at the time notice is required to be given. The term “affected employees” includes managerial and supervisory employees, but does not include business partners. Consultant or contract employees who have a separate employment relationship with another employer and are paid by that other employer, or who are self-employed, are not “affected employees” of the business to which they are assigned. In addition, for purposes of determining whether coverage thresholds are met, either incumbent workers in jobs being eliminated or, if known 60 days in advance, the actual employees who suffer an employment loss may be counted.

(f) Employment loss. (1) The term “employment loss” means (i) an employment termination, other than a discharge for cause, voluntary departure, or retirement, (ii) a layoff exceeding 6 months, or (iii) a reduction in hours of work of individual employees of more than 50% during each month of any 6-month period.

(2) Where a termination or a layoff (see paragraphs (f)(1)(i) and (ii) of this section) is involved, an employment loss does not occur when an employee is reassigned or transferred to employer-sponsored programs, such as retraining or job search activities, as long as the reassignment does not constitute a constructive discharge or other involuntary termination.

(3) An employee is not considered to have experienced an employment loss if the closing or layoff is the result of the relocation or consolidation of part or all of the employer’s business and, prior to the closing or layoff —

(i) the employer offers to transfer the employee to a different site of employment within a reasonable commuting distance with no more than a 6-month break in employment, or

(ii) the employer offers to transfer the employee to any other site of employment regardless of distance with no more than a 6-month break in employment, and the employee accepts within 30 days of the offer or of the closing or layoff, whichever is later.

(4) A “relocation or consolidation” of part or all of an employer’s business, for purposes of paragraph §639.3(h)(4), means that some defin-
able business, whether customer orders, product lines, or operations, is transferred to a different site of employment and that transfer results in a plant closing or mass layoff.

(g) Unit of local government. The term "unit of local government" means any general purpose political subdivision of a State, which has the power to levy taxes and spend funds and which also has general corporate and police powers. When a covered employment site is located in more than one unit of local government, the employer must give notice to the unit to which it determines it directly paid the highest taxes for the year preceding the year for which the determination is made. All local taxes directly paid to the local government should be aggregated for this purpose.

(h) Part-time employee. The term "part-time" employee means an employee who is employed for an average of fewer than 20 hours per week or who has been employed for fewer than 6 of the 12 months preceding the date on which notice is required, including workers who work full-time. This term may include workers who work "an average of fewer than 20 hours per week" for which the period to be used for calculating whether a worker has worked is the shorter of the actual time the worker has been employed or the most recent 90 days.

(i) Single site of employment. (1) A single site of employment can refer to either a single location or a group of contiguous locations. Groups of structures which form a campus or industrial park, or separate facilities across the street from one another, may be considered a single site of employment.

(2) There may be several single sites of employment within a single building, such as an office building, if separate employers conduct activities with-in such a building. For example, an office building housing 50 different businesses will contain 50 single sites of employment. The offices of each employer will be its single site of employment.

(3) Separate buildings or areas which are not directly connected or in immediate proximity may be considered a single site of employment if they are in reasonable geographic proximity, used for the same purpose, and share the same staff and equipment. An example is an employer who manages a number of warehouses in an area but who regularly shifts or rotatess the same employees from one building to another.

(4) Non-contiguous sites in the same geographic area which do not share the same staff or operational purpose should not be considered a single site. For example, assembly plants which are located on opposite sides of a town and which are managed by a single employer are separate sites if they employ different workers.

(5) Contiguous buildings owned by the same employer which have separate management, produce different products, and have separate workforces are considered separate single sites of employment.

(6) For workers whose primary duties require travel from point to point, who are outstationed, or whose primary duties involve work outside any of the employer's regular employment sites (e.g., railroad workers, bus drivers, salespersons), the single site of employment to which they are assigned as their home base, from which their work is assigned, or to which they report will be the single site in which they are covered for WARN purposes.

(7) Foreign sites of employment are not covered under WARN. U.S. workers at such sites are counted to deter-
determine whether an employer is covered as an employer under §639.3(a).

(8) The term "single site of employment" may also apply to truly unusual organizational situations where the above criteria do not reasonably apply. The application of this definition with the intent to evade the purpose of the Act to provide notice is not acceptable.

(j) Facility or operating unit. The term "facility" refers to a building or buildings. The term "operating unit" refers to an organizationally or operationally distinct product, operation, or specific work function within or across facilities at the single site.

(k) State dislocated worker unit. The term "State dislocated worker unit" means a unit designated or created in each State by the Governor under Title III of the Job Training Partnership Act, as amended by EDWAA.

(1) State. For the purpose of WARN, the term "State" includes the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, and the U.S. Virgin Islands.

§639.4 Who must give notice?

Section 3(a) of WARN states that "an employer shall not order a plant closing or mass layoff until the end of a 60-day period after the employer serves written notice of such an order." Therefore, an employer who is anticipating carrying out a plant closing or mass layoff is required to give notice to affected employees or their representative(s), the State dislocated worker unit and the chief elected official of a unit of local government. In most instances, this may be the local site plant manager, the local personnel director or a labor relations officer.

(b) An employer who has previously announced and carried out a short-term layoff (6 months or less) which is being extended beyond 6 months due to business circumstances (including unforeseeable changes in price or cost) not reasonably foreseeable at the time of the initial layoff is required to give notice when it becomes reasonably foreseeable that the extension is required. A layoff extending beyond 6 months from the date the layoff commenced for any other reason shall be treated as an employment loss from the date of its commencement.

(c) In the case of the sale of part or all of a business, §2(b)(1) of WARN defines who the "employer" is. The seller is responsible for providing notice of any plant closing or mass layoff which takes place up to and including the effective date (time) of the sale, and the buyer is responsible for providing notice of any plant closing or mass layoff that takes place thereafter. Affected employees are always entitled to notice; at all times the employer is responsible for providing notice.

(1) If the seller is made aware of any definite plans on the part of the buyer to carry out a plant closing or mass layoff within 60 days of purchase, the seller may give notice to affected employees as an agent of the buyer, if so empowered. If the seller does not give notice, the buyer is, nevertheless, responsible to give notice. If the seller gives notice as the buyer's agent, the responsibility for notice still remains with the buyer.

(2) It may be prudent for the buyer and seller to determine the impacts of the sale on workers, and to arrange between them for advance notice to be
§639.5 When must notice be given?

(a) General rule. (1) With certain exceptions discussed in paragraphs (b), (c) and (d) of this section and in §639.9 of this part, notice must be given at least 60 calendar days prior to any planned plant closing or mass layoff, as defined in these regulations. When all employees are not terminated on the same date, the date of the first individual termination within the statutory 30-day or 90-day period triggers the 60-day notice requirement. A worker's last day of employment is considered the date of that worker's layoff. The first and each subsequent group of terminees are entitled to a full 60 days' notice. In order for an employer to decide whether issuing notice is required, the employer should—

(i) Look ahead 30 days and behind 30 days to determine whether employment actions both taken and planned will, in the aggregate for any 30-day period, reach the minimum numbers for a plant closing or a mass layoff and thus trigger the notice requirement; and

(ii) Look ahead 90 days and behind 90 days to determine whether employment actions both taken and planned each of which separately is not of sufficient size to trigger WARN coverage will, in the aggregate for any 90-day period, reach the minimum numbers for a plant closing or a mass layoff and thus trigger the notice requirement. An employer is not, however, required under §3(d) to give notice if the employer demonstrates that the separate employment losses are the result of separate and distinct actions and causes, and are not an attempt to evade the requirements of WARN.

(2) The point in time at which the number of employees is to be measured for the purpose of determining coverage is the date the first notice is required to be given. If this "snapshot" of the number of employees employed on that date is clearly unrepresentative of the ordinary or average employment level, then a more representative number can be used to determine coverage. Examples of unrepresentative employment levels include cases when the level is near the peak or trough of an employment cycle or when large upward or downward shifts in the number of employees occur around the time notice is to be given. A more representative number may be an average number of employees over a recent period of time or the number of employees on an alternative date which is more representative of normal employment levels. Alternative methods cannot be used to evade the purpose of WARN, and should only be used in unusual circumstances.

(b) Transfers. (1) Notice is not required in certain cases involving transfers, as described under the definition of "employment loss" at §639.3(f) of this part.

(2) An offer of reassignment to a different site of employment should not be deemed to be a "transfer" if the new job constitutes a constructive discharge.

(3) The meaning of the term "reasonable commuting distance" will vary with local and industry conditions. In determining what is a "reasonable commuting distance", consideration should be given to the following factors: geographic accessibility of the place of work, the quality of the roads, customarily available transportation, and the usual travel time.
(4) In cases where the transfer is beyond reasonable commuting distance, the employer may become liable for failure to give notice if an offer to transfer is not accepted within 30 days of the offer or of the closing or layoff (whichever is later). Depending upon when the offer of transfer was made by the employer, the normal 60-day notice period may have expired and the plant closing or mass layoff may have occurred. An employer is, therefore, well advised to provide 60-day advance notice as part of the transfer offer.

(c) Temporary employment. (1) No notice is required if the closing is of a temporary facility, or if the closing or layoff is the result of the completion of a particular project or undertaking, and the affected employees were hired with the understanding that their employment was limited to the duration of the facility or the project or undertaking.

(2) Employees must clearly understand at the time of hire that their employment is temporary. When such understandings exist will be determined by reference to employment contracts, collective bargaining agreements, or employment practices of an industry or a locality, but the burden of proof will lie with the employer to show that the temporary nature of the project or facility was clearly communicated should questions arise regarding the temporary employment understandings.

(3) Employers in agriculture and construction frequently hire workers for harvesting, processing, or for work on a particular building or project. Such work may be seasonal but recurring. Such work falls under this exemption if the workers understood at the time they were hired that their work was temporary. In uncertain situations, it may be prudent for employers to clarify temporary work understandings in writing when workers are hired. The same employers may also have permanent employees who work on a variety of jobs and tasks continuously through most of the calendar year. Such employees are not included under this exemption. Giving written notice that a project is temporary will not convert permanent employment into temporary work, making jobs exempt from WARN.

(4) Certain jobs may be related to a specific contract or order. Whether such jobs are temporary depends on whether the contract or order is part of a long-term relationship. For example, an aircraft manufacturer hires workers to produce a standard airplane for the U.S. fleet under a contract with the U.S. Air Force with the expectation that its contract will continue to be renewed during the foreseeable future. The employees of this manufacturer would not be considered temporary.

(d) Strikes or lockouts. The statute provides an exemption for strikes and lockouts which are not intended to evade the requirements of the Act. A lockout occurs when, for tactical or defensive reasons during the course of collective bargaining or during a labor dispute, an employer lawfully refuses to utilize some or all of its employees for the performance of available work. A lockout not related to collective bargaining which is intended as a subterfuge to evade the Act does not qualify for this exemption. A plant closing or mass layoff at a site of employment where a strike or lockout is taking place, which occurs for reasons unrelated to a strike or lockout, is not covered by this exemption. An employer need not give notice when permanently replacing a person who is deemed to be an economic striker under the National Labor Relations Act. Non-striking employees at the same single site of employment who experi-
ience a covered employment loss as a result of a strike are entitled to notice; however, situations in which a strike or lockout affects non-striking employees at the same plant may constitute an unforeseeable business circumstance, as discussed in §639.9, and reduced notice may apply. Similarly, the “faltering company” exception, also discussed in §639.9 may apply in strike situations. Where a union which is on strike represents more than one bargaining unit at the single site, non-strikers includes the non-striking bargaining unit(s). Notice also is due to those workers who are not a part of the bargaining unit(s) which is involved in the labor negotiations that led to the lockout. Employees at other plants which have not been struck, but at which covered plant closings or mass layoffs occur as a direct or indirect result of a strike or lockout are not covered by the strike/lockout exception. The unforeseeable business circumstances exception to 60 days' notice also may apply to these closings or layoffs at other plants.

§639.6 Who must receive notice?

Section 3(a) of WARN provides for notice to each representative of the affected employees as of the time notice is required to be given or, if there is no such representative at that time, to each affected employee. Notice also must be served on the State dislocated worker unit and the chief elected official of the unit of local government within which a closing or layoff is to occur. Section 2(b)(1) of the Act states that “any person who is an employee of the seller (other than a part-time employee) as of the effective date [time] of the sale shall be considered an employee of the purchaser immediately after the effective date [time] of the sale.” This provision preserves the notice rights of the employees of a business that has been sold, but creates no other employment rights. Although a technical termination of the seller's employees may be deemed to have occurred when a sale becomes effective, WARN notice is only required where the employees, in fact, experience a covered employment loss.

(a) Representative(s) of affected employees. Written notice is to be served upon the chief elected officer of the exclusive representative(s) or bargaining agent(s) of affected employees at the time of the notice. If this person is not the same as the officer of the local union(s) representing affected employees, it is recommended that a copy also be given to the local union official(s).

(b) Affected employees. Notice is required to be given to employees who may reasonably be expected to experience an employment loss. This includes employees who will likely lose their jobs because of bumping rights or other factors, to the extent that such workers can be identified at the time notice is required to be given. If, at the time notice is required to be given, the employer cannot identify the employee who may reasonably be expected to experience an employment loss due to the elimination of a particular position, the employer must provide notice to the incumbent in that position. While part-time employees are not counted in determining whether plant closing or mass layoff thresholds are reached, such workers are due notice.

(c) State dislocated worker unit. Notice is to be served upon the State dislocated worker unit. Since the States are restructuring to implement training under EDWAA, service of notice upon the State Governor constitutes service upon the State dislocated worker unit until such time as the Governor makes public State procedures for serving notice to this unit.
(d) Chief elected official of the unit of local government. The identity of the chief elected official will vary according to the local government structure. In the case of elected boards, the notice is to be served upon the board’s chairperson.

§639.7 What must the notice contain?

(a) Notice must be specific. (1) All notice must be specific.

(2) Where voluntary notice has been given more than 60 days in advance, but does not contain all of the required elements set out in this section, the employer must ensure that all of the information required by this section is provided in writing to the parties listed in §639.6 at least 60 days in advance of a covered employment action.

(3) Notice may be given conditional upon the occurrence or nonoccurrence of an event, such as the renewal of a major contract, only when the event is definite and the consequences of its occurrence or nonoccurrence will necessarily, in the normal course of business, lead to a covered plant closing or mass layoff less than 60 days after the event. For example, if the non-renewal of a major contract will lead to the closing of the plant that produces the articles supplied under the contract 30 days after the contract expires, the employer may give notice at least 60 days in advance of the projected closing date which states that if the contract is not renewed, the plant closing will occur on the projected date. The notice must contain each of the elements set out in this section.

(4) The information provided in the notice shall be based on the best information available to the employer at the time the notice is served. It is not the intent of the regulations, that errors in the information provided in a notice that occur because events subsequently change or that are minor, inadvertent errors are to be the basis for finding a violation of WARN.

(b) As used in this section, the term “date” refers to a specific date or to a 14-day period during which a separation or separations are expected to occur. If separations are planned according to a schedule, the schedule should indicate the specific dates on which or the beginning date of each 14-day period during which any separations are expected to occur. Where a 14-day period is used, notice must be given at least 60 days in advance of the first day of the period.

(c) Notice to each representative of affected employees is to contain:

(1) The name and address of the employment site where the plant closing or mass layoff will occur, and the name and telephone number of a company official to contact for further information;

(2) A statement as to whether the planned action is expected to be permanent or temporary and, if the entire plant is to be closed, a statement to that effect;

(3) The expected date of the first separation and the anticipated schedule for making separations;

(4) The job titles of positions to be affected and the names of the workers currently holding affected jobs.

The notice may include additional information useful to the employees such as information on available dislocated worker assistance, and, if the planned action is expected to be temporary, the estimated duration, if known.

(d) Notice to each affected employee who does not have a representative is to be written in language understandable to the employees and is to contain:

(1) A statement as to whether the planned action is expected to be permanent or temporary and, if the entire
plant is to be closed, a statement to that effect;
(2) The expected date when the plant closing or mass layoff will commence and the expected date when the individual employee will be separated;
(3) An indication whether or not bumping rights exist;
(4) The name and telephone number of a company official to contact for further information.

The notice may include additional information useful to the employees such as information on available dislocated worker assistance, and, if the planned action is expected to be temporary, the estimated duration, if known.

(e) The notices separately provided to the State dislocated worker unit and to the chief elected official of the unit of local government are to contain:
(1) The name and address of the employment site where the plant closing or mass layoff will occur, and the name and telephone number of a company official to contact for further information;
(2) A statement as to whether the planned action is expected to be permanent or temporary and, if the entire plant is to be closed, a statement to that effect;
(3) The expected date of the first separation, and the anticipated schedule for making separations;
(4) The job titles of positions to be affected, and the number of affected employees in each job classification;
(5) An indication as to whether or not bumping rights exist;
(6) The name of each union representing affected employees, and the name and address of the chief elected officer of each union.

The notice may include additional information useful to the employees such as a statement of whether the planned action is expected to be temporary and if so, its expected duration.

(f) As an alternative to the notices outlined in paragraph (e) above, an employer may give notice to the State dislocated worker unit and to the unit of local government by providing them with a written notice stating the name and address of the employment site where the plant closing or mass layoff will occur; the name and telephone number of a company official to contact for further information; the expected date of the first separation; and the number of affected employees. The employer is required to maintain the other information listed in §639.7(e) on site and readily accessible to the State dislocated worker unit and to the unit of general local government. Should this information not be available when requested, it will be deemed a failure to give required notice.

§639.8 How is the notice served?

Any reasonable method of delivery to the parties listed under §639.6 of this part which is designed to ensure receipt of notice at least 60 days before separation is acceptable (e.g., first class mail, personal delivery with optional signed receipt). In the case of notification directly to affected employees, insertion of notice into pay envelopes is another viable option. A ticketed notice, i.e., preprinted notice regularly included in each employee’s pay check or pay envelope, does not meet the requirements of WARN.

§639.9 When may notice be given less than 60 days in advance?

Section 3(b) of WARN sets forth three conditions under which the notification period may be reduced to less than 60 days. The employer bears the burden of proof that conditions for the exceptions have been met. If one of the exceptions is applicable, the employer must give as much notice as is practi-
cable to the union, non-represented employees, the State dislocated worker unit, and the unit of local government and this may, in some circumstances, be notice after the fact. The employer must, at the time notice actually is given, provide a brief statement of the reason for reducing the notice period, in addition to the other elements set out in §639.7.

(a) The exception under §3(b)(1) of WARN, termed “faltering company”, applies to plant closings but not to mass layoffs and should be narrowly construed. To qualify for reduced notice under this exception:

(1) An employer must have been actively seeking capital or business at the time that 60-day notice would have been required. That is, the employer must have been seeking financing or refinancing through the arrangement of loans, the issuance of stocks, bonds, or other methods of internally generated financing; or the employer must have been seeking additional money, credit, or business through any other commercially reasonable method. The employer must be able to identify specific actions taken to obtain capital or business.

(2) There must have been a realistic opportunity to obtain the financing or business sought.

(3) The financing or business sought must have been sufficient, if obtained, to have enabled the employer to avoid or postpone the shutdown. The employer must be able to objectively demonstrate that the amount of capital or the volume of new business sought would have enabled the employer to keep the facility, operating unit, or site open for a reasonable period of time.

(4) The employer reasonably and in good faith must have believed that giving the required notice would have precluded the employer from obtaining the needed capital or business. The employer must be able to objectively demonstrate that it reasonably thought that a potential customer or source of financing would have been unwilling to provide the new business or capital if notice were given, that is, if the employees, customers or the public were aware that the facility, operating unit, or site might have to close. This condition may be satisfied if the employer can show that the financing or business source would not choose to do business with a troubled company or with a company whose workforce would be looking for other jobs. The actions of an employer relying on the “faltering company” exception will be viewed in a company-wide context. Thus, a company with access to capital markets or with cash reserves may not avail itself of this exception by looking solely at the financial condition of the facility, operating unit, or site to be closed.

(b) The “unforeseeable business circumstances” exception under §3(b)(2)(A) of WARN applies to plant closings and mass layoffs caused by business circumstances that were not reasonably foreseeable at the time that 60-day notice would have been required.

(1) An important indicator of a business circumstance that is not reasonably foreseeable is that the circumstance is caused by some sudden, dramatic, and unexpected action or condition outside the employer's control. A principal client's sudden and unexpected termination of a major contract with the employer, a strike at a major supplier of the employer, and an unanticipated and dramatic major economic downturn might each be considered a business circumstance that is not reasonably foreseeable. A government ordered closing of an employment site that occurs without prior notice also may be an unforeseeable business circumstance.
(2) The test for determining when business circumstances are not reasonably foreseeable focuses on an employer's business judgment. The employer must exercise such commercially reasonable business judgment as would a similarly situated employer in predicting the demands of its particular market. The employer is not required, however, to accurately predict general economic conditions that also may affect demand for its products or services.

(c) The "natural disaster" exception in §3(b)(2)(B) of WARN applies to plant closings and mass layoffs due to any form of a natural disaster.

(1) Floods, earthquakes, droughts, storms, tidal waves or tsunamis and similar effects of nature are natural disasters under this provision.

(2) To qualify for this exception, an employer must be able to demonstrate that its plant closing or mass layoff is a direct result of a natural disaster.

(3) While a disaster may preclude full or any advance notice, such notice as is practicable, containing as much of the information required in §639.7 as is available in the circumstances of the disaster still must be given, whether in advance or after the fact of an employment loss caused by a natural disaster.

(4) Where a plant closing or mass layoff occurs as an indirect result of a natural disaster, this exception does not apply but the "unforeseeable business circumstance" exception described in paragraph (b) of this section may be applicable.

§639.10 When may notice be extended?

Additional notice is required when the date or schedule of dates of a planned plant closing or mass layoff is extended beyond the date or the ending date of any 14-day period announced in the original notice as follows:

(a) If the postponement is for less than 60 days, the additional notice should be given as soon as possible to the parties identified in §639.6 and should include reference to the earlier notice, the date (or 14-day period) to which the planned action is postponed, and the reasons for the postponement. The notice should be given in a manner which will provide the information to all affected employees.

(b) If the postponement is for 60 days or more, the additional notice should be treated as new notice subject to the provisions of §§639.5, 639.6, and 639.7 of this part. Rolling notice, in the sense of routine periodic notice, given whether or not a plant closing or mass layoff is impending, and with the intent to evade the purpose of the Act rather than give specific notice as required by WARN, is not acceptable.