



3-10-1989

9th Annual Seminar on Legal Issues for Financial Institutions

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

Joseph M. Scott Jr.
Stoll, Keenon and Park

M. Brooks Senn
Senn, Miller and Smith

John T. McGarvey
Morgan and Pottinger

David C. Pottinger
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Office of Continuing Legal Education at the University of Kentucky College of Law; Scott, Joseph M. Jr.; Senn, M. Brooks; McGarvey, John T.; Pottinger, David C.; Pitt, Dorothy M.; Sniegocki, James E.; Young, Cynthia W.; Deal, John C.; Brinkman, Scott W.; Harper, David W.; Strauss, R. James; Montague, William L.; and Holzknicht, John J., "9th Annual Seminar on Legal Issues for Financial Institutions" (1989). *Continuing Legal Education Materials*. 3.
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**UK
CLE**

**9th ANNUAL
SEMINAR ON**

**LEGAL ISSUES FOR
FINANCIAL INSTITUTIONS**

MARCH 10-11, 1989

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

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Printed in the United States of America

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COLLEGE OF LAW
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The University of Kentucky, College of Law, Office of Continuing Legal Education, was organized in Fall of 1973, as the first permanently staffed, full-time continuing legal education program in the Commonwealth of Kentucky. It endures with the threefold purpose of assisting Kentucky lawyers: to keep abreast of changes in the law resulting from statutory enactments, court decisions and administrative rulings; to develop and sustain practical lawyering and litigation skills; and to maintain a high degree of professional competence in the various areas of the practice of law.

An enormous debt of gratitude is owed to those who contribute their time, expertise and practical insight for the advance planning, the instructional presentations, and the written materials that make our seminars possible.

The Office of Continuing Legal Education welcomes correspondence and comment regarding our overall curriculum, as well as our individual seminars and publications. We hope the seminars and the materials distributed in conjunction with them provide attorneys with the invaluable substantive and practical information necessary to resolve society's increasingly complex legal problems in an efficient and effective manner. To the extent that we accomplish this, we accomplish our goal.

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LEGAL ISSUES FOR FINANCIAL INSTITUTIONS

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PROGRAM

PROGRAM PLANNING CHAIR & MODERATOR: M. Brooks Senn
Senn, Miller & Smith
Louisville, Kentucky

FRIDAY, March 10, 1989

- 8:00 a.m. **Late Registration**, Courtroom, College of Law, University of Kentucky
- 8:50 a.m. **Welcome**, Todd B. Eberle, Associate Dean and Director of Continuing Legal Education, University of Kentucky
- 9:05 a.m. **LENDER LIABILITY: A Considered Viewpoint for Kentucky Financial Institutions**
Joseph M. Scott, Jr.
Stoll, Keenon and Park
Lexington, Kentucky
- 10:00 a.m. **USURY REVISITED**
M. Brooks Senn
Senn, Miller and Smith
Louisville, Kentucky
- 10:55 a.m. **BREAK**
- 11:10 a.m. **CONSUMER REGULATORY REVIEW AND UPDATE: Truth In Lending Review; Adjustable Rate Mortgage Regulations; Regulation B; Home Equity Disclosure Act**
John T. McGarvey
and
David C. Pottinger
Morgan and Pottinger
Louisville, Kentucky
- 12:00 noon **LUNCH BREAK**
- 1:30 p.m. **EMPLOYMENT RELATIONS CONCERNS: Hirings, Promotions and Terminations—Discrimination; Personnel manuals; Employment at will**
Dorothy M. Pitt
Rogers, Fuller & Pitt
Louisville, Kentucky
- 2:15 p.m. **EMPLOYMENT RELATIONS CONCERNS: Employee Defalcation, Dishonesty, and Testing**
James E. Sniegocki
DATAQUEST, INC.
Louisville, Kentucky
- 3:00 p.m. **BREAK**
- 3:15 p.m. **RESPONDING TO INQUIRIES FROM/ REPORTING TO REGULATORY JUDICIAL AND INVESTIGATORY AUTHORITIES: Subpoenas: Transaction reporting; IRS reporting; Financial Privacy Act; Payments for provision of information**
Cynthia W. Young
Wyatt, Tarrant and Combs
Louisville, Kentucky
- 4:00 p.m. **REPRESENTING FINANCIAL INSTITUTIONS BEFORE REGULATORY BODIES**
John C. Deal
Emens, Hurd, Kegler & Ritter Co., L.P.A.
Columbus, Ohio
- 4:45 p.m. **RECESS**

SATURDAY, March 11, 1989

- 9:00 a.m. **LOAN PARTICIPATION INTERESTS:** Legal Issues for the Purchasing Community Bank
Scott W. Brinkman
Hirn, Reed, Harper & Eisinger
Louisville, Kentucky
- 9:55 a.m. **BANKING ISSUES COMMON TO COMMUNITY BANKS AND THEIR BANK HOLDING COMPANY:**
A Roundtable Discussion
- | | |
|--|--|
| David W. Harper
Hirn, Reed, Harper & Eisinger
Louisville, Kentucky | William L. Montague
Stoll, Keenon and Park
Lexington, Kentucky |
| R. James Straus
Brown, Todd & Heyburn
Louisville, Kentucky | John J. Holzknecht
Vice President
Professional Bank Services, Inc.
Louisville, Kentucky |
- 10:50 a.m. **BREAK**
- 11:05 a.m. **BANKING ISSUES COMMON TO COMMUNITY BANKS AND THEIR BANK HOLDING COMPANY** (Continued)
- 12:00 noon **ADJOURN**

LENDER LIABILITY
AND
KENTUCKY FINANCIAL INSTITUTIONS

Joseph M. Scott, Jr.
Laura Day Carruthers
Stoll, Keenon & Park
Lexington, Kentucky

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SECTION A



LENDER LIABILITY
AND
KENTUCKY FINANCIAL INSTITUTIONS

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I. LOAN WORKOUTS: EXCESSIVE CONTROL

A. COMMON LAW LIABILITY.

Many different common law theories are encompassed under the broad heading of "control." Fraud, duress, conspiracy, and interference are dealt with in detail elsewhere and will not be discussed here, but are often discussed in conjunction with excessive control. The "control" theory which is emerging is often also characterized as an "instrumentality" theory, with the courts imposing liability under the traditional principals of agency, alter ego, or joint venture/partnership. In all of these cases, the key question is how far a lender may go in exercising its rights without going too deep so as to result in liability. Once a lender assumes control, it will be held to be a fiduciary to the debtor, requiring it to look after the debtor's interests, as well as its own, which will be virtually impossible.

1. Agency Theory.

a. The Restatement (2d) of Agency, Section 14-0, Comment A states as follows:

A security holder who merely exercises a veto power over the business acts of his debtor by preventing purchases or sales above specified amounts does not thereby become a principal. However, if he takes over the management of the debtor's business either in person or through an agent, and directs what contracts may or may not be made, he becomes a principal, liable as a principal for the obligations incurred thereafter in the normal course of business by the debtor who has now become the general agent. The point at which the creditor becomes a principal is that at which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with his debtor may be.

b. Illustrative cases.

i. A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981). The court cited the Restatement of Agency in holding that a dominant lender was liable to other creditors of the borrower, a grain elevator company, as the principal of the debtor because of the lender's control of the debtor's business. The factors which the court considered in finding the necessary extent of control were as follows:

1. Lender had right of first refusal on grain purchases.

2. Lender had right to enter premises to conduct audits at any time.

3. Lender had right to restrict financing.

4. Lender provided constant recommendations and criticisms regarding finances, salaries, inventories, etc.

5. Lender had right to authorize or veto any capital improvements in excess of \$5,000.

6. Lender had representative on premises to supervise day to day operations.

7. Lender provided debtor with printed forms with Lender's name.

8. Existence of "smoking gun" internal memo in Lender's file stating that debtor needed "strong paternal guidance."

The court held that these factors extended far beyond the normal debtor-creditor relationship and that the lender had basically become the owner of the operation.

ii. Citibank, N.A. v. Data Lease Financial Corp., 828 F.2d 686 (11th Cir. 1987) reh'g. denied, 833 F.2d 1021 (11th Cir. 1987), cert. denied, 108 S. Ct. 1019 (1988). The court held that factual issue existed as to whether debtor's directors were agents of bank.

Bank had a loan secured by stock. Upon default, Bank voted stock to reduce size of Board and to elect Board members. Debtor alleged improper control based partially on testimony of director who admitted that he worked mainly for the Bank.

iii. Krivo Industrial Supply Co. v. National Distillers & Chemical Corp., 483 F.2d 1098 (5th Cir. 1973). The court stated that to be held liable as a principal, the creditor must exercise "such domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal." The court refused to impose liability under the instrumentality doctrine because the degree of control necessary did not exist. The court found that the lender was merely "safeguarding its interests as a major creditor" and had at no time

assumed "actual, participatory, total control" of debtor.

The lender was a mandatory co-signor of the debtor's checks and had the power to decide which trade creditors would be paid. The lender sent its own internal auditors to oversee the debtor's finances and actively manage the debtor's affairs for over a year. However, the court noted that the lender had stepped in at the request of debtor for assistance. Since this is an older case, its result could in all likelihood be different today.

2. Alter Ego Theory. The following cases are illustrative.

a. In re T.E. Mercer Trucking Co., 16 B.R. 176 (Bankr. N.D. Tex. 1981). The court held that the extent of creditor control evidenced in the loan documents suggested that the debtors were "mere instrumentalities or the alter ego" of the creditor and that factual issues existed to prevent a summary judgment. The following rights had been granted the creditor under the loan documents:

i. Joint control with required co-signatures of bank accounts.

ii. Right to participate in day-to-day operations of debtor's premises with full veto power.

iii. Lien on 100% of debtor's stock.

iv. Right to name member of the Board of Directors.

v. Right to review all corporate by-laws and other documents.

vi. Right to set salaries of officers and directors.

vii. Right to force a liquidation of all assets.

b. James E. McFadden, Inc. v Baltimore Contractors, 609 F.Supp. 1102 (E.D. Pa. 1985). The court stated that instrumentality theory requires strong showing of actual participation and total control of debtor by lender to the point that the debtor has, in reality, no separate corporate purpose apart from

that of the lender.

Subcontractor argued that general contractor was mere instrumentality of the bonding company. Court held that bonding company acted merely to minimize its risks as dominant creditor under contract that provided, among other things, for contractor to assign funds to bonding company and required bonding company to approve all advances for labor and materials.

c. Valdes v. Leisure Resource Group, Inc., 810 F.2d 1345 (5th Cir. 1987). The court stated that alter ego theory required some showing of actual and total control of borrower. "In the absence of full ownership, or where there is no ownership of the allegedly controlled entity, other significant indications that the autonomy of a corporation has been supplanted by the actions of the allegedly dominant company must exist before alter ego liability will be imposed." Id. at 1354. The court noted that the borrower continued to observe all corporate formalities and that trade creditors were treated equally and were aware that they were dealing with the borrower, not the lender.

d. NCNB Nat. Bank v. Tiller, 814 F.2d 931 (4th Cir. 1987). The court set forth the following standard to establish "control" liability:

The normal incidents of the borrower-lender relationship, including monitoring, protection and disposition of collateral, do not amount to control. Actual day-to-day involvement in management and operations of the borrower or the ability to compel the borrower to engage in unusual transactions is required for the purpose of showing that a lending institution had control over a borrower. Id. at 936.

e. Matter of Teltronics Services, Inc., 29 B.R. 139, 170 (Bankr. E.D.N.Y. 1983):

[A] non-insider creditor will be held to a fiduciary standard only where his abilities to command the debtor's obedience to his policy directives is so overwhelming that there has been, to some extent, a merger of identity. Unless the creditor has become, in effect, the alter ego of the debtor, he will not be held to an ethical duty in excess of the morals of the marketplace.

3. Joint Venture.

a. Connor v. Great Western Savings and Loan Association, 447 P.2d 609 (Cal. 1968). The court held that joint venture liability required an agreement between borrower and lender with a community of interest in a common business undertaking with the sharing of profits and losses and right of joint control. The construction lender was found not liable for claims involving the developer's negligence. The fact that both the lender and developer profited from the transaction was not sufficient to establish joint venture liability.

b. Edwards v. Northeast Bank, 250 S.E.2d 651 (N.C. App. 1979). The court held that no joint venture existed since there was no express or implied agreement between bank and borrower to carry out a single business venture with the joint sharing of profits and losses. The inventory control agreement entered into between parties was insufficient although Bank had right to receive regular reports on the debtor's inventory and had some degree of control over checks drawn on debtor's accounts.

4. Indicia of "Control".

The cases all involve similar factors which courts do consider in determining whether control that has been exercised is of such an extent that liability will be imposed. Each case will turn on its own facts as to whether excessive control has been exercised, but the following factors will always be considered:

a. Lender's ownership or equity in borrower, or lien in stock.

b. Lender's control of management, either through selection of management or control of their voting power.

c. Physical control of borrower's premises.

d. Economic or financial control, including signing off on checks, paying creditors, controlling salaries.

5. Liability Avoidance Techniques.

Lenders can avoid potential claims to a great extent by using common sense, and by heeding the following suggestions:

a. Do not act on impulse to pull the plug on a struggling borrower. Fast decisions can be dangerous because they are often hastily made and without documentation. Be sure to give your borrower reasonable notice of your decisions.

b. Document the files. It is extremely important in lieu of possible future litigation to have your loan files documented, to prove your reasonable conduct and explain your decision making process. It also offers written proof of what has been said to your borrower to avoid swearing contests at trial. Keep accurate and complete telephone and meeting notes.

c. Do not mislead your borrower. While lenders often do not like to play the "bad guy," it is better to be up-front with your borrower as to what you are truly considering, rather than to try to ease the pain by speaking with optimism and acting differently. Honesty is the best policy.

d. Do honor commitments. If you say you are going to act a certain way, be sure to follow through.

e. Follow the golden rule - do unto other creditors as you would have them do to you. If your actions tend to harm other creditors, it is more likely that liability will be imposed, or your lien will be subordinated.

f. Stay out of the borrower's business. Although it is tempting to assist your borrower to keep afloat, such assistance may lead to "control" from a jury's standpoint. The courts seem to tolerate some monitoring or assistance by lender, but outright demands may mean liability. You may make a number of suggestions, but always leave the final choices up to borrower. Do not place your people on the borrower's Board or in management. Do not become involved in day-to-day affairs or assume any control over cash flow.

g. Keep files clean. While it is important to document your loan files, it is equally crucial what your documentation includes. Do not editorize or make typical "smoking gun" comments.

h. Bring in the experts. As soon as signs of trouble develop, loan officers should contact the appropriate workout or trouble loan officers to handle the situation. Workout officers should watch for

bad blood between borrowers and loan officer. Emotions should never play a part in workout situations.

i. Bring in legal counsel. Although lenders may think counsel are unnecessary at the early stages of a loan workout, it is better to be safe than sorry, and appropriate counsel should monitor the situation and assist in decision making if the borrower's condition deteriorates.

j. Don't be arrogant or overreaching with borrower. Several cases where liability was imposed cite the lender's attitude as a factor. The tone of the dealings is an important factor which often cannot be documented but does exist. Remember to "recommend" courses of conduct rather than "demand" them. Never use profanity or table-slaming threats.

B. TAX AND OTHER STATUTORY LIABILITY.

1. Tax Liability.

a. A lender with excessive control could be held liable under Section 3505 of the Internal Revenue Code for unpaid withholding taxes of borrower to the extent of 25% of the amount so loaned specifically for payroll. Lender must have knowledge that the borrower/employer will not be able to, or does not intend to, pay the withholding taxes.

b. Also, the IRS does not have to give lender notice of the tax assessment before filing suit. Jersey Shore State Bank v. U.S., 107 S.Ct. 782 (1987).

c. If lender learns that taxes are not being paid, lender should stop making the loans altogether, or take steps to insure that taxes will be paid, such as an escrow account.

2. Securities Law Liability. Several theories of liability may apply to a control creditor under the Securities Act of 1933 and/or the Securities and Exchange Act of 1934.

a. Liability as a "Control Person".

i. Lender may be liable for borrower's violation of the

securities law under either the 1933 or 1934 Act. Control is defined in Securities Reg. 230.405 as "the possession, direct or indirect, of the power to direct or cause the direction of management and policies of a person, whether through the ownership of voting securities, by contract or otherwise."

ii. Several cases have held that a creditor is not in control of its debtor because of the mere extension of funds. See, e.g., Fuls v. Shastina Properties, 448 F.Supp. 983 (N.D. Cal. 1978); Wright v. Schock, 571 F.Supp. 642 (N.D. Cal. 1983), aff'd; 742 F.2d 541 (9th Cir. 1984).

iii. Illustrative Cases.

1. In re Falstaff Brewing Corp., 441 F.Supp. 62 (E.D. Mo. 1977). The court refused to dismiss creditors from shareholders' suit alleging liability as control person. Creditors were involved in day-to-day operations of borrower and required implementation of various business policies and replacement of certain officers and directors.

2. Technology Exchange Corporation of America, Inc. v. Grant County State Bank, 646 F.Supp. 179 (D. Col. 1986). The court refused to dismiss creditors upon shareholders' allegations of control under Securities Act where Bank had managed debtor's development project by retaining consultants, marketing, proposing expenditures and disbursements, threatening to withhold funding and requiring debtor to submit

periodic reports.

3. See also 38 ALR
Fed. 725.

iv. Creditors may assert "good faith" defense to control person allegations if creditor can prove it did not have culpable intent with respect to the violations. See, e.g., G.A. Thompson & Co., Inc. v. Partridge, 636 F.2d 945 (5th Cir. 1981).

b. Liability as "Aider and Abettor".

The three necessary elements to impose liability are a violation of the securities law, knowledge or constructive knowledge of the violation, and substantial aid by the aider and abettor in the alleged scheme. Monsen v. Consolidated Dressed Beef Company, 579 F.2d 793 (3d Cir. 1978), cert. denied, 439 U.S. 930 (1978). In Monsen, a bank's knowledge of the debtor's failure to disclose a blanket lien to its employees and shareholders resulted in violation in liability.

3. Other Statutory Liabilities.

a. Environmental cleanup law liabilities as an "operator". U.S. v. Maribile, 15 Env. Law. Rep. 20992 (E.D. Pa. 1985); U.S. v. Maryland Bank & Trust Company, 632 F. Supp. 573 (D. Md. 1986).

b. Fair Labor Standards Act, 29 U.S.C. Section 201, et. seq. Creditor may be liable for borrower's violations of minimum wage and overtime provisions to the extent that the lender forecloses on the tarnished or "hot" goods. Citicorp. Industrial Credit, Inc. v. Brock, 107 S.Ct. 2694 (1987).

c. RICO, 18 U.S.C. Section 1961, et seq. The necessary elements of a RICO claim are as follows:

- i. A person.
- ii. Employed by or associated with an enterprise engaged in interstate commerce.
- iii. That conducts or participates in the conduct of the affairs of the enterprise.
- iv. Through a pattern.
- v. Of racketeering activity.
- vi. That affects interstate commerce.
- vii. Results in injury.

Treble damages and attorneys fee made be awarded.

II. Trends in Cases.

- A. Declining importance of loan agreements.
- B. Declining use of parol evidence rule to preclude oral modifications of loan agreements.
- C. Increasing use of public law concepts:
 - 1. Good faith and fair dealing.
 - 2. Reasonable conduct -- commercially reasonable action.
- D. Inability of lenders to protect via loan documentation:
 - 1. Waiver.
 - 2. Estoppel.
 - 3. Oral modification.
 - 4. Unwaivable lender duties.
 - 5. Declining importance of covenant violations, especially if lender can't show (1) especially significant, or (2) reflects new situation with increased risk.

E. Facts more important than law.

1. Long recitals of facts in cases.
2. Little attention to specific cause of action.
3. Usually, factual combination is critical.

F. Liability cases frequently involve one or more of the following:

1. Trickery.
2. Peremptory action.
3. Personality conflicts.
4. Apparently irrational behavior -- e.g., refusal of new credit even though fully secured.
5. Sole financier with security interests on all or almost all assets.

III. Conduct Creating Risks. In general, must exceed ordinary creditor control. See In re Teltronics Services, Inc., 29 B.R. 139, 168-74 (Bk. E.D.N.Y. 1983) (aggressive collection); In re W.T. Grant Co., 699 F.2d 599, 610 (2d Cir.), cert. denied, 464 U.S. 822 (1983) (use of bargaining power, including debtor's need for funds, to improve status of claims). Also, probably can exercise greater control in workout situation than ordinary lending. See In re W.T. Grant Co., supra (careful watch). Lenders are better off trying to control their security and funds, as compared with the debtor's internal activities. See In re American Lumber Co., 5 B.R. 470 (Bk. D. Minn. 1980) (lender forced granting of security interest; then liquidated assets and discharged employees not necessary for liquidation, cut officers' salaries, controlled payment of other creditors, monitored mail, and was sole signatory on account); A. Gay Jensen Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981) (managerial control). In practice, however, the distinction may be difficult to draw.

- A. Approvals of day to day operations.
- B. Approvals of contracts.
- C. Limitations on debt.

D. Controls over funds. Cf. In re Yonkers Sanitarium, Inc., 22 B.R. 427 (Bk. S.D.N.Y. 1982) (dependence of homeowner on lender for financing not enough).

E. Hiring, firing, or retention of employees or officers. See State Nat'l. Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Civ. App. 1984) (forced hiring of workout consultant).

F. Membership on Board of Directors. Even attending meetings may be risky -- should be carefully controlled.

G. Substantial equity interest.

H. Employees on premises. See In re Process -Manz Press, Inc., 236 F. Supp. 333 (N.D. Ill. 1964), rev'd. on other grounds, 369 F.2d 513 (7th Cir. 1966), cert. denied, 386 U.S. 957 (1967); American Lumber, supra.

I. Directions to sell property, merge, or make basic change in business.

J. Directions to pay or not to pay particular creditors.

K. Encouraging junior creditors to extend new credit. Note that such creditors may sue on joint venture or fraud theory.

L. Animosity between lender and debtor. Cf. K.M.C. Co. v. Irving Trust Co., supra.

M. Review of press releases.

N. Inconsistent conduct. See K.M.C., supra (changed mind several times).

O. Precipitous conduct in declaring defaults, exercising remedies, or refusing new credit -- especially if sole lender and all credit tied up. See K.M.C., supra.

P. Threats -- to do what you can't do, or have no intention of doing. Farah, supra (exercise of certain remedies).

Q. Letter writing debtor -- must respond.

R. Demand loans. See K.M.C., supra (obligation of good faith); Centerre Bank v. Distributors, Inc., 705 S.W.2d 42 (Mo. App. 1985) (no duty). Courts will examine to see whether documents, taken as a whole, negate demand feature -- e.g., by having maturity dates, or events of default. See Reid v. Key Bank, 821 F.2d 9 (1st Cir. 1987).

S. Promises to lend -- especially when part relationship and some "objective" evidence confirming promise. See Landes Constr. Co. v. Royal Bank of Canada, ___ F.2d _____

T. Failure to respond to inquiries.

U. "Scandalous" documents.

BUSINESS

Construction firm awarded \$6.84 million in loan case

By SUSAN TOMPOR
Business Writer

A Bowling Green construction company that went out of business after its bank cut off its credit was awarded \$6.84 million yesterday as the result of a lender-liability suit against American National Bank & Trust Co.

The jury verdict, in the Warren Circuit Court in Bowling Green, consists of \$1.065 million in compensatory damages and \$5.775 million in punitive damages.

The suit was brought in the spring of 1987 by Hanson Construction Co. Inc. and owners H. C. "Hank" Hanson and Virginia Hanson against American National.

The bank, which has \$180 million in assets, is now part of First Kentucky National Corp. in Louisville. First Kentucky is a subsidiary of Cleveland-based National City Corp., which has more than \$20 billion in assets.

Robert Aldridge, chairman and chief executive officer of American National, said after the verdict that the bank has not decided whether to appeal.

"American National believes that it did nothing to harm Mr. Hanson or any other customers," Aldridge said. He declined to comment further on the case.

From 1980 through mid-1985, Hanson and his companies borrowed more than \$600,000

Bank is held liable after company loses its credit and is forced to close

from American National.

Shortly after American National was acquired by First Kentucky National Corp. in February 1985, the bank sought to restructure Hanson's loans — requiring additional collateral.

Charles D. Greenwell, an attorney for Middleton & Reutlinger who represented Hanson, said First Kentucky faced a large amount of problem loans when it first acquired the bank and put in a new team of managers to handle the problems.

From 1984 through 1987 American National had operating losses of more than \$8 million. The bank selected Hanson's loans among 1,000 others that it classified as problem loans, he said.

Although Hanson was not in default and had been current with his payments, Hanson Construction — which primarily built bridges for freeway overpasses — had faced financial losses in the 1980s.

Greenwell said Hanson agreed to restructure the loans in July 1985 and put up additional collateral, including a mortgage on

Virginia Hanson's home and farm.

In return, Greenwell said, the bank promised to give the Hansons up to 15 years to repay their debts; lend him some up-front money necessary to finance future construction contracts; and give him a new line of credit of \$125,000 for operations.

None of those promises was made in writing. And Greenwell said the bank denied making those promises.

But Greenwell called upon Hanson's testimony and the testimony of banking experts who stated that promises of that sort would be common in a "good faith" restructuring agreement.

Within the first year of the restructuring, American National financed a new construction contract, Greenwell said.

And in June 1986, American National also agreed to a \$175,000 line of credit. Greenwell said the company was in the process of turning around and had \$3 million in contracts by January 1987.

But in February 1987, the bank said it would not finance any additional construc-

tion contracts and had cut off credit on the \$175,000 line, Greenwell said.

On March 11, 1987, he said, American National demanded payment on all loans outstanding — about \$680,000 — by April 1, 1987.

The Bowling Green construction company, started in 1967, went out of business on March 23, 1987. It had gross annual sales of about \$2 million and employed about 12 people.

Joseph R. Huddleston, Warren Circuit judge, said the jury found that the bank made fraudulent misrepresentations when it entered into the restructuring agreement and found that the bank did not deal in good faith in enforcing the loan agreement.

Huddleston said the jury determined that the Hansons did act in good faith, even though the bank had argued during the trial that the Hansons concealed certain assets and misrepresented financial figures.

The suit had requested \$10 million in punitive damages and \$2.13 million in compensatory damages, but Greenwell said he was pleased with the verdict.

He did not know if the Hansons would go back into business, but said he believed there is an "excellent chance" that they will.

The Hansons could not be reached for comment.

HENDERSON v. FIRST AND FARMERS BANK OF SOMERSET, INC.

as reported at: 36 Kentucky Law Summary 1
January 20, 1989

U.C.C.
SELF-HELP REPOSSESSION
BREACH OF PEACE
PRESENCE OF PEACE OFFICER
PUNITIVE DAMAGES
INSTRUCTIONS
"GOLDEN RULE" STANDARD

Bank, a secured creditor, conducted a self-help repossession of plaintiff's speedboat upon his default under the secured obligation despite defendant's vehement objections—Held that peaceful self-help repossession is allowed by statute but that same over a debtor's objection constitutes a breach of peace—Moreover, bank's informally obtaining the presence of a peace officer at the scene of the repossession was violative of the statute since the use of the powers of the state to squelch potential breaches of the peace enables a creditor to evade or avoid statutory restrictive on repossession—Whether bank's conduct in repossessing

implied malice was a question of fact and jury award of punitive damages for plaintiff upheld. The jury also impliedly finding an absence of good faith in bank's act of repossession—Also, a separate instruction on the issue of good faith was not required, same being necessarily included in the instructions as given—Trial court's refusal to grant a new trial or a judgment n.o.v. on the award of \$75,000 in punitive damages was not clearly erroneous and thus not reversible error—Plaintiff's final argument was not violative of the golden rule standard and although plaintiff did not specifically ask the jurors to "step into his shoes," neither did he comment upon bank's financial condition—Depositions found to be taxable on costs—

First and Farmers Bank of Somerset, Inc. v. Henderson and Henderson v. First and Farmers Bank of Somerset, Inc.: Pulaski Cir. Ct., Venters, J.; Opinion by Judge Clayton, affirming, rendered 12/16/88. [This opinion is not final and shall not be cited as authority in any courts of the Commonwealth of Kentucky. CR76.30.]

"This appeal arises from a jury verdict in favor of appellee/cross-appellant, Charles Henderson, (hereinafter Henderson) against appellant/cross-appellee, First and Farmers Bank of Somerset, Inc., (hereinafter the Bank) as well as post-trial motions resulting in a partial judgment *non obstante veredicto*. We affirm.

"The substance of the case concerns the manner in which the Bank repossessed Henderson's speed boat in which the Bank had a valid security interest. There was considerable dispute below as to the underlying question of the Bank's right to declare a default. Since there was no appeal taken from the trial court's decision to grant a directed verdict to the Bank on its claim for default, we will assume there was in fact a default.¹

"The real issue was whether the Bank was in good faith in declaring a default premised upon its conclusion it was insecure. The good faith on this issue, which we assume from the directed verdict, does not carry over to the act of repossession.

"There is a two-step analysis involved. Initially, there must be good faith in declaring the default. Then, the right to repossess becomes operative. Thereafter, there is a separate requirement of good faith in carrying out the repossession. See KRS 355.1-203; KRS 355.9-503; and KRS 355.9-507."

"Prior to going to Henderson's residence, the Bank informally requested that the Pulaski County Sheriff's Department have one of its deputies stand by on the scene. Deputy Sheriff Pat Kelly, in full uniform, carrying his weapon, and in a marked car did meet the Bank's employees at the scene prior to any attempt to repossess the boat.

"At the time of the repossession, the boat was located in Henderson's garage. The garage doors were open, however, which allows self-help repossession under KRS 355.9-503 provided there is no other breach of the peace.² After the Bank's employees had entered Henderson's property and hitched the boat on its trailer to their vehicle, they attempted to depart. There is a dispute as to whether Henderson arriving on the scene at this time managed to prevent the Bank's employees from removing the boat from his property and into the public street but in any event, both vehicles stopped.³ There was a confrontation which, at least from Henderson's evidence, could have led to a physical conflict. There was also a clear and vehement verbal objection to the repossession by Henderson.

"²*C.I.T. Corporation v. Short*, 273 Ky. 190, 115 S.W.2d 899, 900 (1938)

"³We note that there would be instances in which a creditor had obtained sufficient dominion over the property to preclude any objection by the debtor. Such does not appear to be the case here. Moreover, since the issue was not argued below or here, we will not speculate on it. See Mikolajczyk, *Breach of the Peace and Section 9-503 of the Uniform Commercial Code—A Modern Definition for an Ancient Restriction*, 82 Dick. L. Rev. 351, 370-72 (1977-78)."

"Any actual violence was forestalled, however, by the timely arrival of Deputy Kelly who had departed his car and approached the antagonists. The deputy's actions at the point of confrontation are in dispute. Henderson maintains that after asking the deputy if the Bank could legally repossess his boat, the deputy nodded in the affirmative. The deputy and the Bank employees allege that he did or said nothing, but merely stood by.

"In any event, Henderson without retracting his objection, stated he was going to call his lawyer in order to discuss the repossession. The Bank's employees took the opportunity to flee the scene with the boat.

"Henderson sued for conversion of the boat, as well as some other miscellaneous items alleged to have been in the boat, but not covered by the security interest. He also demanded punitive damages. Finally, Henderson made a claim for intentional infliction of severe emotional distress. The Bank counterclaimed on the note underlying its security interest.

"After the close of the evidence, the trial court directed a verdict for Henderson on the conversion of the boat and to the Bank on its counterclaim. The remaining issues were submitted to the jury.

"The jury found the fair market value of the boat was \$16,000. As directed, the jury deducted \$14,011.76, the amount of the security interest, therefrom and awarded \$1,988.24 in damages to Henderson. The jury further awarded \$5,000 for emotional distress and \$75,000 for punitive damages. Nothing was awarded for the miscellaneous items.

"The Bank moved for a new trial or a judgment notwithstanding the verdict.

Specifically, the Bank alleged various errors relating to the directed verdict on the conversion claim and the jury verdicts on the emotional distress and punitive damages claims. The Bank further objected to some items submitted by Henderson as costs.

"The court granted a judgment notwithstanding the verdict regarding the emotional distress claim but overruled the motion and objections as to the remaining issues. The Bank's appeal and Henderson's cross-appeal followed. All the errors alleged have been preserved.

"The initial problem to be analyzed concerns the directed verdict against the Bank on the conversion issue. The standard of review on directed verdicts is enunciated in *Spivey v. Sheeler*, Ky., 514 S.W.2d 667 (1974). All fair and reasonable inferences must be drawn in favor of the party opposing the motion, and the court must conclude the evidence was insufficient to sustain a verdict for the opposing party. *Id.* at 673.

"The controlling question regarding the directed verdict involves the proper application of KRS 355.9-503. There, it is provided that a secured party, when the debtor is in default, may carry out a self-help repossession provided there is no breach of the peace.

"A breach of the peace has been defined to include both actual violent acts, and acts likely to induce violence. *O'Leary v. Commonwealth*, Ky., 441 S.W.2d 150, 154 (1969). There has not been a Kentucky case directly applying the general rule to KRS 355.9-503.

"As the commentators note, pre-Code cases are still good law since breach of the peace is not defined in the statute. D. Leibson and R. Nowka, *The Uniform Commercial Code of Kentucky*, Section 8.6(a) at 833 (1983). Unfortunately, there are no cases, even pre-Code, which analyze the effect of the presence of a peace officer on a self-help repossession.⁴

"A case typical of those finding a breach of the peace prior to the adoption of the Code is *National Bond & Investment Co. v. Whitorn*, 276 Ky. 204, 123 S.W.2d 263 (1938). There, two employees of the creditor stopped the debtor on a public street and harangued and harrassed him until the repossession was completed. The court stated that a repossession could not be had if a breach of the peace resulted without explicitly defining the term, any restraint was placed on the debtor, or any force was used against the debtor. *Id.* at 265. The court went on to approve both the compensatory and punitive damages awarded. *Id.* at 266."

"Even without reference to the presence of the deputy, it is clear that repossession in the face of the debtor's objection constitutes a breach of the peace. *National Bond*, *supra*; See Leibson and Nowka at 834. Moreover, the commentators state that a disagreement over repossession ought not have to rise to the level of an assault before a breach is deemed to occur. Leibson and Nowka at 834.

"A quick survey of self-help repossession cases from other jurisdictions is supportive of

the commentator's position. In *Big Three Motors, Inc. v. Rutherford*, Ala., 432 So.2d 483, 85-86 (1983), the Supreme Court of Alabama stated that the use of force, trickery, and fraud constituted a breach of the peace. While the Court of Appeals of Indiana, in *Census Federal Credit Union v. Wann*, Ind. App., 403 N.E.2d 48, 352 (1980), held that self-help repossession could not be had if it was verbally or otherwise contested by the debtor at the actual time and immediate vicinity of the attempted repossession. If such were the case, the creditor must desist and proceed through judicial process. Finally, in *Morris v. First National Bank and Trust Co. of Ravenna*, Ohio, 54 N.E.2d 683, 686-87 (1970), Ohio's highest court held that a breach of the peace was committed when the creditor's agents physically confronted the debtor and disregarded his request to stop even though here was no actual physical conflict.

"The testimony given establishes a clear objection by Henderson. Even if repossession over a mere verbal objection is insufficient to establish a breach of the peace, it is patent that without Deputy Kelly's limited intervention, there would have been a more serious altercation. As a result, it is clear that unless the presence of the deputy negates the breach of the peace, the directed verdict against the bank was proper.

"We are, thus, directly confronted with the novel issue of the effect of a peace officer on self-help repossession. While at first blush the Bank's decision to informally obtain the presence of a peace officer seems to serve the salutary purpose of preserving the peace, a closer analysis reveals it as violative of KRS 355.9-503.

"If a creditor is allowed to unofficially use the powers of the state to squelch potential breaches of the peace,³ he can effectively evade or avoid the statute. The statute makes it clear that a creditor runs the risk of serious liability if he proceeds with a self-help repossession when there is a serious objection by the debtor. If the strong arm of the law is needed, then the creditor must secure judicial intervention when a police officer is carrying out or sanctioning the repossession.

"We have been cited to cases discussing whether an officer's intervention in a self-help repossession constitutes state action. See *U.S. v. Coleman*, 628 F.2d 961 (6th Cir. 1980); and *Gray v. Darnell*, 505 F.2d 741 (6th Cir. 1974). We do not find them exceptionally helpful since the degree of intervention by the officer necessary in our analysis is less than a finding that the state compelled the private party through the actions of the officer to act as he did. See *Coleman* 628 F.2d at 964."

"On that issue, *Stone Machinery Company v. Kessler*, Wash. App., 463 P.2d 651 (1970), is quite persuasive. There, the creditor secured the local sheriff in full regalia to assist in the repossession of a caterpillar tractor since the debtor was inclined toward violent defense of his property. The court held that where the officer was acting under color of office, without legal process, and the creditor thereby

took possession of the collateral over debtor's objection, the creditor had committed trespass. *Id.* at 654. The court explained that the actions amounted to constructive force, intimidation, and oppression constituting a breach of the peace. Moreover, the creditor's actions completely circumvented the purpose and intent of the Code. *Id.* at 655.

"Although the intervention of Deputy Kelly was not as active as that in *Stone Machinery*, the distinction is without difference. The net effect in both cases was to override the debtor's right to object. As a result, under the authorities cited, there was a breach of the peace.

"The court below correctly granted a directed verdict on the conversion issue. There was not a constructive breach of the peace caused by the mere presence of the deputy. The evidence, however, even when viewed most favorably to the Bank, established that the deputy sheriff acting under color of office, without any legal process, enabled the Bank to repossess over Henderson's objection. There was, thus, an actual breach of the peace. Since the decision below was correct, although based upon the wrong grounds, it will not be disturbed on appeal. *Haddad v. Louisville Gas & Electric Company*, Ky., 449 S.W.2d 916, 919 (1969).

"We move on to the Bank's objections to the punitive damages awarded. It is argued that the Bank was entitled to a directed verdict on the issue. Alternatively, it is asserted that a specific instruction on the issue of good faith was in order and that, in any event, the award made was excessive.

"On the directed verdict issue, the Bank stands or falls on *Fort Knox National Bank v. Gustafson*, Ky., 385 S.W.2d 196 (1964). There, the repossession of a mobile home, which was being used as a diner, was at issue. The court found the Fort Knox bank to have acted in good faith. *Id.* at 200. As a result, technical deficiencies in the Fort Knox bank's claim and delivery action would not give rise to a cause of action, nor would liability for punitive damages lie.

"We find *Gustafson* distinguishable. The judge below never found that the Bank was in good faith in carrying out the repossession. As we previously noted, good faith in the repossession attempt is a distinct issue from good faith in the declaration of a default. While the judge below may have assumed the latter, the jury did not find the former, or it could not have awarded punitive damages. We further note that *Gustafson* does not involve self-help repossession. As a result, the Fort Knox bank was properly protected from liability for any minor technical deficiencies since it had resorted to the judicial process. The Bank has no such shield.

"The evidence of the Bank's conduct in making the repossession is clear. Their actions constituted a breach of the peace, and Henderson was properly granted a directed verdict. Since it was established that the Bank had violated KRS 355.9-503, Henderson was entitled to damages suffered as a result. KRS 355.9-507.

"It is well established that punitive damages may be recovered in an action for conversion if the defendant's conduct is sufficiently egregious. *Hensley v. Paul Miller Ford, Inc.*, Ky., 508 S.W.2d 759, 762 (1974). To recover punitives, there must be a finding that the defendant acted with malice, whether actual or implied. Implied malice is conscious wrongdoing. *Fowler v. Mantooth*, Ky., 683 S.W.2d 250, 252 (1984). In determining whether to make such an award, the trier of fact may consider the character of the defendant and the nature and extent of the harm to the plaintiff. In analyzing the character of the defendant's act, the trier may consider its outrageousness, defendant's extent of culpability and motives, the relationship between the parties, and the existence or absence of provocation. *Id.* at 253.

"There is no doubt that a question of fact existed with regard to whether the Bank's conduct in the repossession implied malice. It cannot be said that the Bank's decision to proceed with the repossession after Henderson's objection and his return to his house to call his lawyer could not be found by a reasonable man to show malice. That being the case, a directed verdict would have been improper. *Spivey, supra*. It is equally true that the denial of the judgment notwithstanding the verdict was proper since the evidence must be construed most favorably in favor of the verdict winner. *Hensley, supra*.

"A separate instruction on the issue of good faith was not required. We are directed to give instructions which provide only the bare bones. The instructions can subsequently be fleshed out by counsel in closing argument. *Cox v. Cooper*, Ky., 510 S.W.2d 530 (1974).

"Here, the relevant instruction states the law properly. See *Hensley* and *Fowler, supra*. The question of good faith is necessarily included in the instructions as given. Certainly, counsel for the Bank could argue, and apparently did, that the Bank was in good faith. If the jury had believed the Bank was in good faith, it could not have returned a verdict awarding punitives.

"The Bank next asserts the awarded punitive damages were excessive. The test for the trial court is often styled 'the first blush rule.' *Davis v. Graviss*, Ky., 672 S.W.2d 928, 932 (1984). On review here, we do not apply that rule. Instead, we are directed not to substitute our judgment on the question but can reverse only if the court's ruling was clearly erroneous. *Id.* at 933.

"Although the award does seem high, it is apparent that the jury believed Henderson's assertion that the Bank essentially stole his boat. It is also apparent that the able judge below is in a better position than we are to decide whether the jury's award was excessive. We, therefore, do not find the judge's decision overruling the Bank's post-trial motions clearly erroneous on the issue of excessiveness and hence affirm.

"The Bank's fifth allegation arises from closing argument. We do not find the argument made violative of the golden rule standard.

Notably, the essence of a golden rule argument is to ask the jurors to step into the shoes of the plaintiff. *Stanley v. Ellegood*, Ky., 382 W.W.2d 572, 575 (1964). Here, the request was to act before it is too late without any direction to step into Henderson's shoes.

We note, moreover, that previous cases finding violations of the golden rule standard are also premised upon the combination of the argument and mention of the defendant's financial condition. It was the combination of the two, coupled with repetition, that was particularly invidious. *Id.* Here, we find neither mention of the Bank's financial condition nor repetition.

As a result, the judge's ruling was not in error. It is beyond question that the trial judge is in the best position to assess any actual prejudicial effect. We decline to substitute our judgment in its place.

The final argument of the Bank is that certain costs charged by Henderson were not allowable. Specifically, Henderson sought to recover the costs involved with certain depositions taken for discovery but not expressly used at trial.

Depositions, with any limitation, are included in the list of items recoverable as costs. CR 54.02. The cases cited by the Bank are not on point. The issue here does not relate to expert fees or additional copies. See *Commonwealth, Transportation Cabinet, Department of Highways v. Wireman*, Ky. App., 714 S.W.2d 159 (1986); *Brookshire v. Lavigne*, Ky. App., 713 S.W.2d 481 (1986); and *Phipps v. Collinsworth*, Ky. App., 691 S.W.2d 907 (1985). We note finally that a deposition taken on discovery can be vital to preparation for and the actual conduct of a trial even if it is neither read into evidence nor expressly used to impeach a witness. The costs allowed were correct.*

*We also note that the correctness of the trial judge's allowance of costs here is in accord with a recent amendment to CR 54.02 which was effective January 1, 1988."

On the cross-appeal, we likewise find the trial court's decision was proper. A judgment notwithstanding the verdict is proper when even if after all the evidence is construed most favorably to the verdict winner, a finding in his favor would not be made by a reasonable man. *Hensley*, 508 S.W.2d at 762.

Whatever *Craft v. Rice*, Ky., 671 S.W.2d 247 (1984), actually decided beyond holding the five-year statute of limitations applicable, it is clear that not every upset plaintiff can recover for emotional distress. See *Zurich Insurance Company v. Mitchell*, Ky., 712 S.W.2d 340 (1986). The judge below correctly noted that not every bad act gives rise to a cause of action for the intentional infliction of severe emotional distress, that an extra element of damages for all plaintiffs was not created nor was the distress complained of by Henderson in any sense severe.

The foregoing being correct, the judgment notwithstanding the verdict on the emotional distress claim was correct. We, therefore, affirm.

For all the above listed reasons, we affirm the decision of the Pulaski Circuit Court sustaining the directed verdict on the conversion issue for Henderson, the jury verdict on the punitive damages, and the judgment notwithstanding the verdict on Henderson's emotional distress claim.

The judgment of the Pulaski Circuit Court is affirmed on both the direct and cross appeals."

Miller, Judge, concurs.

McDonald, Judge, concurs in result and files a separate opinion.

USURY REVISITED

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Louisville, Kentucky

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SECTION B



USURY REVISITED

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SECTION B

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SECTION B



I. INTRODUCTION

A. RATE OF INTEREST PERMITTED BANKS DEPENDS UPON:

- (1) The type of credit extension, e.g., is it a simple interest loan, short term single payment loan, pre-computed interest installment loan, purchase of dealer paper, manufactured home financing, credit card or other revolving credit transaction?
- (2) The amount of the credit transaction, e.g., is it in excess of \$15,000?
- (3) The identity of the debtor, e.g., is the credit extended to an individual, corporation, business?
- (4) The purpose of the credit transaction.
- (5) Federal pre-emption of state usury limitations and applicability of "most favored lender" status.

B. WHETHER THE CREDIT TRANSACTION FALLS WITHIN ONE OR MORE OF THE FOREGOING CHARACTERISTICS DETERMINES WHETHER THE INTEREST RATE IS CONTROLLED BY (SEE APPENDIX):

- (1) KRS 360.010 - Fixing the "legal" and "contract" rate of interest in Kentucky.
- (2) KRS 360.025 and 360.027 - Removing the defense of usury from corporations and certain limited partnerships and business trusts.
- (3) 12 USC 85 - Authorizing national banks to charge interest at the greater of the amount permitted by the laws of the state where the national bank is located or 1% in excess of the discount rate, i.e., "most favored lender" status.
- (4) KRS 287.214 - Authorizing Kentucky state banks to charge interest on contracts or obligations of \$15,000 or less at any rate permitted national banks by the laws of the United States.
- (5) 12 USC 1831d - Permitting state insured banks to charge the same rate as national banks under 12 USC 85.
- (6) Sec. 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 - Pre-empting state usury laws on certain real estate and mobile home loans.
- (7) Regulations of the Federal Home Loan Bank Board (12 CFR 590) - Implementing Sec. 501 of the 1980 Act.

- (8) KRS 287.215 - Fixing rates on discount and add-on installment loans.
- (9) KRS 287.710 to 287.770 - Relating to banks credit card and other revolving credit plans.
- (10) KRS 371.210 to 371.330 and KRS 190.090 to 190.140 - Relating to retail installment contracts covering consumers goods and motor vehicles.
- (11) KRS 360.150 - Relating to manufactured home financing transactions.

II. GENERAL USURY STATUTE (KRS 360.010).

A. STATUTORY RATES

- (1) Legal Rate - 8% per annum
- (2) Contract Rate -
 - (a) If original principal amount is \$15,000 or less - the lesser of 19% or 4% in excess of the discount rate (11% at March 10, 1989).
 - (b) If original principal amount is more than \$15,000 - any rate if agreed to in writing.
- (3) Minimum Interest - \$10 "if the legal interest does not account to that sum."

B. LOANS NOT SUBJECT TO KRS 360.010 LIMITATIONS.

- (1) Loans of more than \$15,000 (KRS 360.010). Duff v. Bank of Louisville & Trust Co., Ky., 705 S.W.2d 920 (1986).
- (2) Loans to corporations, limited (but not general) partnerships and business trusts - other than a limited partnership or business trust, the principal asset of which is a one or two-family dwelling - (KRS 360.025 and 360.027).
- (3) Individual guarantors of corporate, limited partnership or business trust loans may not plead usury as a defense, E'Town Shopping Center, Inc. v. Lexington Finance Co., Ky. App., 436 S.W.2d 267 (1969).
- (4) Lines of credit and Master Notes over \$15,000 -

The Attorney General has indicated that a "master note" device is basically a line of credit and that the actual amount advanced to the borrower under the line of credit or master note determined the applicable rate of interest under KRS 360.010. Thus, if a borrower executes a master note for \$16,000 but is advanced only \$8,000 at the time of executing the note, the maximum interest rate is 4% above the "discount rate," or 19%, whichever is less. See OAG 79-169 (March 12, 1979).

A contrary position is arguable where the future advances will exceed \$15,000 and are obligatory and not discretionary with the bank.

C. LOANS (\$15,000 OR LESS) SUBJECT TO KRS 360.010

(1) Computation of Interest:

The general view is that the "per annum" interest rate limitation in KRS 360.010 requires use of either the 365/365 or 360/360 method of computation when a loan of \$15,000 or less is involved. Use of the 365/360 method has been held usurious if the maximum rate of interest is charged. American Timber & Trad. Co. v. First Natl. Bank of Oregon, 511 F.2d 980 (9th Cir. 1973). If the original principal amount exceeds \$15,000, use of the more favorable 365/360 method should be specifically agreed to by the borrower in writing by, for example, describing the computation method in the note.

- (a) 365/365: Under this method, the rate of interest is divided by 365 to produce a daily interest factor. The number of days that the loan is outstanding is then multiplied by this daily interest factor. Under this method, a different amount of interest is charged for months of different lengths.
- (b) 360/360: Under this method, each month is treated as having 30 days. Thus, interest for each month is the same. However, for a calendar year, the interest is exactly the same as that calculated by using the 365/365 method.
- (c) 365/360: This method is a combination of the first two: the interest rate is divided by 360 days (30 days for each month) to create a daily factor. The number of days that a loan is outstanding is then multiplied by this daily factor. Thus interest charged for months of different lengths is different and interest

charged for a calendar year is greater than interest charged under either the 365/365 or 360/360 method.

(2) Determination of Interest.

Amounts paid to and retained by a bank which has the effect of increasing the bank's "yield" will be considered "interest" for usury purposes. Thus, "points", "stand-by", commitment, loan fees or other sums paid to a bank, however, denominated, will be, in my judgment, deemed "interest" for usury limit computations. See Union Cent. Life Ins. Co. v. Edwards, 219 Ky. 748, 294 S.W. 502 (1927); Commonwealth Farm Loan Co. v. Caudle, 203 Ky. 761, 263 S.W.2d 24 (1924).

(3) Closing Costs and Other Fees.

- (a) Closing costs paid to third parties permitted, i.e., title search, appraisal and title insurance fees, cf. Palmer v. Bank of Louisville & Trust Co., Ky. App., 682 S.W.2d 789 (1985);
- (b) Moreover, at common law, a bank could, in addition to interest at the maximum rate, properly charge its borrower with the necessary, reasonable expenses incident to the loan without being guilty of usury. Such expenses included the cost of ascertaining whether the security offered was adequate, title examination costs, appraisals, recording fees and the expenses of preparation of the loan and security documents. Union Cent. Life Ins. Co. v. Edwards, 219 Ky. 748, 294 S.W. 502 (1927), supra., Ashland Nat. Bank v. Conley, 231, Ky. 844, 22 S.W.2d 270 (1929);
- (c) In like manner, fees imposed for the privilege of prepaying a debt are not deemed to be usurious, Hamilton v. Kentucky Title Savings Bank & Trust Co., 159 Ky. 680, 167 S.W. 898 (1914); Webb v. Southern Trust Co., 227 Ky. 79, 11 S.W.2d 988 (1928); and
- (d) Although the Kentucky courts have never ruled on the status of a "late charge," the Kentucky Department of Financial Institutions has historically taken the position that such charges are in the nature of liquidated damages and are permitted so long as they are reasonably related to the expenses incurred by the lender. June 16, 1981, Letter of Ronda S. Paul

to William H. Mohr. The Department is also of the view that the right to impose "late charges" must be included in the loan documents. Also see: April 14, 1970 Memorandum of E. Frederick Zopp, General Counsel to the Department of Banking, to Executive Management of [Various] Financial Institutions, pg. 3, item 8 ("Kentucky statutes support the majority view that a borrower's default and resulting late charges do not make a loan usurious"); OAG 70-276 (May 6, 1970) (" . . . [I]f the consideration is for services actually rendered to the borrower and the agreement for services is made in good faith, and is not a cloak to conceal usury, the transaction is not an usurious loan.")

(4) Discounting Notes - interest in advance at the highest rate.

(a) KRS 287.180(1) empowers banks to "discount" notes.

(b) Permitted for "short-term paper". See: Bablett v. Deposit Bank of Carlisle, 122 Ky. 324, 92 W.W. 283 (1906); Schultz v. Providence Loan Ass'n., 289 Ky. 25, 157 S.W. 2d 736 (1941); Newell v. National Bank of Somerset, 75 Ky. (12 Bush) 57 (1876); Warren Deposit Bank v. Robinson's Adm'rs., 18 Ky. L.R. 78, 35 S.W. 275 (1896); 57 ALR 2d 633-674, "Taking or Charging Interest in Advance as Usury"; Evans v. National Bank of Savanna, 251 U.S. 108 (1919).

What is "short term paper" is an open question. See November 12, 1981 Memorandum for Ronda Paul, Attorney for Department of Banking, to all Examiners ("The Departmental position is that short-term (one year or less) notes may be discounted even though the resultant Annual Percentage Rate (APR) would be greater than the rate allowed by KRS 360.010.")

(5) Penalties (KRS 360.020)

(a) If an usurious rate of interest is knowingly charged, the entire interest is forfeited.

(b) Where a greater rate of interest has been paid, the debtor may, if the action is brought within two years from the time the usurious transaction occurred, recover twice the amount of interest paid.

D. RENEWAL (EXTENDING THE TIME OF PAYMENT) OF LOANS.

(1) Position of Department of Financial Institutions

- (a) If a \$15,000 or less fixed-rate loan is renewed and the maximum rate permissible under KRS 360.010 has changed (either increased or decreased) since the loan was made, the renewal is viewed as a new contract and the decreased maximum rate must be used. (Similarly, any increased maximum rate may be used.) See June 26, 1984 Memorandum from Ballard W. Cassady, Jr., Commissioner.

Example: Bank makes a 6-month \$10,000 loan to X at 11% , which is 4% above the discount rate of 7%. Six months later, the loan is renewed (i.e., the time of payment is extended for an additional six months) and the discount rate has decreased to 6 1/2%. The maximum rate of interest which may be charged is 10 1/2%.

- (b) If a bank makes a demand loan of \$15,000 or less bearing interest payable in installments at the maximum rate permitted by KRS 360.010 at the time the loan is made, it is required to reduce the interest rate on such loan on the next succeeding interest installment payment date after a decline in the maximum interest rate permitted under KRS 360.010 - notwithstanding the fact that the bank has not demanded payment of the loan's principal. This conclusion is apparently on the basis that a demand loan bearing interest payment in installments is in some manner "continued" or "renewed" on every interest payment date.

- (2) Changes in usury law. Although there apparently is no Kentucky decision directly on point, where the "renewal" only extends the time of payment of the original note and makes no change in the principal thereof or in any of its other terms, a strong argument can be made that the rule in Kentucky is that the rate of interest originally agreed to between the parties may continue to be charged on the basis that:

- (a) It is long been established that a note bearing lawful interest at the time it is entered into is not made usurious by a subsequent change in the law reducing the permitted rate of interest. See Lee v. Davis, 8 Ky. 397, 1 A.K. Marsh. 397 (1818); Jump v. Johnson, 12 Ky. Law

Rep. 100, 13 S.W. 843 (1890); Abner v. York, 19 Ky. Law Rep. 643, 41 S.W. 309 (1897); Mix v. Fidelity Trust & Safety Vault Co., 103 Ky. 77, 44 S.W. 393 (1898); Holland v. Holman, 21 Ky. Law Rep. 105, 50 S.W. 1102 (1899); Curry v. Adams' Adm'r., 22 Ky. Law Rep. 256, 57 S.W. 8 (1900); Foard v. Grinter's Ex'rs, 14 Ky. Rep. 5, 18 S.W. 1034 (1892); Mastin v. Cochran's Ex'rs., 24 Ky. L. Rep. 712, 76 S.W. 343 (1903); 4 ALR 2d 932, 935.

(b) Where a note is given merely in renewal for another note and not in payment, the renewal does not extinguish the original debt or in any way change the debt except for postponing the time of payment, even though the first note is surrendered. See Cantrell Construction Company v. Carter, 418 F.2d 705 (6th Cir. 1969); White v. Winchester Land Development Corp., Ky. App., 584 S.W.2d 56 (1979); Georgi v. First National Bank of Louisville, Ky. App., 557 S.W.2d 442 (1977), In re Zemansky, 39 F.Supp. 628 (D.C.S.D. Cal. 1941); Dufresne v. Hammersten, ___ Id. ___, 106 Pac.2d 861 (1940).

(3) The Department's second position on the "renewal" of a demand note appears to be inconsistent with Mastin v. Cochran's Ex'r., 25 Ky. L. Rep. 712, 76 S.W. 343 (1903).

III. FEDERAL PREEMPTION - RESIDENTIAL REAL PROPERTY

Sec. 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (Pub. L. 96-221) (codified at 12 U.S.C. 1735f-7 note) provides that state constitutions or laws limiting the rate or amount of interest, discount points, finance charges or other charges are preempted and do not apply to loans secured by a first lien on:

- (a) "residential real property,"
- (b) "all stock allocated to a dwelling unit in a residential cooperative housing corporation," or
- (c) a "residential manufactured home" so long as the loan documents contain certain consumer protection provisions prescribed by regulations of the Federal Home Loan Bank Board.

A. Purpose of Credit Irrelevant. Sec. 501 focuses upon the type of collateral and the priority of the lender's interest in the collateral. If a first lien is taken on

residential real property, a residential manufactured home or a dwelling unit in a residential cooperative housing corporation, the test is met.

- (1) Thus, a corporate loan secured by a first mortgage on a shareholder's residential real property is preempted under Sec. 501.
- (2) Similarly, it is not necessary that the loan be a "purchase money" loan. So long as the requisite type of collateral and a first lien interest therein is obtained, Sec. 501's preemption provision are applicable.

B. Residential Real Property - is defined in FHLBB Regulations issued under Sec. 501 of the 1980 Act [12 C.F.R. 590.2(f)] as:

". . . real estate improved or to be improved by a structure or structures designed primarily for dwelling, as opposed to commercial use."

- C. Not All Charges Preempted. Sec. 501 only relates to "interest, discount points, finance charges or other charges." Other provisions of state law, (i.e., laws limiting prepayment charges, attorney's fees and the like) are not preempted and will apply to the loan.
- D. "Residential Manufactured Home" Loans. Sec. 501 of the 1980 Act preempts state usury laws with respect to loans secured by a first lien on a "residential manufactured home" (which includes mobile homes) only if the consumer protection provisions of the FHLBB regulations (12 C.F.R. 590) are complied with. See regulations at pages B-49 to 55 of the Appendix which contain provisions:
- (1) Covering balloon payments, prepayment penalties, late charges and defenses;
 - (2) Requiring the creditor to give 30 days prior notice of any action leading to repossession or foreclosure (except in the case of abandonment or other extreme circumstances);
 - (3) Requiring the creditor, upon repayment in full, to refund the unearned portion of any pre-computed finance charge in an amount not less than the amount which would be calculated by the actuarial method (not the "rule of 78's) except that the debtor is not entitled to a refund which is less than \$1.

IV. "MOST FAVORED LENDER" STATUS

A. NATIONAL BANKS - 12 U.S.C. 85 grants most favored lender status to national banks by giving them a choice:

- (1) They may charge interest at the highest rate allowed by state law to lenders generally in the state where the bank is located, i.e., national banks may "borrow" competing lenders' rates; or
- (2) They may charge interest at 1% over the discount rate on 90-day commercial paper in effect at the district federal reserve bank.

See Tiffany v. Bank of Missouri, 85 U.S. (18 Wall.) 409 (1874); Northway Lanes v. Hackley Union Nat. Bank & Trust Co., 464 F. 2d 855 (6th Cir. 1972); Fisher v. First Nat. Bank of Chicago, 538 F.2d 1284 (7th Cir. 1976); Fisher v. First Nat. Bank of Omaha, 548 F.2d 255 (8th Cir. 1977); 12 CFR 7.7310(a) - Comptroller of the Currency, Interpretive Ruling.

B. KENTUCKY STATE INSURED BANKS - KRS 287.214 and 12 U.S.C. 1831d grant "most favored lender" status to Kentucky state banks - with KRS 287.214 granting such status independent of the deposit insurance status of the bank.

See Vanderweyst v. First State Bank of Benson, 425 N.W.2d 803 (Minn. 1988) cert. den. 109 U.S. 369 (1988) - the first appellate court decision holding that 12 U.S.C. 1831d (Sec. 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub.L. 96-221) extended most favored lender status to federally-insured state banks.

C. OTHER PROVISIONS - If a bank "borrows" a competing lender's rates, it must also comply with other provisions of state law relating to that class of loans that are material to the determination of the interest rate, e.g., provisions relating to the amount of the loan, the term, method of repayment, delinquency and other charges, and the like. See Northway Lanes v. Hackley Union Nat. Bank & Trust Co., 464 Fed.2d 855 (6th Cir. 1972); August 11, 1988, letter from Robert B. Serino, Deputy Chief Counsel, Comptroller of the Currency to Ms. Linda T. Lowe, Assistant Attorney General of the State of Iowa.

V. "BORROWING" CREDIT UNION AND PETTY LOAN COMPANY RATES.

A. GENERAL CONSIDERATIONS

Under its "most favored lender" status discussed under Section IV above, a national bank or state insured bank may, with respect to loans of \$15,000 or less, elect to "borrow" the rates and charges permitted state chartered credit unions or petty loan companies. A bank wishing to do so should obtain competent counsel to advise it with respect to the technical issues which arise when "most favored lender" status is sought. Generally, if a bank "borrows" the higher rates permitted by KRS Chapters 290 or 288, it must also comply with the other provisions of those chapters relating to loan amount, maturity, methods of payment, delinquency and other charges, and the like.

The general departmental policy of the Kentucky Department of Financial Institutions "permit[s] use of the interest rate structure found in both KRS Chapter 288, the Consumer Loan Company Act, and KRS Chapter 290, the Credit Union Act." See February 8, 1985 letter of James M. Baker, General Counsel, Department of Financial Institutions, to Joseph A. Cleves, Jr.

However, the Department requires, for examination and evaluation purposed, that loans made by state insured banks pursuant to their "most favored lender" status:

". . . be segregated on . . . [the bank's] books according to the statutes under which they are made It is suggested that . . . [the bank's] EDP servicer provide a special numeric coding for this."

B. CREDIT UNION LOANS AND CHARGES (KRS CH. 290)

(1) Loan Conditions, Rates and Charges

(a) A credit union may loan to members for such purposes and upon such conditions as the bylaws may provide (KRS 290.425) "Interest rates on loans shall be determined by the board of directors, not to exceed two percent (2%) per month on unpaid balances" (KRS 290.435).

(2) Types of Loans

(a) KRS Ch. 290 does not contain any restrictions upon the types of loans which a credit union may make and authorizes the credit union's board of directors to "[e]stablish the

policies of the credit union with respect to the granting of loans and the extending of lines of credit, including the maximum amount which may be loaned to any one (1) member" [KRS 290.225(4)], with the only limitations being that (i) a member's loan may not exceed 10% of the credit union's capital and (ii) aggregate loans secured by first mortgages on real estate may not exceed 50% of the credit union's unimpaired capital (KRS 290.465 and 290.505).

- (b) Thus, national and state insured banks in Kentucky may establish demand, single payment and simple interest installment loan programs of \$15,000 or less and charge not more than 2% per month on the unpaid balances of such loans. In order to conform to the provisions of KRS Ch. 290, the board of directors of a bank electing to "borrow" the state chartered credit union rate should adopt resolutions establishing the loan programs, the policies to be followed in connection with such programs, the interest rates to be charged and the other conditions to be complied with in implementing such programs (see KRS 290.225(4), 290.425, 290.435, 290.465 and 290.505). Since credit union rates can only be computed on "unpaid balances," it appears that such programs cannot include pre-computed, add on or discount loans.

The Kentucky Department of Financial Institutions' General Counsel has opined that:

"KRS 290.425 permits a credit union to make loans for such purposes and upon such conditions as its bylaws may provide. If a bank's written loan policy permit demand, variable rate and short-term loans, these loans would be compatible with KRS 290.425 so long as the interest rate at no time exceeds two percent (2%) per month on the unpaid balance."

C. **PETTY LOAN COMPANY LOANS AND CHARGES (KRS CH. 288)**

- (1) Amount and Types of Loans: Petty loan company licensees are authorized to lend up to \$15,000 excluding charges [KRS 288.530(1)]. No scheduled repayment of such loan may be more than 60 months and 15 days from the date of the loan if the amount of the loan is \$3,000 or less, or 120 months if the amount of the loan is more than \$3,000, and every contract of loan must "provide for repayment of the

amount lent in substantially equal installments at approximately equal periodic intervals of time" [KRS 288.580(2)]

Since KRS 288.580(2) does not require that the equal periodic installments be on a monthly or other specified period, it would appear that KRS Chapter 288 loans can be made on a quarterly, semiannual or other periodic installment basis so long as such installments are substantially equal as to amount and time. If the loan is made on other than a monthly installment basis, however, KRS 288.530(5) would appear to limit any deferral charge on such loans to \$.02 for each dollar of deferred installment rather than \$.02 for each dollar of the installment times the number of months which the maturity of the contract is extended. See "Deferral Charges" discussed below.

On the other hand, the specific provisions of KRS 288.580(2), requiring that all loans must provide for repayment of the amount lent in substantially equal installments, would appear to limit petty loan companies to installment loans and preclude them from making demand and single payment loans.

(2) Permitted Charges: KRS 288.530(1) authorizes a petty loan company to charge and receive:

(a) On loans of \$3,000 or less--3% per month on that part of the unpaid principal balance not in excess of \$1,000 and 2% per month on that part of the unpaid principal balance exceeding \$1,000 but not exceeding \$3,000.

(b) On loans exceeding \$3,000--2% per month on the unpaid balance of the principal amount of the loan [§3(1)].

Since KRS 288.530(1) provides that the foregoing charges shall "not [be] in excess" of the specified rates, variable rate loans would appear to be authorized. It is understood that the Kentucky Department of Financial Institutions interpretes KRS 288.580(2), requiring loan repayments to be in substantially equal installments, to only require the repayment of principal in substantially equal installments. See August 30, 1982 letter of J. Rick Jones, Attorney for Department of Financial Institutions, to David W. Harper, Greenebaum, Doll and McDonald.

The foregoing charges may either be (1) computed in advance at the agreed rate on scheduled unpaid

principal balances of the cash advance on the assumption that all scheduled payments will be made when due and then added to the original cash advance with the resulting sum being the face amount of the note [KRS 288.530(1)]; or (2) at the option of the petty loan company, computed on the unpaid principal balance of the loan from time to time outstanding, [KRS 288.530(b)].

It should be noted that under the first option, the interest calculation needs to be studied carefully since it is not the same method as would be employed if the loan were made under KRS 287.215 (add-on or discount installment loans made by banks).

If the charge is computed under the second option (a) the charge may not be paid, deducted, received in advance or compounded and must be computed only on unpaid principal balances for the time actually outstanding [KRS 288.530(8)]; and (b) no delinquency or deferral charges are permitted:

(3) Other Charges: In addition to the foregoing, a petty loan company is authorized to charge and collect the following:

(a) Closing Costs: On loans secured by real estate mortgages, the following costs if they are not paid to the petty loan company or to a person "related" to the company:

1. Fees or premiums for title examination, abstract of title, title insurance, survey or similarly purposes;
2. Fees for preparation of a deed, settlement statement, or other documents;
3. Escrows for future payment of taxes, including assessments for improvements, insurance and water, sewer and land rents;
4. Fees for notarizing deeds and other documents; and
5. Appraisal fees.

(b) Filing Fees and Premiums: Fees for filing and releasing liens and instruments securing the loan and premiums for property damage and credit insurance [KRS 288.530(10)].

- (c) Delinquency Charges: If 1/2 or more of any installment remains unpaid more than seven (7) days after it is due, a delinquency charge of \$.02 for each dollar of the "scheduled installment" may be collected for each full month the installment remains unpaid [KRS 288.530(4)].
- (d) Deferral Charges: If a wholly unpaid installment is deferred one or more full months, a deferral charge may be collected not exceeding \$.02 for each dollar of the installment so deferred multiplied by the number of months the maturity of the contract is extended [KRS 288.530(5)]. However, the number of months by which the deferral charges is multiplied to arrive at the total deferral charge cannot exceed the number of installments which are due and wholly unpaid or due within 15 days from the deferral date.
- (e) Rebates: KRS 288.530(6) requires precomputed charges to be refunded if the loan is prepaid in full; refund is required for partial prepayments. Although, KRS 288.530(6) requires that the refund be of "the portion of the charges applicable to the full installment periods following the installment date nearest the date of prepayment", KRS 288.530(2) provides:

"The portion of the charges applicable to any particular monthly installment period, as originally scheduled or following a deferment, shall bear the same ratio to the total charges, excluding any adjustments made pursuant to subsection (3) of this section, as the balance scheduled to be outstanding during that monthly period bears to the sum of all monthly balances scheduled originally by the contract of loan."

This language appears to be the operational equivalent of the "rule of 78's" and to sanction rebates on that basis. The Sixth Circuit has so held. Maddox v. Kentucky Finance Company, Inc., ___ Fed.2d ___ (6th Cir. 1984).

- (4) Collateral: Loans made under KRS Chapter 288 may be either secured or unsecured. If secured, any type of collateral (including first mortgages on real estate) may be taken as security except that if the amount of the loan is \$3,000 or less only

second or more inferior real estate mortgages are permitted. [KRS 288.580(3)]. KRS 288.570(2) also permits loans made under KRS Chapter 288 to be secured by wage assignments so long as the amount collected from the employer does not exceed 10% of the amount owed to the borrower for each pay period.

- (5) Insurance: Under KRS 288.560(1) as amended, a petty loan company may request a borrower to insure tangible property, other than household goods, offered as security for a loan exceeding \$300 and may also request that life, health or disability insurance be obtained by the borrower or any two of them if there are two or more borrowers as additional security for the loan; however, only "one (1) policy of life insurance may be written in connection with any loan transaction" [KRS 288.560(2)]. Premiums for such insurance may be deducted from the loan proceeds and paid to the insurance carrier [KRS 288.560(3)].
- (6) Maximum Indebtedness: KRS 288.530(1) prohibits a petty loan company from splitting or dividing a loan or permitting a borrower to become indebted "under more than one (1) contract of loan at the same time" if, as a result, more interest or other consideration is received by the petty loan company than would otherwise be permitted by KRS Chapter 288. Thus, if a borrower desires to borrow \$10,000, the petty loan company cannot divide the loan into ten \$1,000 loans so as to charge 3% per month on each; rather, it is limited to a 2% a month since the loan exceeds \$3,000.

Also, KRS 288.530(12) prohibits a petty loan company from charging interest or other consideration at a rate greater than it would be permitted to charge if it were not a petty loan company licensee in any case when the unpaid principal, excluding charges, exceeds \$15,000 at any time on account of "any loan or loans" from the petty loan company licensee to the borrower as principal obligator, guarantor or surety. This prohibition has the effect of limiting the maximum principal obligation of any borrower to a petty loan company to \$15,000.

To the extent that a Kentucky national or state bank "borrows" the petty loan company rates in making loans permitted by KRS Chapter 288, this prohibition would likewise limit the maximum principal indebtedness on "petty loan" types of credit extensions to \$15,000.

VI. INSTALLMENT LOANS - PRE-COMPUTED INTEREST (KRS 287.215)

A. INTRODUCTION AND APPLICABILITY

- (1) KRS 287.215 is basically "rate" legislation - authorizing banks to make installment loans with precomputed ("add-on" or "discount") interest. KRS 287.215 is not limited to "consumer loans"; rather, it is applicable to all types of credit.
- (2) Since Duff v. Bank of Louisville & Trust Co., Ky., 705 S.W.2d 920 (1986), KRS 287.215's applicability is effectively limited to loans of \$15,000 or less although the statute has no explicit dollar limitation.

B. INTEREST RATE AND CALCULATION

- (1) "Add-on". KRS 287.215(1)(a) permits an 8% "add-on" rate; that is, a rate which does not exceed \$8 per \$100 per annum upon the principal amount of the loan.
- (2) "Discount". If the loan does not exceed 5 years and 32 days, the "\$8 per \$100 per annum" interest rate can be received (which has the effect of "discounting" the interest from the loan proceeds). KRS 287.215(1)(b).

C. OTHER PERMITTED CHARGES.

- (1) KRS 287.215 contains very limited language on the types of other charges which a bank can directly or indirectly charge, contract for or receive. They are:
 - (a) An investigation fee equal to the lesser of \$1 for each \$50 or fraction thereof, or \$16, KRS 287.215(2).
 - (b) Lawful fees actually paid to a public officer for filing, recording or releasing any instrument securing the loan, KRS 287.215(2).
 - (c) Delinquency charges, which cannot exceed \$.05 for each dollar of each installment more than 10 days late (only one delinquency charge can be made on any one installment payment), KRS 287.215(3).
 - (d) Attorney's fees, which cannot exceed 15% of the unpaid balance, and court costs; provided the note is referred to an attorney who is not

the salary employee of the bank for collection, KRS 287.215(3).

- (2) In addition to the foregoing charges, the bank may collect from the debtor or add to principal amount of the loan, charges for title exam, appraisals and title insurance so long as such charges are not retained by the bank but are, rather, paid to third parties. Palmer v. Bank of Louisville & Trust Co., Ky. App., 682 S.W.2d 789 (1985).

D. OTHER PROVISIONS.

- (1) Wage Assignments. Assignments, pledges or transfers of wages to be earned or paid in the future are prohibited, KRS 287.215(5).
- (2) First Mortgages on Real Estate. First mortgages on real estate are prohibited (except (a) where created by virtue of a judgment or decree, (b) first mortgages on unimproved real estate not exceeding 10 acres, or (c) first mortgages on real estate on which there is located or to be located a residential mobile home), KRS 287.215(5).
- (3) Splitting-Up Loans. A loan cannot be split up or divided to permit a person to become obligated to the bank under more than one loan at the same time for the purpose of obtaining a greater charge than otherwise permitted under KRS 287.215. (See OAG 74-304 (April 22, 1974), which takes the position that a bank cannot have in its loan files two or more loans at the same time involving the same person where one of the loans is made pursuant to KRS 287.215. The fact that the loans were made at different times is "inconsequential"), KRS 287.215(6).
- (4) Balloon Payments. If any payment is more than twice as large as the average of the earlier scheduled payments, the debtor has the right to refinance without penalty the "balloon" payment on terms "no less favorable" to the debtor than the original loan, KRS 287.215(1)(c).
- (5) Prepayment and Rule of 78's. The borrower has the right to prepay the loan in whole or in part at any time. If the loan is fully prepaid prior to maturity, a rebate must be made at a rate not less than in accordance with the Rule of 78's if the maximum financing charge permitted by the statute has been taken. If a lesser charge has been taken, a rebate at not less than a proportional rate must be made, KRS 287.215(4)

- (a) In computing the rebate, a minimum charge of \$10 can be retained to cover acquisition costs, and where the rebate is less than \$1, no rebate need be made. (Note: the \$10 charge cannot be taken before the Rule of 78's rebate computation is made. According to the Attorney General, the rebate computation must be based on the total finance charge. See OAG 82-260 (April 9, 1982)).
- (6) Provisions Required in Note. Every note evidencing a loan under KRS 287.215 must contain the following information and provisions:
- (a) The original principal amount of the loan excluding any charge made under KRS 287.215;
 - (b) A statement of the total charges for the loan;
 - (c) The amount and the date of each installment;
 - (d) The date of final maturity; and
 - (e) An agreement that the debtor may repay the loan in whole or in part at any time, and that if the loan is paid in full before final maturity, the debtor will receive a refund of the unearned portion, KRS 287.215(7).
- (7) Copy to Debtor. At the time of the loan, the debtor must receive either a copy of the note or a statement of the transaction containing the provisions and information required to be contained in the note, KRS 287.215(7).
- (8) Payment Receipts. The bank must deliver a receipt for each payment received, KRS 287.215(7).
- (9) Advertising. In advertising for a loan subject to KRS 287.215, every advertisement stating the amount of the loan must state the original principal amount and show in detail any charges to be made, KRS 287.215(8).

E. PENALTY

If a willful violation of any provision of KRS 287.215 occurs, the loan is void and the bank loses its right to collect or receive any interest or charges whatsoever on the loan. However, the unpaid principal remains payable, KRS 287.215(10).

VII. BANK CREDIT CARDS AND OTHER REVOLVING CREDIT (KRS 287.710 - 287.770)

A. COVERED TRANSACTIONS

Generally KRS 287.710 to 287.770 authorize banks to engage in revolving credit transactions - the principal one being credit cards. However, other types of revolving credit - such as overdraft checking and home equity lines of credit - are also covered so long as the arrangement contemplates that:

- (1) The bank may extend credit by permitting the debtor to make purchases of goods or services, or obtain loans, from time to time, directly from the bank or indirectly by use of a credit card, check or other device;
- (2) The unpaid balances of purchases made, the principal of loans obtained, and finance and other appropriate charges are debited to the debtor's account;
- (3) A finance charge, if made, is computed on the outstanding unpaid balances of the debtor's account from time to time; and
- (4) The bank renders statements to the debtor at regular intervals and the amount of such statements is payment on a specified date or, at the borrower's option, may be paid in installments, KRS 287.710(6).

B. FINANCE CHARGES; PERIODIC RATE.

- (1) A periodic rate not exceeding 1 3/4% per month of either the "average daily unpaid balance" of the debtor's account during the billing cycle, or of the "unpaid balance" of such account on the same day of each billing cycle, KRS 287.740.
- (2) A variation of not more than four days from billing cycle to billing cycle is deemed "the same day for each billing cycle," KRS 287.640.

C. OTHER PERMITTED CHARGES.

- (1) If provided for in the revolving credit plan, the following additional fees, charges and costs may be collected:
 - (a) Annual Fee. An annual fee of \$20, KRS 287.750.

- (b) Delinquency Charges. Delinquency charges not exceeding \$5 each month, if payments required by the revolving credit plan are not made when due, KRS 287.750(1).
- (c) Real Estate Closing Costs. All fees and closing costs incurred in connection with the taking of a mortgage on real estate, if bona fide and not retained by the bank, can be collected, KRS 287.750(2).
- (d) Attorney's Fees. Reasonable attorney's fees and court costs, if the account is referred to an attorney who is not a salaried employee of the bank for collection, KRS 287.750(3).

D. MISCELLANEOUS

- (1) Initial Disclosure. Before opening a revolving credit plan, the bank must deliver or mail to the debtor a statement of the provisions of the plan containing the disclosures required by KRS 360.210 to KRS 360.265, the requisite federal Truth-in-Lending disclosures, and a statement that the debtor may pay the unpaid balance of his or her account in whole or in part at any time. If two or more persons having the same residence are authorized to obtain credit under the plan, the disclosures and any subsequent periodic statements may be delivered or mailed to the one person designated by the plan, KRS 287.720.
- (2) Periodic Statements. The information required by the federal Truth-in-Lending Act in the form of a periodic statement for each billing cycle is also required by KRS 287.730(1). A legend to the effect that the debtor may at any time pay the aggregate balance owed or any part thereof is also required, KRS 287.730(1).
- (3) Free Ride Period. Where the revolving credit plan involves the use of a credit card for the purchase of goods or services from a third-party, no finance charge can be imposed upon the debtor if payment in full of the entire outstanding unpaid balance owed on the debtor's account is received at the place designated by the bank by the date of the statement for the next billing cycle, KRS 287.730(2).

VIII. RETAIL INSTALLMENT SALES ACT (KRS 371.210 - 371.330)

A. SCOPE

- (1) This act generally applies to consumer transactions, i.e., the sale of "goods" or "services" when purchased primarily for personal, family or household use.
- (2) The sale of "motor vehicles" are specifically excluded from coverage, KRS 371.210(3).
 - (a) With respect to KRS 371.210(3)'s exclusion of "motor vehicles," that term is defined to include a "mobile home . . . used primarily to transport persons or property on a public highway . . ." There has been some confusion over whether the "stationary" mobile home (as opposed to a motor home, which clearly is a "motor vehicle") is subject to the provisions of the Motor Vehicle Retail Installment Sales Act (KRS 190.090 et. seq.) or the Installment Sales Act (KRS 371.210, et seq.).
 1. In 1980, the Attorney General stated in a footnote to his opinion that retail installment sales of mobile homes "would not fall within the ambit of KRS Chapter 190 . . . Therefore, such contracts are covered by the provisions of KRS 371.210, et. seq.," OAG 80-51 (January 14, 1980).
 2. Later, in another opinion, the Attorney General attempted to resolve the apparently conflicting statutes by stating that stationary mobile homes with a cash price of \$5,000 or less were covered by the Motor Vehicle Retail Installment Sales Act, while stationary mobile homes having a cash price in excess of \$5,000 were covered by the Retail Investment Sales Act. OAG 80-111 (February 8, 1980).
 3. In 1984, the General Assembly removed the "\$5,000 cash sale price" qualification from the definition of a "motor vehicle" in the Motor Vehicle Retail Installment Sales Act. As a result, the Attorney General's distinction between the two statutes appears to be no longer applicable.

4. Finally, also in 1984, the Attorney General again opined that a manufactured home financing transaction providing for a rate of interest that may be adjusted at certain regular intervals is governed by the provisions of KRS 360.150. The manufactured home financing transaction providing for a fixed rate of interest is governed by the Motor Vehicle Retail Installment Sale Act. KRS 190.090 et seq. (OAG 84-353)

(b) As a result, the most conservative approach is to finance stationary mobile homes transactions (i.e., purchase installment contracts) as if the more restrictive finance charge rates authorized by the Motor Vehicle Retail Installment Sales Act were applicable.

B. FINANCE CHARGE RATES.

- (1) KRS 371.260(1) specifically permits the seller to receive a "time price differential" in retail installment contracts payable in substantially equal monthly installment, but places no limitation upon the amount of the time price differential.
- (2) Thus, because of the traditional distinction between "interest" and a "time price differential", see Munson v. White, 309 Ky. 295, 217 S.W.2d 641 (1920), the Retail Installment Sales Act contains no limit on the amount of finance charge which can be collected.

C. OTHER PROVISIONS.

- (1) Disclosure Requirements. There are specific disclosure requirements relating to type size and the like, and a "NOTICE TO THE BUYER" provision which must be contained in the contract. The retail installment contract also must disclose certain information with respect to the sale, such as the cash sale price, the down payment, official fees, the amount of the time price differential and other similar information, KRS 371.220.
- (2) Prepayment and Rebates. The buyer must have the right to prepay the contract at any time without penalty. He is entitled to receive a refund of unearned charges under the Rule of 78's. Acquisition costs of \$10 can be deducted before computing the rebate. Rebates of less than \$1 need not be made, KRS 371.260(2).

- (3) Delinquency Charges. Delinquency charges for payments more than 10 days late are collectable in an amount not exceeding 5% of the installment or \$5, whichever is less. However, a minimum delinquency charge of \$1 may be collected, KRS 371.270(1).

IX. MOTOR VEHICLE RETAIL INSTALLMENT SALES ACT (KRS 190.090 - 190.140)

A. SCOPE.

This act relates to:

- (1) Any sale of a motor vehicle for other than business or commercial use evidenced by a retail installment contract in which the buyer agrees to pay a "time sale price" payable in two or more installments, KRS 190.090(2).
- (2) "Motor Vehicle" generally includes any device in, upon, or by which any personal property is or may be transported or drawn upon a highway, KRS 190.090(4).
- (a) Some exceptions exist for road machinery and farm implements.
- (b) Under a literal reading of this definition, a "stationary" mobile home could be a "motor vehicle" subject to the Motor Vehicle Retail Installment Sales Act, rather than "goods" covered by the more general Retail Installment Sales Act contained at KRS 371.210 et. seq. This is the view of the Kentucky Attorney General, see Section VIII, A(2)(a)4 above.
- (c) Formerly, the defunction of a motor vehicle was limited to vehicles having a cash sales price of \$5,000 or less. This dollar qualification was deleted by the 1984 General Assembly.

B. FINANCE CHARGE RATES AND COMPUTATION.

- (1) For any new or used motor vehicle sold in its model years, a \$11/\$100 "add-on" rate can be charged, KRS 190.110(1).
- (2) For any new motor vehicle not sold in its model year, \$13/\$100 "add-on" rate can be charged, KRS 190.110(1).

- (3) For any used motor vehicle having a model year of one or two years prior to the year in which the sale is made, \$13/\$100 "add-on" rate can be charged, KRS 190.110(1).
- (4) For all other motor vehicles, a \$15/\$100 "add-on" rate can be charged, KRS 190.110(1).
- (5) At the seller's option, the finance charge can be computed on a simple interest basis, and at a fixed or variable rate, but in this event the amount of finance charge that may be collected cannot exceed the amount that could have been collected if the finance charge were pre-computed, KRS 190.110(4).

NOTE: The Kentucky Court of Appeals has held [Roberts v. Capitol Cadillac-Olds, Inc. No. 87-CA-1245-MR (October 21, 1988)] that in calculating the finance charge permitted by KRS 190.110(1), the duration of the contract is ignored.

Thus, in its decision, the Court of Appeals calculated the maximum permissible finance charge allowed under KRS 190.110 by multiplying the amount financed by the buyer (\$10,997.31) by \$11 and dividing the produce by \$100. The result, \$1,209.70, was determined to be the maximum permissible finance charge despite the fact that the loan was not for one year but for five (5) years. In effect, the court held that for five-year installment sales contracts, the maximum permissible annual finance charge is approximately 4.19 percent (computed on a simple interest basis charging interest daily on the unpaid balance). A motion for rehearing is currently pending before the court. The Kentucky Bankers Association has requested leave to file an amicus curiae brief.

C. MISCELLANEOUS PROVISIONS.

- (1) Disclosure Requirements. KRS 190.110 contains requirements of what the retail installment contract must contain. At least 8 point type is required. The cash sale price, the amount of the down payment, official fees, the amount, if any, included for insurance and other benefits (together with a description of the type of coverage and benefits), the principal balance, the amount of finance charge and the "time balance" must be disclosed.
- (2) Collateral. A motor vehicle installment sale contract cannot take a security interest in any

goods other than the motor vehicle and its accessories, KRS 190.100(1)(b).

(3) Prepayment and Rebates.

(a) If the finance charge is pre-computed, the buyer may prepay the contract at any time and is entitled to receive a refund of a portion of the finance charge computed in accordance with the Rule of 78's. However, an acquisition cost of \$25 can be deducted from the finance charge before computation of the refund is made. No refund of less than \$1 need be made, KRS 190.120(1).

(b) If the finance charge is determined by the "simple interest" method, the right of repayment also exists without any rebate but a minimum finance charge of \$25 can be collected in any event, KRS 190.120(2).

(4) Deferred Payments. The scheduled due date or a schedule payment can be deferred. Additional finance charges computed at the same rate and by the same method as set out in the original contract can be collected. A refinancing charge for such extension, deferment or renewal not exceeding \$5 can also be collected, KRS 190.130.

(5) Delinquency Charges. When the finance charge has been determined by a pre-computed method, a delinquency charge on each installment not paid within 10 days of its due date, in an amount not exceeding 5% of each installment of \$5, whichever is less, can be collected, KRS 190.100(1)(d).

(6) Attorney's Fees. When the finance charge has been determined by the pre-computed method, attorney's fees not exceeding 15% of the amount due and payable under the contract, plus court costs, can be collected if the contract is referred to an attorney not a salaried employee of the holder of the contract for collection. KRS 190.100(1)(d). (Because of the statute's peculiar wording, a question exists as to whether attorney's fees can be collected where the finance charge is determined on a "simple interest" basis. Arguably, the more general "attorney's fees" provisions of KRS 453.250 should permit the collection of attorneys' fees in a "simple interest" situation.)

X. MANUFACTURED HOME FINANCING (KRS 360.150)

A. SCOPE.

First enacted in 1982, KRS 360.150 is limited to a "manufactured home financing transaction," which involves the sale of a "manufactured home" or a direct loan used to finance the purchase of a "manufactured home," if the transaction provides "that the rate of interest may be adjusted at certain regular intervals." Thus, KRS 360.150 is only applicable to variable rate transactions.

On the other hand, if the transaction provides "for a fixed rate of interest payable in substantially equal successive installments over a fixed term, KRS 360.150 is NOT applicable.

- (1) "Manufactured Home". As amended in 1984, the term includes the typical single family mobile home as well as a pre-fabricated dwelling that is manufactured in two or more modules at a location other than a homesite, and which is designated to be used as a residence when the modules are transported to the homesite, and the modules are joined together and installed on a permanent foundation systems. The term includes the plumbing, heating, air conditioning and electrical systems contained in the structure, KRS 360.150(1)(c).
- (2) Affect of Federal Preemption Laws. To the extent that a "manufactured home financing transaction" will result in the taking of a first lien on "residential real property" or "residential manufactured housing," as defined in Section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980, the provisions of that statute, which preempt certain state laws to the contrary, may also apply. See Section III above for a discussion of the 1980 Act.
- (3) Option To Comply With Federal Agencies' Regulations. In lieu of complying with KRS 360.150, the debtor and lender may agree on terms authorized or permitted in any program for residential mortgage loans by the FHLBB, the Comptroller of the Currency, or any other federal department, agency or board, KRS 360.150(13).

B. VARIABLE RATE TRANSACTIONS

If the transaction provides that the rate of interest may be "adjusted" at certain regular intervals, KRS 360.150 requires that specific indices be used.

Further, the frequency with which such adjustments may be made, and limitations on the amount thereof, are specified, KRS 360.150(2).

- (1) Available Indices. KRS 360.150(3) only permits the use of two indices:
 - (a) The monthly average yield on U.S. treasury securities adjusted to a constant maturity of 5 years; or
 - (b) An index approved by the FHLBB or by the Comptroller of the Currency for adjustable or variable interest rates on residential mortgage loans.
- (2) Minimum Interval Between Adjustment. The rate of interest cannot increase or decrease during the six-month period following the loan transaction. Further, at least six months must elapse between subsequent changes, KRS 360.150(4).
- (3) Ceiling on Amount of Adjustment.
 - (a) Where the stated regular interval between rate adjustments is six months, an adjustment may not result in a rate of interest which is more than 1% greater or less than the interest rate in effect prior to such adjustment, KRS 360.150(6).
 - (b) If the stated regular interval between rate adjustments exceeds six months, then the maximum adjustment, either up or down, is 1%, multiplied by the number of whole consecutive six month periods in the interval between rate adjustments, KRS 360.150(6).
- (4) Decreased Mandatory. Any increases in the rate of interest permitted are optional with the creditor; however, decreases are mandatory whenever the total decrease in the index equals or exceeds one-quarter (1/4) of 1%, KRS 360.150(7).
- (5) Prior Written Notice. The creditor must send written notification of any rate adjustment, by first class mail, postage pre-paid, at least one month before the date that the new rate of interest takes effect, KRS 360.150(12).
- (6) Computation of Adjustment.
 - (a) First Adjustment. Adjustments, either up or down, to the rate of interest shall, for the

first adjustment following the loan transaction, be equal to the difference between the index value in effect on the first day of the second calendar month preceding the particular adjustment date, and the value in effect on the first day of the month in which the loan transaction occurred, KRS 360.150(5).

- (b) Subsequent Adjustments. Adjustments after the first adjustment must be equal to the difference between the index value in effect on the first day of the second month preceding the adjustment date and the index value in effect on the first day of the second month preceding the date of the immediately preceding rate adjustment, KRS 360.150(5).
- (7) Result of Adjustment on Payment Terms. By agreement, adjustments to the rate of interest may result in changes in the amount of regular installment payments due, or changes in the term of the financing, or a combination of both, KRS 360.150(10).

APPENDIX

360.010 Legal interest rate; agreement for higher rate; minimum charge for negotiated bank loan

(1) The legal rate of interest is eight per cent (8%) per annum, but any party or parties may agree, in writing, for the payment of interest in excess of that rate as follows: (a) at a per annum rate not to exceed four per cent (4%) in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve Bank in the Federal Reserve District where the transaction is consummated or nineteen per cent (19%), whichever is less, on money due or to become due upon any contract or other obligation in writing where the original principal amount is fifteen thousand dollars (\$15,000) or less, and (b) at any rate on money due or to become due upon any contract or other obligation in writing where the original principal amount is in excess of fifteen thousand dollars (\$15,000); and any such party or parties, and any party or parties who may assume or guarantee any such contract or obligation, shall be bound for such rate of interest as is expressed in any such contract, obligation, assumption, or guaranty, and no law of this state prescribing or limiting interest rates shall apply to any such agreement or to any charges which pertain thereto or in connection therewith; provided, however, nothing herein contained shall be construed to amend, repeal, or abrogate any other law of this state pertaining to any particular types of transactions for which the maximum rate of interest is specifically prescribed or provided.

(2) Any state or national bank may charge ten dollars (\$10.00) for any loan negotiated at the bank in this state, even if the legal interest does not amount to that sum.

HISTORY: 1980 c 77, § 1, eff. 4-1-80
1974 H 467; 1972 S 231, § 1; 1970 H 622, § 2; 1966 c 234; KS 2218

360.020 Civil penalty for charging excessive interest; partial payment applied first to interest

(1) The taking, receiving, reserving, or charging a rate of interest greater than is allowed by KRS 360.010, when knowingly done, shall be deemed a forfeiture of the entire interest which the note, bill, or other evidence of debt carries with it, or which has been agreed to be paid thereon. In case the greater rate of interest has been paid, the person by whom it has been paid, or his legal representatives, may recover, in an action in the nature of an action of debt, twice the amount of the interest thus paid from the creditors taking or receiving the same: provided, that such action is commenced within two years from the time the usurious transaction occurred.

(2) Partial payment on a debt bearing interest shall be first applied to the interest then due.

HISTORY: 1972 S 231, § 2, eff. 6-16-72
1970 H 622, § 3; 1944 c 173, § 21; KS 883i-31, 2219

360.025 Excess rate of interest prohibited as defense of corporation

(1) No corporation shall hereafter plead or set up the taking of more than the legal rate of interest, as a defense to any action brought against it to recover damages on, or enforce payment of, or other remedy on, any mortgage, bond, note or other obligation, executed or assumed by such corporation: Provided, that this section shall not apply to any action which is now pending or to any suit or action instituted subsequent to June 16, 1960, upon any mortgage, bond, note or other obligation executed or assumed by such corporation prior to June 16, 1960.

(2) The provisions of subsection (1) of this section shall not apply to a corporation, the principal asset of which shall be the ownership of a one or two family dwelling.

HISTORY: 1960 c 221, § 1, 2, eff. 6-16-60

360.027 Excess rate of interest prohibited as defense of limited partnership or business trust

(1) No limited partnership or business trust shall hereafter plead or set up the taking of more than the legal rate of interest, as a defense to any action brought against it to recover damages on, or enforce payment of, or other remedy on, any mortgage, bond, note or other obligation, executed or assumed by such limited partnership; provided, that this section shall not apply to any action instituted subsequent to June 16, 1972, upon any mortgage, bond, note or other obligation executed or assumed by such limited partnership or business trust prior to June 16, 1972.

(2) The provisions of subsection (1) of this section shall not apply to a limited partnership, or business trust, the principal asset of which shall be the ownership of a one or two-family dwelling.

HISTORY: 1972 S 110, eff. 6-16-72

§ 85. Rate of interest on loans, discounts, and purchases

Any association may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the greater, and no more, except that where by the laws of any State a different rate is limited for banks organized under State laws, the rate so limited shall be allowed for associations organized or existing in any such State under this title. When no rate is fixed by the laws of the State, or Territory, or District, the bank may take, receive, reserve, or charge a rate not exceeding 7 per centum, or 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, or in the case of business or agricultural loans in the amount of \$25,000 or more, at a rate of 5 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve district where the bank is located, whichever may be the greater, and such interest may be taken in advance, reckoning the days for which the note, bill, or other evidence of debt has to run. The maximum amount of interest or discount to be charged at a branch of an association located outside of the States of the United States and the District of Columbia shall be at the rate allowed by the laws of the county, territory, dependency, province, dominion, insular possession, or other political subdivision where the branch is located. And the purchase, discount, or sale of a bona fide bill of exchange, payable at another place than the place of such purchase, discount, or sale, at not more than the current rate of exchange for sight-drafts in addition to the interest, shall not be considered as taking or receiving a greater rate of interest.

(R. S. § 5197; June 16, 1933, ch 89, § 25, 48 Stat. 191; Aug. 23, 1935, ch 614, Title III, § 314, 49 Stat. 711; Oct. 29, 1974, P. L. 93-501, Title II, as affected by Act Nov. 5, 1979, P. L. 96-104, § 1, 93 Stat. 789; Nov. 5, 1979, P. L. 96-104, Title I, § 101, 93 Stat. 789; Dec. 28, 1979, P. L. 96-161, Title II, §§ 201, 212, 93 Stat. 1235, 1239.)

287.214 Rate of interest allowed on loans of \$15,000 or less; trust company not to extend credit; exception

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

HISTORY: 1984 c 324, § 23, eff. 7-13-84
1979 ex s, c 17, § 1

§ 1831d. State-chartered insured banks and insured branches of foreign banks

(a) **Interest rates.** In order to prevent discrimination against State-chartered insured banks, including insured savings banks and insured mutual savings banks, or insured branches of foreign banks with respect to interest rates, if the applicable rate prescribed in this subsection exceeds the rate such State bank or insured branch of a foreign bank would be permitted to charge in the absence of this subsection, such State bank or such insured branch of a foreign bank may, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section, take, receive, reserve, and charge on any loan or discount made, or upon any note, bill of exchange, or other evidence of debt, interest at a rate of not more than 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where such State bank or such insured branch of a foreign bank is located or at the rate allowed by the laws of the State, territory, or district where the bank is located, whichever may be greater.

(b) **Interest overcharge; forfeiture; interest payment recovery.** If the rate prescribed in subsection (a) exceeds the rate such State bank or such insured branch of a foreign bank would be permitted to charge in the absence of this section, and such State fixed rate is thereby preempted by the rate described in subsection (a), the taking, receiving, reserving, or charging a greater rate of interest than is allowed by subsection (a), when knowingly done, shall be deemed a forfeiture of the entire interest which the note, bill, or other evidence of debt carries with it, or which has been agreed to be paid thereon. If such greater rate of interest has been paid, the person who paid it may recover in a civil action commenced in a court of appropriate jurisdiction not later than two years after the date of such payment, an amount equal to twice the amount of the interest paid from such State bank or such insured branch of a foreign bank taking, receiving, reserving, or charging such interest.

(Sept. 21, 1950, ch 967, § 2(27), as added Mar. 31, 1980, P. L. 96-221, Title V, Part C, § 521, 94 Stat. 164.)

Depository Institutions Deregulation and Monetary Control Act of 1980

Act of March 31, 1980; 94 Stat. 161; Public Law 96-221

TITLE V—STATE USURY LAWS

PART A—MORTGAGE USURY LAWS

[§ 58,901]

MORTGAGES

SEC. 501. (a)(1) The provisions of the constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any loan, mortgage, credit sale, or advance which is—

(A) secured by a first lien on residential real property, by a first lien on all stock allocated to a dwelling unit in a residential cooperative housing corporation, or by a first lien on a residential manufactured home; [As amended by Act of October 8, 1980 (Housing and Community Development Act of 1980), Sec. 324 (a), 94 Stat. —.]

(B) made after March 31, 1980; and

(C) described in section 527(b) of the National Housing Act (12 U.S.C. 1715f-5(b)), except that for the purpose of this section—

(i) the limitation described in section 527(b)(1) of such Act that the property must be designed principally for the occupancy of from one to four families shall not apply;

(ii) the requirement contained in section 527(b)(1) of such Act that the loan be secured by residential real property shall not apply to a loan secured by stock in a residential cooperative housing corporation or to a loan or credit sale secured by a first lien on a residential manufactured home;

(iii) the term "federally related mortgage loan" in section 527(b) of such Act shall include a credit sale which is secured by a first lien on a residential manufactured home and which otherwise meets the definitional requirements of section 527(b) of such Act, as those requirements are modified by this section;

(iv) the term "residential loans" in section 527(b)(2)(D) of such Act shall also include loans or credit sales secured by a first lien on a residential manufactured home;

(v) the requirement contained in section 527(b)(2)(D) of such Act that a creditor make or invest in loans aggregating more than \$1,000,000 per year shall not apply to a creditor selling residential manufactured homes financed by loans or credit sales secured by first liens on residential manufactured homes if the creditor has an arrangement to sell such loans or credit sales in whole or in part, or if such loans or credit sales are sold in whole or in part to a lender, institution, or creditor described in section 527(b) of such Act or in this section or a creditor, as defined in section 103(f) of the Truth in Lending Act, as such section was in effect on the day preceding the date of enactment of this title, if such creditor makes or invests in residential real estate loans or

loans or credit sales secured by first liens on residential manufactured homes aggregating more than \$1,000,000 per year; and

(vii) the term "lender" in section 527(b)(2)(A) of such Act shall also be deemed to include any lender approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act, and any individual who finances the sale or exchange of residential real property which such individual owns and which such individual occupies or has occupied as his principal residence. [As amended by the Act of October 8, 1980 (Housing and Community Development Act of 1980), Sec. 324(e), 94 Stat. —.]

→ *Sec. 501(a)(2) as in effect prior to April 1, 1986. For law effective April 1, 1986, see below.*

(2)(A) The provisions of the constitution or law of any State expressly limiting the rate or amount of interest which may be charged, taken, received, or reserved shall not apply to any deposit or account held by, or other obligation of a depository institution. For purposes of this paragraph, the term "depository institution" means—

(i) any insured bank as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(ii) any mutual savings bank as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(iii) any savings bank as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(iv) any insured credit union as defined in section 101 of the Federal Credit Union Act (12 U.S.C. 1752);

(v) any member as defined in section 2 of the Federal Home Loan Bank Act (12 U.S.C. 1422); and

(vi) any insured institution as defined in section 408 of the National Housing Act (12 U.S.C. 1730a).

(B) This paragraph shall not apply to any such deposit, account, or obligation which is payable only at an office of an insured bank, as defined in section 3 of the Federal Deposit Insurance Act, located in the Commonwealth of Puerto Rico.

→ *As amended by Act Sec. 207(b)(11) effective April 1, 1986, Depository Institutions Deregulation and Monetary Control Act of 1980 Sec. 501(a)(2) reads:*

(2) The provisions of the constitution or law of any State expressly limiting the rate or amount of interest which may be charged, taken, received, or reserved shall not apply to any deposit or account held by, or other obligation of a depository institution. For purposes of this paragraph, the term "depository institution" means—

(i) any insured bank as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(ii) any mutual savings bank as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(iii) any savings bank as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813);

(iv) any insured credit union as defined in section 101 of the Federal Credit Union Act (12 U.S.C. 1752);

(v) any member as defined in section 2 of the Federal Home Loan Bank Act (12 U.S.C. 1422); and

(vi) any insured institution as defined in section 408 of the National Housing Act (12 U.S.C. 1730a).

(b)(1) Except as provided in paragraphs (2) and (3), the provisions of subsection (a)(1) shall apply to any loan, mortgage, credit sale, or advance made in any State on or after April 1, 1980.

(2) Except as provided in paragraph (3), the provisions of subsection (a)(1) shall not apply to any loan, mortgage, credit sale, or advance made in any State after the date (on or after April 1, 1980, and before April 1, 1983) on which such State adopts a law or certifies that the voters of such State have voted in favor of any provision, constitutional or otherwise, which states explicitly and by its terms that such State does not want the provisions of subsection (a)(1) to apply with respect to loans, mortgages, credit sales, and advances made in such State.

(3) In any case in which a State takes an action described in paragraph (2), the provisions of subsection (a)(1) shall continue to apply to—

(A) any loan, mortgage, credit sale, or advance which is made after the date such action was taken pursuant to a commitment therefor which was entered during the period beginning on April 1, 1980, and ending on the date on which such State takes such action; and

(B) any loan, mortgage, or advance which is a rollover of a loan, mortgage, or advance, as described in regulations of the Federal Home Loan Bank Board, which was made or committed to be made during the period beginning on April 1, 1980, and ending on the date on which such State takes any action described in paragraph (2).

(4) At any time after the date of enactment of this Act, any State may adopt a provision of law placing limitations on discount points or such other charges on any loan, mortgage, credit sale, or advance described in subsection (a)(1).

(c) The provisions of subsection (a)(1) shall not apply to a loan, mortgage, credit sale, or advance which is secured by a first lien on a residential manufactured home unless the terms and conditions relating to such loan, mortgage, credit sale, or advance comply with consumer protection provisions specified in regulations prescribed by the Federal Home Loan Bank Board. Such regulations shall—

(1) include consumer protection provisions with respect to balloon payments, prepayment penalties, late charges, and deferral fees;

(2) require a 30-day notice prior to instituting any action leading to repossession or foreclosure (except in the case of abandonment or other extreme circumstances);

(3) require that upon prepayment in full, the debtor shall be entitled to a refund of the unearned portion of the precomputed finance charge in an amount not less than the amount which would be calculated by the actuarial method, except that the debtor shall not be entitled to a refund which is less than \$1; and

(4) include such other provisions as the Federal Home Loan Bank Board may prescribe after a finding that additional protections are required.

(d) The provisions of subsection (c) shall not apply to a loan, mortgage, credit sale, or advance secured by a first lien on a residential manufactured home until regulations required to be

issued pursuant to paragraphs (1), (2), and (3) of subsection (c) take effect, except that the provisions of subsection (c) shall apply in the case of such a loan, mortgage, credit sale, or advance made prior to the date on which such regulations take effect if the loan, mortgage, credit sale, or advance includes a precomputed finance charge and does not provide that, upon prepayment in full, the refund of the unearned portion of the precomputed finance charge is in an amount not less than the amount which would be calculated by the actuarial method, except that the debtor shall not be entitled to a refund which is less than \$1. The Federal Home Loan Bank Board shall issue regulations pursuant to the provisions of paragraphs (1), (2), and (3) of subsection (c) that shall take effect prospectively not less than 30 days after publication in the Federal Register and not later than 120 days from the date of enactment of this Act.

(e) For the purpose of this section—

(1) a "prepayment" occurs upon—

- (A) the refinancing or consolidation of the indebtedness;
- (B) the actual prepayment of the indebtedness by the consumer whether voluntarily or following acceleration of the payment obligation by the creditor; or
- (C) the entry of a judgment for the indebtedness in favor of the creditor;

(2) the term "actuarial method" means the method of allocating payments made on a debt between the outstanding balance of the obligation and the precomputed finance charge pursuant to which a payment is applied first to the accrued precomputed finance charge and any remainder is subtracted from, or any deficiency is added to, the outstanding balance of the obligation;

(3) the term "precomputed finance charge" means interest or a time price differential within the meaning of sections 106(a) (1) and (2) of the Truth in Lending Act (15 U.S.C. 1605(a) (1) and (2)) as computed by an add-on or discount method; and

(4) the term "residential manufactured home" means a manufactured home as defined in section 603(6) of the National Mobile Home Construction and Safety Standards Act of 1974 which is used as a residence.

National Mobile Home Construction and Safety Standards Act of 1974
Sec. 603(6) reads:

(6) "mobile home" means a structure, transportable in one or more sections, which is eight body feet or more in width and is thirty-two body feet or more in length, and which is built on a permanent chassis and designed to be used as a dwelling with or without a permanent foundation when connected to the required utilities, and includes the plumbing, heating, air-conditioning, and electrical systems contained therein;

(f) The Federal Home Loan Bank Board is authorized to issue rules and regulations and to publish interpretations governing the implementation of this section.

(g) This section takes effect on April 1, 1980.

[94 Stat. 161, as amended by Act of October 8, 1980. (Housing and Community Development Act of 1980). Sec. 308(c)(6), 94 Stat. —.]

REGULATIONS FOR FEDERALLY-RELATED MORTGAGE LOANS

Federal Home Loan Bank Board Final Rule

12 CFR 590; 45 F. R. 24113

Title 12, Code of Federal Regulations, Subchapter G

PART 590—PREEMPTION OF STATE USURY LAWS

[§ 10,281]

Sec. 590.1 Authority, purpose, and scope.
(a) *Authority.* This Part contains regulations issued under section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 161.

(b) *Purpose and Scope.* The purpose of this permanent preemption of state interest-rate ceilings applicable to Federally-related residential mortgage loans is to ensure that the availability of such loans is not impeded in states having restrictive interest limitations. This Part applies to loans, mortgages, credit sales, and advances, secured by first liens on residential real property, stock in residential cooperative housing corporations, or residential manufactured homes as defined in § 590.2 of this Part.

.05 **Sec. 590.100. Status of interpretations** issued under Public Law 96-161. The Board continues to adhere to the views expressed in the formal Interpretations issued under the authority of Section 105(c) of Pub. L. 96-161, 93 Stat. 1233 (1979). These interpretations, which relate to the temporary preemption of state interest ceilings contained in Pub. L. 96-161, may be found at 45 FR 2840 (Jan. 15, 1980); 45 FR 6165 (Jan. 25, 1980); 45 FR 8000 (Feb. 6, 1980); 45 FR 15821 (Mar. 12, 1980).

[*Board Interpretation, November 3, 1982; 47 F. R. 49829.*]

.10 **Sec. 590.101. State criminal usury statutes.** (a) Section 501 provides that "the provision of the constitution or laws of any State expressly limiting the rate or amount

of interest, discount points, finance charges, or other charges shall not apply to any" federally-related loan secured by a first lien on residential real property, a residential manufactured home, or all the stock allocated to a dwelling unit in a residential housing cooperative. 12 U. S. C. 1735f-7 note (Supp. IV 1980). The question has arisen as to whether the federal statute preempts a state law which deems it a criminal offense to charge interest at a rate in excess of that specified on the state law.

(b) In the Board's view, Section 501 preempts all state laws which expressly limit the rate or amount of interest chargeable on a federally-related residential first mortgage. It does not matter whether the statute in question imposes criminal or civil sanctions; Section 501, by its terms, preempts "any" state law which imposes a ceiling on interest rates. The wording of the federal statute clearly expresses an intent to displace all direct state law restraints on interest. Any state law that conflicts with this Congressional purpose must yield.

[*Board Interpretation, November 3, 1982; 47 F. R. 49829.*]

[§ 10,282]

Sec. 590.2 Definitions. For the purposes of this Part, the following definitions apply:

(a) **Loans** means any loans, mortgages, credit sales, or advances.

(b) **Federally-related loans** include any loan:

(1) Made by any lender whose deposits or accounts are insured by any agency of the Federal government;

(2) Made by any lender regulated by any agency of the Federal government;

(3) Made by any lender approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act;

(4) Made in whole or in part by the Secretary of Housing and Urban Development; insured, guaranteed, supplemented, or assisted in any way by the Secretary or any officer or agency of the Federal government, or made under or in connection with a housing or urban development program administered by the Secretary, or a housing or related program administered by any other such officer or agency;

(5) Eligible for purchase by the Federal National Mortgage Association, the Government National Mortgage Association, or the Federal Home Loan Mortgage Corporation, or made by any financial institution from which the loan could be purchased by the Federal Home Loan Mortgage Corporation; or

(6) Made in whole or in part by any entity which:

(i) Regularly extends, or arranges for the extension of, credit payable by agreement in more than four installments or for which the payment of a finance charge is or may be required; and

(ii) Makes or invests in residential real property loans, including loans secured by first liens on residential manufactured homes, that aggregate more than \$1,000,000 per year; *except* that the latter requirement shall not apply to such an entity selling residential manufactured homes and providing financing for such sales through loans or credit sales secured by first liens on residential manufactured homes, if the entity has an arrangement to sell such loans or credit sales in whole or in part, or where such loans or credit sales are sold in whole or in part, to a lender or other institution otherwise included in this section.

(c) "Loans which are secured by first liens on real estate" means loans on the security of any instrument (whether a mortgage, deed of trust, or land contract) which makes the interest in real estate (whether in fee, or in a leasehold or subleasehold extending, or renewable, automatically or at the option of the holder or the lender, for a period of at least 5 years beyond the maturity of the loan) specific security for the payment of the obligation secured by the instrument; *Provided* That the instrument

is of such a nature that, in the event of default, the real estate described in the instrument could be subjected to the satisfaction of the obligation with the same priority as a first mortgage of a first deed of trust in the jurisdiction where the real estate is located.

(d) "Loans secured by first liens on stock in a residential cooperative housing corporation" means loans on the security of: (1) a first security interest in stock or a membership certificate issued to a tenant stockholder or resident member by a cooperative housing organization; and (2) an assignment of the borrower's interest in the proprietary lease or occupancy agreement issued by such organization.

(e) "Loans secured by first liens on residential manufactured homes" means a loan made pursuant to an agreement by which the party extending the credit acquires a security interest in the residential manufactured home which will have priority over any conflicting security interest.

(f) "Residential real property" means real estate improved or to be improved by a structure or structures designed primarily for dwelling, as opposed to commercial use.

(g) "Residential manufactured home" shall mean a manufactured home as defined in the National Manufactured Home Construction and Safety Standards Act, 42 U. S. C. 5402(6), which is or will be used as a residence.

(h) "State" means the several states, Puerto Rico, the District of Columbia, Guam, the Trust Territories of the Pacific Islands, the Northern Mariana Islands, and the Virgin Islands except as provided in § 501(a)(2)(B) of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 161.

[Sec. 590.2, as amended effective April 1, 1980, 45 F. R. 28306; effective May 13, 1983, 48 F. R. 21560.]

→ Proposed Amendment to Sec. 590.2 ←

Sec. 590.2 would be amended by adding a new subparagraph (b)(7) to read as follows:

"(b)(7) Made by any individual who finances the sale or exchange of residential real property which such individual owns and which such individual occupies or has occupied as his or her principal residence." The proposed amendment would also amend Sec. 590.2 by redesignating existing subparagraph (c) as (c)(1) and adding a new (c)(2) as follows:

(2) "Loans which are secured by first liens on real estate" shall also include purchase-money loans secured by liens on property subject to prior liens securing prior indebtedness, when the loan so secured:

(i) matures no earlier than the latest maturity date of the prior indebtednesses;

(ii) equals in principal amount the aggregate of the outstanding prior indebtedness plus the additional funds advanced;

(iii) requires periodic payments by the borrower sufficient to meet required current payments on prior indebtedness;

(iv) requires the lender to make payments due on prior indebtedness as long as payments are received from the borrower;

(v) gives the lender the right to cure defaults with respect to any prior indebtedness or to satisfy such indebtedness; and

(vi) obligates the borrower to reimburse the lender for sums advanced in order to secure or protect the lender's lien; *Provided*, that such lender shall at all times have sufficient funds available to satisfy such prior indebtedness. Lenders regularly examined and supervised by a state or Federal authority will be deemed to have sufficient funds available if the amount of prior indebtedness is recorded as a liability on the lender's books.

.01 Proposed Amendment.—The Board has been asked to consider the applicability of the Federal usury preemption statute to wraparound-mortgage loans used for the purchase of residential real property. As described by requestors, a wraparound-mortgage loan is a purchase-money loan that: (1) is secured by a lien on residential real property on which there exists one or more prior liens securing prior indebtedness; (2) matures no earlier than the latest maturity date of any such indebtedness; and (3) is evidenced by a note or bond which: (A) in principal amount equals the aggregate of the outstanding prior indebtedness plus the additional funds advanced by the wraparound lender; (B) requires payments by the wraparound borrower to the wraparound lender of periodic installments at least sufficient to make required current payments on the prior indebtedness; and (C) requires the wraparound lender to make the payments due on the prior indebtedness as long as installments are received from such borrower. In addition, the wraparound lender has the right to cure defaults with respect to any prior indebtedness or to satisfy such indebtedness. The wraparound lender also has the right to obtain from the borrower any funds it advances that are necessary to secure or protect its lien.

Unlike a conventional first-mortgage transaction, the wraparound borrower is able to take advantage of any existing low-interest loan which is secured by the property. Since the wraparound lender advances only a portion of the total purchase price, the combined interest rate on the wraparound note can be much lower than that required in a comparable first-mortgage transaction. If calculated as a percentage of the sums actually advanced, however, the interest rate on the loan may exceed state interest rate ceilings.

Some lenders have submitted to the Board that a wraparound mortgage of the type described above would confer greater rights to a wraparound lender than a regular second mortgage and would be sufficient to satisfy the statutory first-lien requirement. In the event of default by the wraparound borrower, the wraparound lender is in a position to keep payments on the initial lien current and prevent a foreclosure of that lien. Thus, the wraparound lender's rights in the collateral are not necessarily subject to prior satisfaction of the the initial lien.

The Board believes that in certain circumstances the wraparound mortgage described above would have characteristics and would confer rights sufficient to satisfy the first-lien requirement of the statute. Under the proposed regulation, a wraparound mortgage that met the standards described above would be deemed to satisfy the statutory first-lien requirement if it also met the following requirements. First, the wraparound mortgage must be created as part of a purchase-money transaction (*i. e.*, a transaction in which the borrower is obtaining funds to purchase residential real property). Second, the wraparound lender must have funds sufficient at all times to make payments on the prior encumbrances. In view of the possibility of acceleration of prior liens, a wraparound lender must have assets sufficient to satisfy the entire preceding obligation if the lender is to have the equivalent of a first lien.

When previously asked whether wraparound mortgages satisfied the definition of first lien formerly contained in § 541.14 of the Regulations of the Federal Savings and Loan System (12 CFR Subchapter C), the Board's Office of General Counsel has taken the position most recently that wraparound mortgages would satisfy that definition only if the Federal association recorded the amount of prior encumbrances as a liability on the association's books. In this way, the Board's field examiners would be made aware of the potential liability and could ensure that the association was financially able to protect its investment.

The Federal usury preemption statute, however, applies to a much broader range of lenders than the regulations for Federal associations. The Board cannot assume that methods developed for regularly supervised and examined lenders will have equal validity if applied to the other lenders covered by the statute. The proposal therefore draws a distinction between lenders that are regularly examined and supervised by a Federal or state authority and unsupervised lenders. Regulated lenders would meet the requirements for first lien by establishing a liability account descriptive of the lender's prior-lien obligation. The Board specifically requests comments from representatives of unregulated lenders, such as mortgage bankers, regarding alternative standards which might guarantee that such lenders will be able to protect themselves in the event of borrower default. Escrows in the amount of the prior indebtedness have been suggested for this purpose.

The Board is of the view that the proposed regulatory amendment would advance the stated Congressional purposes of the Federal usury preemption by fostering the continued availability of home financ-

ing. By providing financing at lower rates than the prevailing rate on other mortgages, wraparound loans should permit greater numbers of households to purchase homes.

Excerpts from order of the Federal Home Loan Bank Board, December 18, 1980; 45 F. R. 86500.

[§ 10.283]

Sec. 590.3 Operation. (a) The provisions of the constitution or law of any state expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any Federally-related loan:

- (1) Made after March 31, 1980; and
- (2) Secured by a first lien on:
 - (i) Residential real property;
 - (ii) Stock in a residential cooperative housing corporation when the loan is used to finance the acquisition of such stock; or
 - (iii) A residential manufactured home, provided that the loan so secured contains the consumer safeguards required by § 590.4 of this Part;

(b) The provisions of paragraph (a) shall apply to loans made in any state on or before the date (after April 1, 1980 and prior to April 1, 1983) on which the state adopts a law or certifies that the voters of such state have voted in favor of any law, constitutional or otherwise, which states explicitly and by its terms that such state does not want the provisions of paragraph (a) to apply with respect to loans made in such state, *except* that—

(1) The provisions of paragraph (a) shall apply to any loan which is made after such date pursuant to a commitment therefor which was entered into during the period beginning on April 1, 1980, and ending on the date the state takes such action;

(2) The provisions of paragraph (a) shall apply to any rollover of a loan which loan was made, or committed to be made, during the period beginning on April 1, 1980, and ending on the date the state takes such action, if the mortgage document or loan note provided that the interest rate to the original borrower could be changed through the use of such rollover; and

(3) At any time after the date of adoption of these regulations, any state may adopt a provision of law placing limitations on discount points or such other charges on any loan described in this Part.

(c) Nothing in this section preempts limitation in state laws on prepayment charges, attorneys' fees, late charges or other provisions designed to protect borrowers.

[Sec. 590.3, as amended effective April 1, 1980, 45 F. R. 28306.]

→ Proposed Amendment to Sec. 590.3 ←

The proposed amendment would change subsection (a)(2)(ii) by striking the word "stock" the first time it appears and inserting in its place the words "all stock allocated to a dwelling unit", and by striking out the phrase "where the loan, mortgage, or advance is used to finance the acquisition of such stock".

Sec. 590.4. Consumer protection rules for Federally related loans, mortgages, credit sales and advances secured by first liens on residential mobile homes.

(a) *Definitions.* As used in this section:

(1) *Prepayment.* A "prepayment" occurs upon—

(i) Refinancing or consolidation of the indebtedness;

(ii) Actual prepayment of the indebtedness by the debtor, whether voluntarily or following acceleration of the payment obligation by the creditor; or

(iii) The entry of a judgment of the indebtedness in favor of the creditor.

(2) *Actuarial Method.* The term "actuarial method" means the method of allocating payments made on a debt between the outstanding balance of the obligation and the finance charge pursuant to which a payment is applied first to the accumulated finance charge and any remainder is subtracted from, or any deficiency is added to, the outstanding balance of the obligation.

(3) *Precomputed Finance Charge.* The term "precomputed finance charge" means interest or a time/price differential as computed by the add-on or discount method. Precomputed finance charges do not include loan fees, points, finder's fees, or similar charges.

(4) *Creditor.* The term "creditor" means any entity covered by this Part, including those which regularly extend or arrange for extension of credit and assignees that are creditors under § 501(a)(1)(C)(v) of the Depository Institutions Deregulation and Monetary Control Act of 1980.

(b) *General.* (1) The provisions of the Constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any loan, mortgage, credit sale, or advance which is secured by a first lien on a residential mobile home if a creditor covered by this Part complies with the consumer protection regulations of this section.

(2) *Relation to State Law.* (i) In making loans or credit sales subject to this section, creditors shall comply with state and Federal law in accordance with the following:

(A) *State law regulating matters not covered by this section.* When state law regulating matters not covered by this section is

otherwise applicable to a loan or credit sale subject to this section, creditors shall comply with such state law provisions.

(B) *State law regulating matters covered by this section.* Creditors need comply only with the provisions of this section, unless the Board determines that an otherwise applicable state law regulating matters covered by this section provides greater protection to consumers. Such determinations shall be published in the Federal Register and shall operate prospectively.

(ii) Any interested party may petition the Board for a determination that state law requirements are more protective of consumers than the provisions of this section. Petitions shall be sent to: Secretary to the Board, Federal Home Loan Bank Board, 1700 G Street, NW, Washington, D. C. 20552, and shall include:

(A) A copy of the state law to be considered;

(B) Copies of any relevant judicial, regulatory, or administrative interpretations of the state law; and

(C) An opinion or memorandum from the state Attorney General or other appropriate state official having primary enforcement responsibilities for the subject state law provision, indicating how the state law to be considered offers greater protection to consumers than the Board's regulation.

(c) *Refund of precomputed finance charge.* In the event the entire indebtedness is prepaid, the unearned portion of the precomputed finance charge shall be refunded to the debtor. This refund shall be in an amount not less than the amount which would be refunded if the unearned precomputed finance charge were calculated in accordance with the actuarial method, except that the debtor shall not be entitled to a refund which is less than one dollar. The unearned portion of the finance charge is, at the option of the creditor, either:

(1) That portion of the precomputed finance charge which is allocable to all unexpired payment periods as originally scheduled, or if deferred, as deferred. A payment period shall be deemed unexpired if prepayment is made within 15 days after the payment period's scheduled due date. The unearned precomputed finance charge is the total of that which would have been earned for each such period had the loan not been precomputed, by applying to unpaid balances of principal, according to the

actuarial method, an annual percentage rate based on those charges which are considered precomputed finance charges in this section, assuming that all payments were made as originally scheduled, or as deferred, if deferred. The creditor, at its option, may round this annual percentage rate down to the nearest one-quarter of the one percent; or

(2) the total precomputed finance charge less the earned precomputed finance charge. The earned precomputed finance charge shall be determined by applying an annual percentage rate based on the total precomputed finance charge (as that term is defined in this section), under the actuarial method, to the unpaid balances for the actual time those balances were unpaid up to the date of prepayment. If a late charge has been collected, it shall be treated as a payment.

(d) *Prepayment penalties.* A debtor may prepay in full or in part the unpaid balance of the loan at any time without penalty. The right to prepay shall be disclosed in the loan contract in type larger than that used for the body of the document.

(e) *Balloon payments.*—(1) *Federal associations.* Federal association creditors may enter into agreements with debtors which provide for non-amortized and partially-amortized loans on residential manufactured homes, and such loans shall be governed by the provisions of this section and § 545.33(f) of this Chapter.

(2) *Other creditors.* All other creditors may enter into agreements with debtors which provide for non-amortized and partially-amortized loans on residential manufactured homes to the extent authorized by applicable Federal or state law or regulation.

(f) *Late charges.* (1) No late charge may be assessed, imposed, or collected unless provided for by written contract between the creditor and debtor.

(2) To the extent that applicable State law does not provide for a longer period of time, no late charge may be collected on an installment which is paid in full on or before the 15th day after its scheduled or deferred due date even though an earlier maturing installment or a late charge on an earlier installment may not have been paid in full. For purposes of assessing late charges, payments received are deemed to be applied first to current installments.

(3) A late charge may be imposed only once on an installment; however, no such

charge may be collected for a late installment which has been deferred.

(4) To the extent that applicable State law does not provide for a lower charge or longer grace period, a late charge on any installment not paid in full on or before the 15th day after its scheduled or deferred due date may not exceed the lesser of \$5.00 or five percent of the unpaid amount of the installment.

(5) If, at any time after imposition of a late charge, the lender provides the borrower with written notice regarding amounts claimed to be due but unpaid, the notice shall separately state the total of all late charges claimed.

(6) Interest after the final scheduled maturity date may not exceed the maximum rate otherwise allowable under state law for such contracts, and if such interest is charged, no separate late charge may be made on the final scheduled installment.

(g) *Deferral fees.* (1) With respect to mobile home credit transactions containing precomputed finance charges, agreements providing for deferral of all or part of one or more installments shall be in writing, signed by the parties, and

(i) Provide, to the extent that applicable State law does not provide for a lower charge, for a charge not exceeding one percent of each installment or part thereof for each month from the date when such installment was due to the date when it is agreed to become payable and proportionately for a part of each month, counting each day as 1/30th of a month;

(ii) Incorporate by reference the transaction to which the deferral applied;

(iii) Disclose each installment or part thereof in the amount to be deferred, the date or dates originally payable, and the date or dates agreed to become payable; and

(iv) Set forth the fact of the deferral charge, the dollar amount of the charge for each installment to be deferred, and the total dollar amount to be paid by the borrower for the privilege of deferring payment.

(2) No term of a writing executed by the borrower shall constitute authority for a lender unilaterally to grant a deferral with respect to which a charge is to be imposed or collected.

(3) The deferral period is that period of time in which no payment is required or made by reason of the deferral.

(4) Payments received with respect to deferred installments shall be deemed to be applied first to deferred installments.

(5) A charge may not be collected for the deferral of an installment or any part thereof if, with respect to that installment, a refinancing or consolidation agreement is concluded by the parties, or a late charge has been imposed or collected, unless such late charge is refunded to the borrower or credited to the deferral charge.

(h) *Notice Before Repossession, Foreclosure or Acceleration.* (1) Except in the case of abandonment or other extreme circumstances, no action to repossess or foreclose, or to accelerate payment of the entire outstanding balance of the obligation, may be taken against the debtor until 30 days after the creditor sends the debtor a notice of default in the form set forth in paragraph (h)(2) of this section. Such notice shall be sent by registered or certified mail with return receipt requested. In the case of default on payments, the sum stated in the notice may only include payments in default and applicable late or deferral charges. If the debtor cures the default within 30 days of the postmark of the notice and subsequently defaults a second time, the creditor shall again give notice as described above. The debtor is not entitled to notice of default more than twice in any one-year period.

(2) The notice in the following form shall state the nature of the default, the action the debtor must take to cure the default, the creditor's intended actions upon failure of the debtor to cure the default, and the debtor's right to redeem under state law.

TO:
DATE:, 19.....
.....
.....

**Notice of Default and Right To
Cure Default**

Name, address, and telephone number of creditor

Account number, if any

Brief identification of credit transaction

You are now in default on this credit transaction. You have a right to correct this default within 30 days from the post-marked date of this notice.

If you correct the default, you may continue with the contract as though you did not default. Your default consists of: Describe default alleged

Cure of default: Within 30 days from the postmarked date of this notice, you may cure your default by (describe the acts necessary for cure, including, if applicable, the amount of payment required, including itemized delinquency or deferral charges).

Creditor's rights: If you do not correct your default in the time allowed, we may exercise our rights against you under the law by (describe action creditor intends to take).

If you have any questions, write (the creditor) at the above address or call (creditor's designated employee)

..... at (telephone number) between the hours of and on (state days of week)

If this default was caused by your failure to make a payment or payments, and you want to pay by mail, please send a check or money order, do not send cash.

[Sec. 590.4, as amended effective April 1, 1980, 45 F. R. 28306; May 27, 1980, 45 F. R. 35347; effective July 30, 1980, 45 F. R. 43687 and 46341; effective July 31, 1980, 45 F. R. 50556; effective May 13, 1983, 48 F. R. 21561.]

[§ 10,285]

Sec. 590.5 Interpretations. (a) The Board periodically will publish Interpretations under section 501 of the Depository Institutions Deregulation and Monetary Act of 1980, Pub. L. No. 96-221, 94 Stat. 161, in the *Federal Register* in response to written requests sent to the Secretary to the Board, 1700 G Street, N. W., Washington, D. C. 20552.

287.215 Authority to charge interest in advance; installment loans with interest in advance; exceptions; restrictions on installment loans

(1) (a) In addition to the powers heretofore granted, any bank or trust company or combined bank and trust company shall have the power to lend money repayable in installments; to charge or to receive in advance interest therefor in the case of a loan having a maximum maturity of not more than five (5) years and thirty-two (32) days; to contract for a charge for a secured or unsecured installment loan, and which under its terms shall be repayable in installments over a period of not exceeding ten (10) years and thirty-two (32) days, which charge shall be at a rate not exceeding eight dollars (\$8) per one hundred dollars (\$100) per annum upon the principal amount of the loan which charge or charges shall be for the entire period of the loan and may be collected in advance only if the maximum maturity of the loans does not exceed five (5) years and thirty-two (32) days.

(b) If the maturity of the loan exceeds five (5) years and thirty-two (32) days but does not exceed ten (10) years and thirty-two (32) days the charge of interest may not be discounted or received in advance but may be added on to the principal amount of the loan and shall not be discounted.

(c) If any scheduled payment or deferred payments are more than twice as large as the average of the earlier scheduled payments, the debtor and creditor shall agree that the debtor has the right to finance the amount of such payment or deferred payments at the time they are due without penalty. The terms of the refinancing which are agreed to by the debtor and the creditor shall be no less favorable to the debtor than the terms of the original loan.

(2) In addition to the charge permitted by this section, no further amount shall be directly or indirectly charged, contracted for, or received on any such installment loan, except lawful fees actually paid to a public officer for filing, recording, or releasing any instrument securing the loan and delinquent charges as hereinafter set out, and except an investigation fee not exceeding one dollar (\$1) for each fifty dollars (\$50) or fraction thereof upon the first eight hundred dollars (\$800) of the principal amount of such loans.

(3) Delinquency charges may be made not to exceed five cents (5¢) for each dollar of each installment more than ten (10) days in arrears, and only one delinquency charge shall be made on any one installment. No delinquency charge shall exceed five dollars (\$5) on any one installment. In addition to such delinquency charges, attorney's fees not exceeding fifteen percent (15%) of the unpaid balance and court costs may be collected, provided that the note is referred to an attorney not a salaried employee of the holder for collection.

(4) The lending institution shall permit the borrower to repay his loan in whole or in part at any time. If a loan is paid in full prior to maturity, the lending institution shall make a rebate at a rate not less than in accordance with the Rule of 78s if the maximum financing charge permitted hereunder has been taken. If a lesser charge has been taken, the rebate shall be at not less than a proportional rate. Provided, however, the lending institution shall be permitted in computing rebates to retain a minimum charge of ten dollars (\$10) to cover its acquisition costs and where the amount of credit for anticipation of repayment is less than one dollar (\$1), no rebate need be made.

(5) In the case of loans made under this section the corporation shall not take any assignment, pledge or transfer of wages to be earned or paid in the future, nor any first lien or first mortgage on real estate as security, except such lien as is created by virtue of a judgment or decree or first mortgage liens on loans on unimproved real estate not

exceeding ten (10) acres in size or on real estate on which there is located or to be located a residential mobile home. Nothing in this section is intended to prevent lending institutions from making loans under the provisions of the National Housing Act or any other federal legislation, which loans are hereby authorized.

(6) No lending institution under this section shall split up or divide a loan or permit any person to become obligated to it under more than one contract of loan at the same time for the purpose of obtaining a greater charge than would otherwise be permitted by this section.

(7) Every note evidencing a loan made under this section shall contain the following information and provisions: The original principal amount of the loan excluding any charge made under this section; a statement of the total charge for the loan; the amount and the date of each installment; the date of final maturity; an agreement that the borrower may repay the loan in whole or in part at any time, and that if the loan is paid in full before final maturity, the borrower will receive a refund of the unearned portion of the charge as required by this section. At the time the loan is made, the lending institution shall give the borrower either a copy of the note, or a statement of the transaction containing the provisions and information required to be contained in the note. The lending institution shall deliver a receipt for each payment.

(8) In advertising for loans subject to this section, every advertisement shall conform to the following requirement: Any statement of the amount of the loan shall be the original principal amount showing in detail any charge made under this section.

(9) KRS 288.420, 288.620 and 360.010 shall not apply to loans made under authority of this section, but said sections shall remain in full force and effect for all other purposes. Nothing in this section shall be construed to impair the validity or effect of said sections with respect to loans other than those made pursuant to this section nor shall anything in this section be construed to impair the validity or effect of KRS 360.025.

(10) Any contract of loan in the making or collection of which any act shall have been done which constitutes a willful violation of any provision of this section shall be void, and the bank, trust company, or combined bank and trust company shall have no right to collect or receive any interest or charges whatsoever on such loan, but the unpaid principal of the loan shall be paid in full to the lending institution.

HISTORY: 1984 c 111, § 125, eff. 7-13-84
1980 c 78, § 1; 1974 c 184, § 1; 1972 c 267, § 1; 1962 c 79; 1946 c 60

REVOLVING CREDIT PLANS

INSTALLMENT SALES CONTRACTS

371.210 Definitions for KRS 371.210 to 371.330

As used in KRS 371.210 to 371.330, unless the context otherwise requires:

(1) "Goods" means all tangible chattels personal when purchased primarily for personal, family or household use and not for commercial, industrial or agricultural use, but not including motor vehicles as herein defined, money, things in action or intangible personal property other than merchandise certificates or coupons as herein described. The term includes such chattels which are furnished or used, at the sale of or subsequently, in the modernization, rehabilitation, repair, alteration, improvement or construction of real property as to become a part thereof whether or not severable therefrom. The term also includes merchandise certificates or coupons, issued by a retail seller, not redeemable in cash and to be used in their face amount in lieu of cash.

(2) "Services" means work, labor or services of any kind when purchased primarily for personal, family or household use and not for commercial or business use, but not including services for which the prices charged are required by law to be determined or approved by or to be filed, subject to approval or disapproval, with the United States or any state, or any department, division, agency, officer or official of either as in the case of transportation services.

(3) "Motor vehicle" means any automobile, mobile home, recreational vehicle, motorcycle, trucktrailer, semitrailer, truck tractor and bus designed and used primarily to transport persons or property on a public highway, or any vehicle designed to run only on rails or tracks or in the air, excepting however, any boat trailer and any vehicle propelled or drawn exclusively by muscular power.

(4) "Retail buyer" or "buyer" means a person who buys or agrees to buy goods or obtain services or agrees to have services rendered or furnished, from a retail seller.

(5) "Retail seller" or "seller" means a person regularly and principally engaged in the business of selling goods to retail buyers.

(6) "Retail installment transaction" means any transaction in which a retail buyer purchases goods or services from a retail seller pursuant to a retail installment contract or a retail charge agreement, as defined in this section, which provides for a time price differential, as defined in this section, and under which the buyer agrees to pay the unpaid balance in one or more installments.

(7) "Retail installment contract" means an instrument, other than a retail charge agreement or an instrument reflecting a sale made pursuant thereto, entered into in this state evidencing a retail installment transaction. The term "retail installment contract" may include a chattel mortgage, a security agreement, a conditional sale contract and a contract in the form of a bailment or a lease if the bailee or lessee contracts to pay as compensation for their use a sum substantially equivalent to or in excess of the value of the goods sold and if it is agreed that the bailee or lessee is bound to become, or for no other or a merely nominal consideration, has the option of becoming the owner of the goods upon full compliance with the provisions of the bailment or lease.

(8) "Retail charge agreement" means an instrument prescribing the terms of retail installment transactions which may be made thereunder from time to time and under the

terms of which a time price differential, as defined in this section, is to be computed in relation to the buyer's unpaid balance from time to time.

(9) "Time price differential" however denominated or expressed, means the amount which is paid or payable for the privilege of purchasing goods or services to be paid for by the buyer in installments over a period of time. It does not include the amount, if any, charged for insurance premiums, delinquency charges, attorneys fees, court costs, or official fees.

(10) "Cash sale price" means the price stated in a retail installment contract or in a sales slip or other memorandum furnished by a retail seller to a retail buyer under or in connection with a retail charge agreement, for which the seller would have sold or furnished to the buyer and the buyer would have bought or obtained from the seller the goods or services which are the subject matter of a retail installment transaction, if the sale had been a sale for cash. The cash sale price may include any taxes and charges for delivery, installation, servicing, repairs, alterations or improvements.

(11) "Official fees" means the amount of the fees prescribed by law for filing, recording or otherwise perfecting, and releasing or satisfying, a retained title, lien or other security interest created by a retail installment transaction.

(12) "Time sale price" means the total of the cash sale price of the goods or services and the amount, if any, included for insurance, if a separate identified charge is made therefor, and the official fees and the time price differential.

(13) "Principal balance" means the cash sale price of the goods or services which are the subject matter of a retail installment contract plus the amounts, if any, included therein, if a separate identified charge is made therefor and stated in the contract, for insurance and official fees, less the amount of the buyer's down payment in money or goods or both.

(14) "Holder" means the retail seller of the goods or services under the retail installment contract or retail charge agreement or the assignee if the retail installment contract or the retail charge agreement or any indebtedness under either has been sold or otherwise transferred.

(15) "Person" means an individual, partnership, joint venture, corporation, association or any other group, however organized.

(16) Words of the masculine gender include the feminine and the neuter and, when the sense so indicates, words of the neuter gender may refer to any gender.

HISTORY: 1982 c 395, § 23, eff. 7-15-82
1962 c 136, § 1

371.220 Requisites of retail installment contract

(1) Each retail installment contract shall be in writing, dated, signed by the retail buyer, and completed as to all essential provisions, except as otherwise provided in KRS 371.250.

(2) The printed or typed portion of the contract, other than instructions for completion, shall be in a size equal to at least eight point type. The contract shall be desig-

ated "Retail Installment Contract" and shall contain substantially the following notice printed or typed in a size equal to at least ten point bold type: "NOTICE TO THE BUYER. DO NOT SIGN THIS CONTRACT BEFORE YOU READ IT OR IF IT CONTAINS BLANK SPACES. YOU ARE ENTITLED TO A COPY OF THE CONTRACT YOU SIGN."

(3) The retail seller shall deliver to the retail buyer, or mail to him at his address shown on the retail installment contract, a copy of the contract as accepted by the seller. Until the seller does so, a buyer, who has not received delivery of the goods or been furnished or rendered the services, shall have the right to rescind his contract and receive a refund of all payments made and return of all goods traded in to the seller on account of or in contemplation of the contract, or if such goods cannot be returned, the value thereof. Any acknowledgment by the buyer of delivery of a copy of the contract shall be in a size equal to at least ten point bold type and, if contained in the contract, shall appear directly above the buyer's signature.

(4) The retail installment contract shall contain the names of the seller and the buyer, the place of business of the seller, the residence or other address of the buyer as specified by the buyer and a description or identification of the goods sold or to be sold, or services furnished or to be furnished or rendered.

(5) The retail installment contract shall contain the following items:

(a) The cash sale price of the goods or services;
(b) The amount of the buyer's down payment, identifying the amounts paid in money and allowed for goods sold in;

(c) The difference between items (a) and (b);
(d) The aggregate amount, if any, included for insurance, if a separate identified charge is made therefor, specifying the type or types of insurance and the term or terms of coverage;

(e) The aggregate amount of official fees;
(f) The principal balance, which is the sum of items (d) and (e);

(g) The amount of the time price differential; and
(h) The amount of the time balance owed by the buyer to the seller, which is the sum of items (f) and (g) and, except as otherwise provided in the next two sentences, the maximum number of installment payments required, the amount of each installment and the due date of each payment necessary to pay such balance. If installment payments other than the final payment are stated as series of equal scheduled amounts and if the amount of the final installment payment does not substantially equal the scheduled amount of each preceding installment payment, the maximum number of payments and the amount and due date of each payment need not be separately stated and the amount of the scheduled final installment payment may be stated as the remaining unpaid balance. The due date of the first installment payment may be fixed by a day or date or may be fixed by reference to the date of the contract or to the time of delivery or installation.

The above items need not be stated in the sequence or order set forth; additional items may be included to explain the computations made in determining the amount to be paid by the buyer.

HISTORY: 1962 c 136, § 2(1) to (5), eff. 1-1-63

371.230 Contracts composed of more than one document

A retail installment contract need not be contained in a single document. If the contract is contained in more than one document, one such document shall be an original document signed by the retail buyer, stated to be applicable to purchases of goods or services to be made by the retail buyer from time to time. In such case such document, together with the sales slip, account book or other written statement relating to each purchase, shall set forth all of the information required by KRS 371.220 to 371.290 and shall constitute the retail installment contract for each purchase. On each succeeding purchase pursuant to such original document, the sales slip, account book or other written statement may at the option of the seller constitute the memorandum required by KRS 371.290.

HISTORY: 1962 c 136, § 2(6), eff. 1-1-63

371.240 Contracts made by mail

(1) Retail installment contracts negotiated and entered into by mail without personal solicitation by salesmen or other representatives of the seller and based upon a catalog of the seller, or other printed solicitation of business, if such catalog or other printed solicitation clearly sets forth the cash sale prices and other terms of sales to be made through such medium, may be made as provided in this section. The provisions of KRS 371.210 to 371.330 with respect to retail installment contracts shall be applicable to such sales, except that:

(a) The designation and notice provisions of subsection (2) of KRS 371.220 shall not be applicable to such contract; and

(b) The retail installment contract, when completed by the buyer, need not contain the items required by subsection (5) of KRS 371.220.

(2) When the contract is received from the retail buyer, the seller shall prepare a written memorandum containing all of the information required by subsection (5) of KRS 371.220 to be included in a retail installment contract. In lieu of delivering a copy of the contract to the retail buyer as provided in subsection (3) of KRS 371.220, the seller shall deliver to the buyer a copy of such memorandum prior to the due date of the first installment payable under the contract.

HISTORY: 1962 c 136, § 2(7), eff. 1-1-63

371.250 Contract not to be signed in blank; acknowledgment of delivery of copy

A retail installment contract shall not be signed by any party thereto when it contains blank spaces of items which are essential provisions of the transaction; provided, however, if delivery of the goods is not made at the time of the execution of the contract, the identifying numbers or marks of the goods or similar information and the due date of the first installment may be inserted by the seller in the seller's counterpart of the contract after it has been signed by the buyer. The buyer's acknowledgment, conforming to the requirements of KRS 371.220 to 371.290, of delivery of a copy of the contract shall be presumptive proof or, in the case of a holder of the contract without knowledge to the contrary when he purchases it, conclusive proof of such delivery and of compliance with this section in any action or proceeding.

HISTORY: 1962 c 136, § 2(8), eff. 1-1-63

371.260 Time price differential; prepayment

(1) Notwithstanding the provisions of any other law, a retail installment contract payable in substantially equal successive monthly installments beginning one month from the date of the contract may provide for, and the seller or holder may then charge, collect and receive a time price differential.

(2) Notwithstanding the provisions of any retail installment contract to the contrary, any buyer may prepay in full the unpaid time balance thereof at any time before its final due date and, if he does so, shall receive a refund credit thereon for such prepayment. The amount of such refund credit shall represent at least as great a proportion of the original time price differential, after deducting therefrom a maximum of ten dollars, as (a) the sum of the monthly unpaid balances under the schedule of payments in the contract beginning as of the date after such prepayment which is the next succeeding monthly anniversary date of the due date of the first installment under the contract, or, if the prepayment is prior to the due date of the first installment under the contract, then as of the date after such prepayment which is the next succeeding monthly anniversary date of the date of the contract, bears to (b) the sum of all the monthly unpaid balances under the schedule of installment payments in the contract. Where the amount of refund credit is less than one dollar, no refund credit need be made.

HISTORY: 1962 c 136, § 2(9)(10), eff. 1-1-63

371.270 Charge for installment default; refinancing options

(1) The holder of any retail installment contract, if it so provides, may collect a delinquency and collection charge on each installment in default for a period of more than ten days in the amount not to exceed five percent of each installment or five dollars, whichever is less, provided that a minimum charge of one dollar may be made, or in lieu thereof, interest after maturity on each such installment not to exceed the highest lawful contract rate.

(2) The holder of a retail installment contract upon request by the buyer, may agree to an amendment thereto to extend or defer the schedule due date of all or any part of any installment or installments or to renew, restate or reschedule the unpaid balance of the contract, and may collect for same a refinance charge not to exceed an amount ascertained as provided under either of the following optional methods of computation:

Option I. The refinance charge may be computed on the amount of the scheduled installment or installments extended or deferred for the period of extension or deferment at the rate of one and one-half percent per month; provided, that a minimum deferment charge of one dollar shall be permitted. Such amendment may also include payment by the buyer of the additional cost to the holder of premiums for continuing in force any insurance coverages provided for in the contract until the end of such deferral period, and of any additional necessary official fees.

Option II. The refinance charge may be computed as follows: The sum of the unpaid balance as of the refinancing date and the cost for any insurance and other benefits incidental to the refinancing, and for any additional necessary official fees and any accrued delinquency and collection charges, after deducting a refund credit as for prepayment pursuant to subsection (2) of KRS 371.260, shall constitute a principal balance for such refinancing on

which the refinance charge may be computed for the term of the refinanced contract at the applicable rate for finance charges. Acquisition costs under the refund schedule in subsection (2) of KRS 371.260 shall not apply in calculating refinance charges.

(3) The amendment to the contract must be confirmed in a writing signed by the holder. The writing shall set forth the terms of the amendment and the new due dates and amounts of the installments, and shall either be delivered to the buyer or mailed to him at his address as shown on the contract. Said writing together with the original contract and any previous amendments thereto shall constitute the retail installment contract.

HISTORY: 1962 c 136, § 2(11), eff. 1-1-63

371.280 Written statement of payments and amount unpaid

Upon written request of the buyer, the holder of a retail installment contract shall give or forward to the buyer a written statement of the dates and amounts of payments and the total amount unpaid under the contract. A buyer shall be given a written receipt for any payment when made in cash. Such a statement or receipt shall be given the buyer once without charge; if any additional statement is requested by the buyer, it shall be supplied by the holder at a charge not in excess of one dollar for each additional statement or receipt so supplied.

HISTORY: 1962 c 136, § 2(12), eff. 1-1-63

371.290 Consolidation of subsequent purchases with existing contract; memorandum; allocation of payments

(1) If, in a retail installment transaction, a retail buyer makes any subsequent purchases of goods or services from a retail seller from whom he has previously purchased goods or services under one or more retail installment contracts, and the amounts under such previous contract or contracts have not been fully paid, the subsequent purchases may, at the seller's option, be included in and consolidated with one or more of the previous contract or contracts. Each subsequent purchase shall be a separate retail installment contract under KRS 371.210 to 371.330, notwithstanding that the same may be included in and consolidated with one or more of such previous contract or contracts. All the provisions of KRS 371.210 to 371.330 with respect to retail installment contracts shall be applicable to such subsequent purchases except as stated in subsections (2) to (7) of this section.

(2) In the event of such consolidation, in lieu of the buyer's executing a retail installment contract respecting each subsequent purchase, as provided in KRS 371.220 to 371.290, it shall be sufficient if the seller shall prepare a written memorandum of each subsequent purchase, in which case the provisions of subsections (1), (2), (3) and (4) of KRS 371.220 shall not be applicable. Unless previously furnished in writing to the buyer by the seller, by sales slip, memoranda or otherwise, such memorandum shall set forth with respect to each subsequent purchase the following:

(a) The cash sale price of the goods or services;

(b) The amount of the buyer's down payment, identifying the amounts paid in money and allowed for goods traded in;

- (c) The difference between items (a) and (b);
- (d) The aggregate amount, if any, included for insurance, if a separate identified charge is made therefor, specifying the type or types of insurance and the term or terms of coverage;
- (e) The aggregate amount of official fees;
- (f) The principal balance, which is the sum of items (b) and (c);
- (g) The amount or rate of the time price differential;
- (h) The amount of the time balance owed by the buyer to the seller, which is the sum of items (f) and (g);
- (i) The outstanding balance of the previous contract or contracts;
- (j) The consolidated time balance, which is the sum of items (h) and (i);
- (k) The revised installments applicable to the consolidated time balance, if any.

The seller shall deliver to the buyer a copy of such memorandum prior to the due date of the first installment such consolidated contract.

- (3) When such subsequent purchases are made, if the seller has retained title or taken a lien or other security interest in any of the goods purchased under any one of the contracts included in the consolidation;
- (4) The entire amount of all payments made prior to such subsequent purchases shall be deemed to have been applied on the previous purchases;
- (5) Each payment after such subsequent purchases made on this consolidated contract shall be deemed to have been allocated to all of the various purchases in the same ratio as the original cash sale prices of the various purchases bear to the total of all;
- (6) Where the amount of each installment payment is increased in connection with such subsequent purchases, at the seller's option, the subsequent payments may be deemed to be allocated as follows: an amount equal to the original periodic payment to the previous purchase, the balance to the subsequent purchase. However, the amount of any down payment on the subsequent purchase shall be allocated in its entirety to such subsequent purchase.
- (7) The provisions of subsections (3), (4), (5) and (6) of this section shall not apply to cases where such previous and subsequent purchases involve equipment, parts, or other goods attached or affixed to goods previously purchased and not fully paid, or to services in connection therewith rendered by the seller at the buyer's request.

HISTORY: 1962 c 136, § 2(13), eff. 1-1-63

371.300 Requisites of retail charge agreement

- (1) Each retail charge agreement shall be in writing and signed by the buyer. A copy of any such agreement executed on or after January 1, 1963, shall be delivered or mailed to the buyer by the seller prior to the date on which the first payment is due thereunder. Any acknowledgment by the buyer of delivery of a copy of the agreement contained in the body thereof shall be in a size equal to at least ten point bold type and shall appear directly above the buyer's signature. No agreement executed on or after January 1, 1963, shall be signed by the buyer when it contains blank spaces to be filled in after it has been signed. The buyer's acknowledgment, conforming to the requirements of this subsection, of delivery of a

copy of an agreement shall be presumptive proof, in any action or proceeding, of such delivery and that the agreement, when signed, did not contain any blank spaces as provided in KRS 371.210 to 371.330. All retail charge agreements executed on or after January 1, 1963, shall state the maximum amount or rate of the time price differential to be charged and paid pursuant thereto. Any such agreement shall contain substantially the following notice printed or typed in a size equal to at least ten point bold type: "NOTICE TO THE BUYER—DO NOT SIGN THIS AGREEMENT BEFORE YOU READ IT OR IF IT CONTAINS BLANK SPACES. YOU ARE ENTITLED TO A COPY OF THE AGREEMENT YOU SIGN."

(2) The seller shall promptly supply the buyer under the retail charge agreement with a statement as of the end of each monthly period, which need not be a calendar month, or other regular period agreed upon in writing by the seller and the buyer, in which there is any unpaid balance thereunder, which statement shall recite the following:

- (a) The unpaid balance under the retail charge agreement at the beginning and at the end of the period;
- (b) Unless otherwise furnished by the seller to the buyer by sales slip, memorandum, or otherwise, a description or identification of the goods or services purchased during the period, the cash sale price and the date of each purchase;
- (c) The payments made by the buyer to the seller and any other credits to the buyer during the period;
- (d) The amount, if any, of any time price differential for such period; and
- (e) A legend to the effect that the buyer may at any time pay his total unpaid balance or any part thereof.
- (3) A retail charge agreement may provide for, and the seller or holder may then, notwithstanding the provisions of any other law, charge, collect and receive, in addition to the cash price, a time price differential for the privilege of paying in installments thereunder.

HISTORY: 1962 c 136, § 3, eff. 1-1-63

371.310 Assignment of contracts and agreements

Notwithstanding the provisions of any other law:

(1) An assignee may purchase or acquire or agree to purchase or acquire any retail installment contract or retail charge agreement or any indebtedness under either from a seller on such terms and conditions and for such price as may be mutually agreed upon;

(2) Filing of the assignment, notice to the buyer of the assignment and any requirement that the seller be deprived of dominion over payments upon a retail installment contract or retail charge agreement, or over the goods if returned to or repossessed by the seller, shall not be necessary to the validity of a written assignment of the retail installment contract or retail charge agreement or any indebtedness under either as against creditors, subsequent purchasers, pledgees, mortgagees and lien claimants of the seller; and

(3) Unless the buyer has notice of the assignment of

his retail installment contract, retail charge agreement or any indebtedness under either, payment therefor made by the buyer to the holder last known to him shall be binding upon all subsequent holders.

HISTORY: 1962 c 136, § 4, eff. 1-1-63

371.320 Prior acts and agreements of retail buyer do not waive requirements of KRS 371.210 to 371.330

No act or agreement of the retail buyer before or at the time of the making of a retail installment contract, retail charge agreement or purchases thereunder shall constitute a valid waiver of any of the provisions of KRS 371.210 to 371.330 or of any remedies granted to the buyer by law.

HISTORY: 1962 c 136, § 5, eff. 1-1-63

371.325 Operation of waiver of defense clause as to defense acquired in third party materialmen's lien

No waiver of defense clause in any retail installment contract shall operate to cut off any defense that an owner-occupant of a single or double family dwelling or the appurtenances or additions thereto may have acquired by virtue of a third party materialmen's lien under KRS 376.010(4).

HISTORY: 1974 S 2, § 2, eff. 6-21-74

371.330 KRS 371.210 to 371.330 do not affect validity of pre-1963 contracts

The provisions of KRS 371.210 to 371.330 shall not invalidate or make unlawful retail installment contracts or retail charge agreements executed prior to January 1, 1963.

HISTORY: 1962 c 136, § 7, eff. 1-1-63

371.990 Penalties

(1) Any person who violates any of the provisions of KRS 371.130, or assents to any such violation shall be fined not less than fifty nor more than two hundred dollars for each offense.

(2) Any person who shall willfully and intentionally violate any provision of KRS 371.210 to 371.330 shall be guilty of a misdemeanor and upon conviction shall be punished by a fine not exceeding five hundred dollars or by imprisonment for not more than six months, or both.

(3) Any person who violates any provision of KRS 371.210 to 371.330 except as a result of an accidental or bona fide error shall be barred from the recovery of any time price differential, or any delinquency or collection charge under or in connection with the related retail installment contract or retail charge agreement; but the holder may nevertheless recover from the buyer an amount equal to the cash price of the goods or services and the cost to the seller or holder of any insurance included in the transaction.

(4) Notwithstanding the provisions of subsections (2),

(3) and (4) of this section, any failure, other than a willful and intentional failure, to comply with any provision of KRS 371.210 to 371.330 may be corrected within ten days after the holder is notified thereof in writing by the buyer and, if so corrected, neither the seller nor the holder is subject to any penalty under subsections (2), (3) and (4) of this section.

HISTORY: 1962 c 136, § 6, eff. 1-1-63
KS 4758a-3

INSTALMENT SALES CONTRACT

190.090 Definitions for KRS 190.090 to 190.140

As used in KRS 190.090 to 190.140 unless the context or subject matter otherwise requires:

(1) "Person" means an individual, partnership, corporation, association, and any other group however organized.

(2) "Retail instalment sale" means any sale for other than business or commercial use evidenced by a retail instalment contract wherein retail buyer agrees to buy and retail seller agrees to sell a motor vehicle at a time sale price payable in two or more instalments. The cash sale price of the motor vehicle, the amount, if any, included for insurance and other benefits, official fees and the finance charge, shall together constitute the time sale price.

(3) "Retail instalment contract" means any agreement, entered into in this state, evidencing a retail instalment sale of a motor vehicle, other than for the purpose of resale, pursuant to which title to, or a lien upon the motor vehicle is retained by the retail seller as security for the retail buyer's obligation. This term includes a mortgage, conditional sale contract or any contract for the bailment or leasing of a motor vehicle by which the bailee or lessee contracts to pay as compensation for its use a sum substantially equivalent to the time sale price of the motor vehicle and by which it is agreed that the bailee or lessee is bound to become, or has the option of becoming, the owner of such motor vehicle.

(4) "Motor vehicle" means any device in, upon, or by which any person or property is, or may be transported or drawn upon a highway. The term does not include self-propelled wheelchairs and invalid tricycles, tractors, power shovels, road machinery, implements of husbandry and other agricultural machinery, or other machinery not designed primarily for highway transportation but which may incidentally transport persons or property on a highway, or devices which move upon or are guided by a track or travel through the air. A moped as defined in KRS 190.010 shall be subject to the same requirements as a motor vehicle under this section.

(5) "Retail seller" or "seller" means a person who sells or agrees to sell a motor vehicle under a retail instalment contract to a retail buyer.

(6) "Retail buyer" or "buyer" means a person who buys or agrees to buy a motor vehicle from a retail seller not for the purpose of resale and who executes a retail instalment contract in connection therewith.

(7) "Sales finance company" means a person engaged in the business of creating and holding or purchasing or acquiring retail instalment contracts from a retail seller. The term includes a bank, trust company, private banker, industrial bank, investment company or national bank, if so engaged.

(8) "Cash sale price" means the price at which the seller would in good faith sell to the buyer, and the buyer would in good faith buy from the seller, the motor vehicle which is the subject matter of the retail instalment contract, if such sale were a sale for cash, instead of a retail instalment sale. The cash sale price may include any taxes, registration fees, certificate of title fees, if any, license fees, charges for delivery, servicing, repairing, or improving the motor vehicle, including accessories and their installation.

(9) "Official fees" means the fees prescribed by law for filing, recording or otherwise perfecting and releasing or satisfying a retained title or a lien created by a retail instalment contract.

(10) "Finance charge" means that part of the time sale price by which it exceeds the aggregate of the cash sale price, the amount, if any, included for insurance and other benefits and official fees included in the retail instalment sale.

(11) Words in the singular include the plural and vice versa.

HISTORY: 1984 c 391, § 1, eff. 7-13-84
1978 H 25, § 11; 1956 c 105, § 1

190.100 Instalment contracts

(1)(a) Every retail instalment contract shall be in writing in at least eight (8) point type, shall contain all the agreements of the parties, shall be signed by the retail buyer, and a copy thereof shall be furnished to such retail buyer at the time of the execution of the contract.

(b) No provision of a retail instalment contract which purports to provide for the inclusion of title to or a lien upon any goods other than the motor vehicle, accessories and special or auxiliary equipment used in connection therewith which either are the subject of the retail instalment sale or are substitution in whole or in part therefor, as security for payment of such time sale price shall be valid or enforceable; but the other provisions of the retail instalment contract shall not be affected thereby.

(c) No provisions for confession of judgment, power of attorney therefor, or wage assignment contained in any retail instalment contract shall be valid or enforceable.

(d) If the finance charge applicable to a retail instalment contract has been determined by a pre-computed method, the holder of a retail instalment contract may collect a delinquency and collection charge on each instalment in arrears for a period not less than ten (10) days in an amount not in excess of five percent (5%) of each instalment or five dollars (\$5.00), whichever is the less. In addition to such delinquency and collection charge, the retail instalment contract may provide for the payment of attorneys' fees not exceeding fifteen percent (15%) of the amount due and payable under such contract where such contract is referred to an attorney not a salaried employe of the holder of the contract for collection, plus the court costs.

(e) Unless notice has been given to the retail buyer of actual or intended assignment of a retail instalment contract, payment thereunder or tender thereof made by the retail buyer to the last known holder of such contract shall be binding upon all subsequent holders or assignees.

(f) Upon written request from the retail buyer, the holder of the retail instalment contract shall give or forward to the retail buyer a written statement of the total amount unpaid under such contract. A retail buyer shall be given a written receipt for any payment when made in cash.

(2) The retail instalment contract shall contain the following:

(a) The cash sale price of the motor vehicle which is the subject matter of the retail instalment sale;

(b) The amount of the retail buyer's down payment, whether made in money or goods, or partly in money or partly in goods;

(c) The difference between paragraphs (a) and (b) of this subsection;

(d) 1. Amount, if any, included for insurance and other

benefits;

2. Types of coverage and benefits;

(e) Official fees as defined in KRS 190.090;

(f) Principal balance, which is the sum of paragraphs (c), (d), and (e) of this subsection.

(3) The retail instalment contract shall contain a definite statement in twelve (12) point bold type or larger, that the insurance, if any included in the retail instalment sale provides or does not provide coverage for personal liability and property damage caused to others, as the case may be.

(4) The amount, if any, included for insurance, shall not exceed the premiums chargeable in accordance with applicable rate filings made with the commissioner of insurance. Every retail seller or sales finance company, if insurance on the motor vehicle is included in a retail instalment contract shall within thirty (30) days after execution of the retail instalment contract send or cause to be sent to the retail buyer a policy or policies or certificate of insurance, which insurance shall be written by a company authorized to do business in this state, clearly setting forth the amount of the premium, the kind or kinds of insurance and the scope of the coverage and all the terms, exceptions, limitations, restrictions and conditions of the contract or contracts of the insurance. The buyer of a motor vehicle under a retail instalment contract shall have the privilege of purchasing such insurance from an agent or broker of his own selection and of selecting an insurance company acceptable to the seller; provided, however, that the inclusion of the insurance premium in the retail instalment contract when the buyer selects the agent, broker or company, shall be optional with the seller. If any such policy is canceled, the unearned insurance premium refund received by the holder of the contract shall be credited to the final maturing instalments of the retail instalment contract.

(5) Any sales finance company hereunder may purchase or acquire from any retail seller any retail instalment contract on such terms and conditions as may be agreed upon between them. No filing of the assignment, no notice to the retail buyer of the assignment, and no requirement that the retail seller shall be deprived of dominion over the payments thereunder or the goods covered thereby if repossessed by the retail seller shall be necessary to the validity of a written assignment of a retail instalment contract as against creditors, subsequent purchasers, pledgees, mortgagees and lien claimants of the retail seller.

(6) An acknowledgment in the body of the retail instalment contract by the retail buyer of the delivery of a copy thereof shall be conclusive proof of delivery in any action or proceeding by or against any assignee of a retail instalment contract.

HISTORY: 1984 c 391, § 2, eff. 7-13-84
1956 c 105, § 2

190.110 Finance charges; rates; computation

(1) The finance charge in a retail instalment sale shall not exceed the following rates:

Class 1. Any new or used motor vehicle designated by the manufacturer by a year model not earlier than the year in which the sale is made—eleven dollars (\$11.00) per one hundred dollars (\$100).

Class 2. Any new motor vehicle not in class 1 and any used motor vehicle designated by the manufacturer by a year model of one (1) or two (2) years prior to the year in which the sale is made—thirteen dollars (\$13.00) per one hundred dollars (\$100).

Class 3. All other motor vehicles not in class 1 or 2—fifteen dollars (\$15.00) per one hundred dollars (\$100).

(2) Such finance charge shall be computed on the principal balance as determined under KRS 190.100 (2) on contracts payable in successive monthly payments substantially equal in amount extending for a period of one (1) year. On contracts providing for instalment payments extending for a period less than or greater than one (1) year, the finance charge shall be computed proportionately.

(3) When a retail instalment contract provides for unequal or irregular instalment payments, the finance charge shall be at the effective rate provided in subsection (1) of this section, having due regard for the schedule of payment.

(4) The finance charge allowed by this section may be pre-computed by using an add-on method. Alternatively, the seller may, at his option, compute the finance charge on a simple interest basis, at a fixed or variable rate, but in such case the amount of finance charge that the seller may collect shall not exceed the amount that could be collected if the finance charge were pre-computed.

HISTORY: 1984 c 391, § 3, eff. 7-13-84
1980 c 321, § 2; 1956 c 105, § 3

190.120 Payment in full before maturity

(1) If the finance charge applicable to the retail instalment contract has been determined by a pre-computed method, the retail buyer may pay in full at any time before the stated maturity date and upon such prepayment in full the retail buyer shall receive a refund of a portion of the finance charge computed in accordance with the Rule of 78's. An acquisition cost of twenty-five dollars (\$25) shall be deducted from the finance charge before computation of the refund. Where the refund is less than one dollar (\$1.00) no refund need be made and acceleration of the balance by the seller, caused by the default of the buyer or otherwise, shall not affect the date of computation. Any balance remaining unpaid as of the stated maturity date shall then be subject to accumulation of additional finance charges at the rate specified in the contract.

(2) If the finance charge applicable to the retail instalment contract has or will be determined by a simple interest method, the retail buyer may pay in full at any time before the stated maturity date without penalty, except that the holder may collect and receive a minimum finance charge of twenty-five dollars (\$25) in any event.

HISTORY: 1984 c 391, § 4, eff. 7-13-84
1956 c 105, § 4

190.130 Extension, deferral or renewal; when; service fee; additional charge

The holder of a retail instalment contract may, upon agreement with the retail buyer, extend the scheduled due date, defer the scheduled payment of all or part of any instalment payment or payments, or renew the balance of such contract. In any such case the holder may restate the amount of the instalments and the time schedule therefor, and collect as a refinance charge for such extension, deferral or renewal, a flat service fee not to exceed five dollars (\$5.00) and an additional finance charge computed at the same rate and by the same method as originally set out in the retail instalment contract computed from the date o

such extension, deferment or renewal.

HISTORY: 1984 c 391, § 5, eff. 7-13-84
1956 c 105, § 5

190.140 Citation of KRS 190.090 to 190.140

KRS 190.090 to 190.140 may be cited as "The Motor Vehicle Retail Instalment Sales Act."

HISTORY: 1956 c 105, § 8, eff. 7-1-56

360.150 Manufactured home financing

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

(a) "Lender" means a person regularly engaged in the business of selling or financing manufactured homes:

1. Who is an arranger of credit; or

2. Who regularly extends consumer credit that is subject to a finance charge or is payable by written agreement in more than four (4) installments (not including a down payment) and to whom the obligation is initially payable, either on the face of the note or contract, or by agreement when there is no note or contract;

(b) "Interest" means finance charge expressed as an annual percentage rate. The finance charge is the cost of consumer credit as a dollar amount. It includes any charge payable directly or indirectly by the lender as an incident to or a condition of the extension of credit;

(c) "Manufactured home" means a moveable dwelling unit, designed and constructed for permanent occupancy by a single family, which dwelling contains permanent eating, cooking, sleeping, and sanitary facilities; or a prefabricated dwelling that is manufactured in two (2) or more modules at a location other than a homesite and which is designed to be used as a residence when the modules are transported to the homesite, and the modules are joined together and installed on a permanent foundation system. The term includes the plumbing, heating, air conditioning, and electrical systems contained in the structure; and

(d) "Manufactured home financing transaction" shall include both the credit sale of a manufactured home and a direct loan used to finance the purchase of a manufactured home.

(2) A manufactured home financing transaction may provide for a fixed rate of interest payable in substantially equal successive installments over a fixed term, or may provide that the rate of interest may be adjusted at certain regular intervals. In this latter event, the manufactured home financing transaction shall be subject to the provisions in this section.

(3) Adjustments in the interest rate charged must be based on changes in a specific index, as set forth in the financing agreement. The index may be only:

(a) The monthly average yield on United States treasury securities adjusted to a constant maturity of five (5) years; or

(b) An index approved by the federal home loan bank board or by the office of the comptroller of the currency, department of the treasury, for adjustable or variable interest rates on residential mortgage loans.

(4) The rate of interest shall not increase or decrease during the six-month period beginning with the date of execution of the financing agreement, and at least six (6) months shall elapse between changes.

(5) Adjustments, either up or down, to the rate of interest on each adjustment date shall, for the initial adjustment, be equal to the difference between the index value in effect on the first day of the second calendar month preceding the adjustment date and the value in effect on the first day of the month in which the financing agreement is executed. For adjustments after the initial adjustment, adjustments shall be equal to the difference between the index value in effect on the first day of the second month preceding the adjustment date and the index value in effect on the first day of the second month preceding the date of the immediately preceding rate adjustment.

(6) Where the stated regular interval between rate adjustments is six (6) months, an adjustment to the interest rate may not result in a rate of interest which is more than one (1) percentage point greater or less than the interest rate

in effect prior to such adjustment. If the stated regular interval between rate adjustments exceeds six (6) months, then the maximum adjustment either up or down shall be one (1) percentage point multiplied by the number of whole consecutive six (6) month periods in the interval between rate adjustments.

(7) Any increase in the rate of interest permitted by this section shall be optional with the creditor. Decreases in the rate of interest shall be mandatory whenever the total decrease in the index value equals or exceeds one-quarter ($\frac{1}{4}$) of one (1) percentage point.

(8) If the creditor agrees to impose limitations on interest rate changes that are more restrictive than the limitations specified in this section, then such limitations shall apply to both increases and decreases.

(9) Any changes in the index which are not reflected in a rate adjustment may, by agreement of the parties, be carried over to subsequent rate adjustment periods, and be implemented to the extent not offset by opposite movement in the index.

(10) By agreement of the parties, adjustments to the rate of interest may result in changes in the amount of regular installment payments due under the financing agreement, or in changes in the term of the financing agreement, or in a combination of such changes in amount and term. Adjustments to the amount of installment payments may be made less frequently than adjustments to the interest rate.

(11) For all manufactured home financing transactions under this section, the creditor shall comply with all applicable requirements and disclosures pursuant to Part I of the Consumer Protection Act (Truth-In-Lending Act) 15 USC sec. 1601, et. seq., as amended, and as implemented by Regulation Z promulgated by the board of governors of the federal reserve system.

(12) The creditor shall send written notification of any rate adjustment, by first class mail, postage prepaid, at least one (1) month before the date that the new rate of interest shall take effect.

(13) Notwithstanding any of the requirements and limitations set forth by subsections (3) through (12) of this section, the parties may agree on any terms or provisions in the manufactured housing financing agreement as may be authorized or permitted in any program for residential mortgage loans by the federal home loan bank board or by the office of the comptroller of the currency, department of the treasury, or any other federal department, agency or board. In such event, the creditor shall comply with all applicable limitations, requirements and disclosures of the agency that relate thereto.

HISTORY: 1984 c 197, § 1, eff. 7-13-84
1982 c 335

NOTES ON DECISIONS AND OPINIONS

OAG 84-353. A manufactured home financing transaction providing for a rate of interest that may be adjusted at certain regular intervals is governed by the provisions of KRS 360.150. The manufactured home financing transaction providing for a fixed rate of interest is governed by the Motor Vehicle Retail Installment Sale Act, KRS 190.090 et seq.

CONSUMER REGULATORY REVIEW AND UPDATE

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SECTION C



CONSUMER REGULATORY REVIEW AND UPDATE

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OVERVIEW

1988 was a very active year in the field of consumer compliance -- regulatory issues. The following is a summary of several specific areas in which changes became effective in 1988 or are slated to become effective in 1989.

- . Fair Debt Collection Practices Act

FTC adopted and published Staff Commentary

- . Equal Credit Opportunity Act -- Regulation B

Congress passed Women's Business Opportunity Act of 1988 which contains an amendment to the Equal Credit Opportunity Act. Congress directed the Federal Reserve Board to expand Regulation B in certain areas.

- . Fair Credit Reporting Act

FTC proposed Official Staff Commentary

- . Truth-in-Lending and Regulation Z

A. Adjustable Rate Mortgages. The Federal Reserve Board amended Regulation Z December 28, 1987. The final version of the Official Commentary was published April 5, 1988. Compliance became mandatory October 1, 1988.

B. Fair Credit and Charge Card Disclosure Act. Congress passed this Act (HR515) which amended the Truth-in-Lending Act. The Federal Reserve Board proposed regulations implementing the Act.

C. Home Equity Loans Consumer Credit Protection Act of 1988. Congress adopted amendments to the Truth-in-Lending Act (HR3013). The Federal Reserve Board proposed amendments to Regulation Z.

(Note: As of the date this material was prepared, many of the proposals, etc. were pending. It is anticipated that most will become final by mid-1989.)

I. FEDERAL FAIR DEBT COLLECTION PRACTICES ACT

A. SOURCE AND STATUS OF "THE LAW"

1. The Fair Debt Collection Practices Act is set out at 15 U.S.C. 1692 et seq. The original version became effective March 20, 1978. A significant amendment, removing the exemption of attorneys-at-law from coverage of the Act, became effective July 9, 1986.
2. On December 13, 1988, the Federal Trade Commission published final "Statements of General Policy or Interpretation Staff Commentary on the Fair Debt Collection Practices Act" 53 FR 50097. The stated intention was to supercede all previously issued staff interpretations and to clarify and codify the interpretations set out in the statement.
3. The FTC originally proposed the Commentary on March 7 1986, and requested public comment. Four months later, Congress removed the attorney-at-law exemption from the coverage of the Act and the final version of the Commentary was delayed until December 1988. The final version added comments attempting to explain how the Act applies to attorneys and the practice of law.

B. PRINCIPAL REVISIONS TO THE PREVIOUSLY PUBLISHED COMMENTARY

The bulk of the proposed Commentary was adopted without change but several areas were changed or qualified. A summary of the principal revisions follows:

1. The Commentary clarifies that a debt collector who seeks location information by mail may identify his employer when expressly asked to do so.
2. The Act requires a debt collector to contact a consumer's attorney if the consumer advises that the debt collector is to contact that attorney on all future debts. The Commentary now provides that the debt collector is not prohibited from contacting the consumer at a "much later" time about another debt and that it is the obligation of the consumer to remind the debt collector that he is still represented by the attorney.
3. An example has been added to clarify that the consumer's consent to a third party contact need not be in writing.
4. A comment has been added to clarify that the use of the term "personal" or "confidential" on a mailing envelope does not violate the Act. This section reaffirms the position that the intent of the Act is to prevent language or symbols which would reveal that communications pertain to debt collection -- not to totally bar the use of harmless words or symbols on an envelope.
5. A comment has been expanded to expressly declare that any waiver of the venue provisions of the Act by the debtor must be clear and furnished directly to the debt collector and may not be in the credit contract.

C. SPECIAL COMMENTS RELATING TO ATTORNEYS AND THE PRACTICE OF
LAW

1. Attorneys or law firms that engage in traditional debt collection activities (sending letters, making collection calls) are covered by the FDCPA but those whose practice is limited to legal activities are not covered.
2. A student loan is a "debt" covered by the Act. However, alimony, tort claims and nonpecuniary obligations are not covered.
3. A salaried attorney who collects a debt on behalf of and in the name of his creditor/employer is exempt from coverage of the Act.
4. Debt collectors (including attorney debt collectors) are subject to the venue limitations of the Act.
5. An attorney may communicate with a witness in a law suit that has been filed. (Editors Note: This comment falls short of approving contact with a witness prior to the filing of a law suit.)
6. A debt collector may place a public notice required by law as a prerequisite to enforcing a debt.
7. An attorney debt collector must provide the required validation notice even if a previous debt collector has given such a notice.
8. An attorney debt collector may take legal action within 30 days of sending the required validation notice even if the consumer disputes the debt within that time period.

9. If a judgment has been obtained in a forum that satisfies the venue requirements of the Act a debt collector may bring suit to enforce the Judgment in another jurisdiction.

II. EQUAL CREDIT OPPORTUNITY ACT -- REGULATION B

A. SOURCE AND STATUS OF "THE LAW"

The original Equal Credit Opportunity Act (15 U.S.C. 1691 et seq.) became effective on October 28, 1975, and was later amended, effective March 23, 1977. On October 25, 1988, Congress adopted the Women's Business Ownership Act of 1988 (HR5050), which amended the Act again. -- The Federal Reserve Board has not yet issued proposed amendments to Regulation B.

B. DECLARED FINDINGS AND PURPOSES

Congress found that women-owned businesses have become a major contributor to the American economy and despite much progress, women, as a group, are subjected to discrimination in entrepreneurial endeavors because of their gender. Congress declared it was in the national interest to expeditiously remove discriminatory barriers to the creation and development of small business concerns owned and controlled by women. The Act affects many areas and creates a special National Women's Business Council. It amends the Small Business Act and creates demonstration projects, implements form simplification and establishes preferred financing for women.

C. AMENDMENTS TO EQUAL CREDIT OPPORTUNITY ACT

The amendments set out in Section 301 of Title 3 of the Act require significant changes in present business/commercial

lending practices.

1. Entities making business or commercial loans must maintain records or other data relating to loans to evidence compliance with the ECOA for a period of at least one year. This represents a significant expansion of the present record retention requirement in Regulation B (Sec. 202.3(d)(3)(ii)) which requires that such records be kept for only 90 days.
2. The Federal Reserve Board is also mandated to provide regulations requiring that an applicant for a business or commercial loan must receive a written notice of the applicant's right to receive a written statement of the reasons for the denial of such loan. This represents a significant departure from the requirements of the present Regulation B (Sec. 202.3(d)(3)(i)) since business applicants are currently entitled to a statement of the reasons for denial only if they request such in writing within a 30 day period.

D. IMPLEMENTING REGULATIONS

At the time of writing, the Federal Reserve Board has not proposed regulations implementing the changes mandated by the Act.

III. FAIR CREDIT REPORTING ACT

A. SOURCE AND STATUS OF "THE LAW"

1. The Fair Credit Reporting Act 15 U.S.C. 1681 et seq. became effective on April 25, 1971.
2. On August 25, 1988, the Federal Trade Commission published Proposed Official Commentary to the FCRA -- 53 FR 29696. The Comment period closed October 7, 1988.
3. An FTC Staff Attorney has unofficially advised that the FTC received over 100 separate comments comprising over 600 pages in response to the proposal. The estimate was that the Official Commentary should become final "sometime during 1989".

B. PRINCIPAL CHANGES FROM PRIOR VIEWS

The following is a summary of some specific areas and concepts addressed in the Proposed Commentary which are different from those set out in present interpretations and informal staff opinion letters.

1. The present concept of "pre-screening" is expanded to include situations where demographic analysis is performed in preparing the list, in addition to the traditional credit screen by a consumer reporting agency, and multiple lists of consumers, who meet different creditworthiness criteria, are provided to a client who intends to make different credit offers to

- consumers, based on which criteria they meet (for example, offering each a credit card but with different credit limits).
2. The Proposed Commentary expands the availability of consumer reports to investigate welfare fraud by making it clear that any public office charged with determining a consumer's eligibility for such a benefit can obtain a consumer report on that consumer.
 3. Reporting of Chapter XIII or Wage Earner Plans can be provided for a ten year period rather than the seven year period previously approved.
 4. The seven year period for reporting a particular account starts with the actual date the account was "charged to profit or loss" or "placed for collection" and not the date the consumer first became delinquent on the account.
 5. The Proposed Commentary rejects existing interpretations and states that users of consumer credit reports for purposes other than credit, employment or insurance need not provide notices concerning the use of such reports nor must consumer reporting agencies require such users to send a notice.
 6. The Proposed Commentary limits the right of an individual consumer to dispute the accuracy or completeness of items in his file. It provides that

the consumer may dispute only a particular obligation, and may furnish a statement of extenuating circumstances on a particular account and not on his entire credit file generally.

7. If a user of a consumer report is considering whether or not to promote a present employee but decides not to promote or reassign that employee, the employee does not have to be notified of the use of the consumer report in the evaluation process.

IV. ADJUSTABLE RATE MORTGAGES -- REGULATION Z

A. SOURCE AND STATUS OF "THE LAW"

1. The "changes" in this area were accomplished by direct amendments to Regulation Z effected by the Federal Reserve Board. The effective date of the original amendments was December 28, 1987. However, financial institutions had until October 1, 1988, to comply with the new requirements.
2. The changes were basically implemented by making additions to Sections 17 and 18 of the Regulation and creating new Sections designated 19b and 20c. The Official Commentary to the new Regulation Sections was published in final form on April 4, 1988. 53 FR 11047.

B. COVERAGE AND SCOPE

1. The amendments apply only to transactions in which the debt bears interest at a variable rate.
2. Coverage is limited to closed-end transactions secured by the consumer's principal dwelling.
 - a. All purchase money loans are covered as they have always been.
 - b. (NEW) Now includes all loans using the consumer's current principal dwelling as security, for example: home improvement loans, general home equity loans, etc.

3. The amendment does not apply if the term of the loan is one year or less. Such loans are still covered by the requirements of Section 226.18(f)(1).

C. Initial - Pre Application Disclosures (NEW CONCEPTS)

1. These new disclosures must be made to the consumer when an application form is initially furnished or before the consumer pays a non-refundable application fee, whichever is earlier. (Note: This is not a substitution for the timing requirements of furnishing disclosures under Section 226.18(f) but in addition thereto.)

a. Where the covered application reaches the financial institution by telephone or by way of an intermediary agent or broker, these initial disclosures must be placed in the mail or delivered to the consumer not later than three business days after the creditor receives the consumer's application.

2. The new disclosures fall into two general categories.

a. First, an ARM brochure or booklet describing in general terms how a variable rate loan (an ARM) works. The financial institution may use the "Consumer Handbook on Adjustable Rate Mortgages" developed by the Federal Reserve Board and the FHLBB or may use a "suitable substitute".

- b. Second, a "loan program" disclosure containing detailed, specific information about the major aspects of the program actually offered by the financial institution. Separate "loan program" disclosures must be furnished to the consumer for each "variable - rate program in which the consumer expresses an interest." The detailed "loan program" disclosures may be an insert into the consumer handbook.
3. The specific "loan program" disclosure must address some thirteen different aspects of the financial institution's program, as applicable. The disclosures must address:
 - a. The fact that the interest rate, payment or term of the loan may change.
 - b. The index or formula used in making adjustments and a source of information about the index or formula. If the interest rate changes at the creditor's discretion, that fact must be disclosed. If the index is internally defined, such as by the creditor's prime rate, the creditor may either briefly describe the index or state that the rate changes are at the creditor's discretion.
 - c. An explanation of how the interest rate and payment will be determined including a general

explanation of how the index is adjusted, for example, by the addition of a margin.

- d. A statement that the consumer should ask about the current margin value and the current interest rate. Since these disclosures can be preprinted in advance, the statement is required to alert the consumer to the fact that they should inquire about the current margin value being applied to the index.
- e. The fact that the interest rate will be discounted or has a premium added, and a statement that the consumer should ask about the amount of the discount or premium. This disclosure of course applies only where the initial interest rate is not determined by the index or formula used to make later interest rate adjustments.
- f. The frequency of interest rate and payment changes. If interest rate changes will be imposed more frequently or at different intervals than payment changes, the financial institution must reveal the frequency and timing of both types of changes.
- g. Any rules relating to changes in the index, interest rate, payment amount, and outstanding loan balance including, for example, an explanation of interest rate or payment

limitations, negative amortization, and interest rate carryovers. This section also applies to preferred-rate employee loans where the rate will increase if the employee leaves the financial institution's employ, whether or not the underlying rate is fixed or variable.

- h. An historical example based on a \$10,000.00 loan amount illustrating how payments and the loan balance would have been affected by interest rate changes implemented according to the terms of the financial institution's loan program. The example must be based on index values beginning in 1977 and updated annually until a 15 year history is shown. The example must reflect all significant loan program terms, such as negative amortization, interest rate carryover, interest rate discounts and interest rate or payment limitations, that would have been affected by movement in the index during the period. The disclosure must only calculate the payments for the term of the loan. If the index has not been available for 15 years, the disclosure need only go back as far as the values are available. Where interest rate adjustments are implemented more frequently than once a year, the disclosures shall assume that the interest rate and payment resulting from the index

value chosen will stay in effect for an entire year for the purpose of calculating the loan balance at the end of the year. For the purpose of disclosure under this section the financial institution must select a margin that has actually been used during the six months preceding preparation of the disclosure. That margin may be used until the financial institution updates the disclosure form to reflect the most recent index values.

- i. An explanation of how the consumer may calculate the payments on the loan amount to be borrowed, based on the most recent payment shown in the historical example. The disclosure must explain how the consumer may calculate his or her actual monthly payment for a loan amount other than \$10,000.00 but the creditor is not required to calculate the consumer's actual payment.
- j. The maximum interest rate and payment for a \$10,000.00 loan originated at the most recent interest rate shown in the historical example and the initial interest rate and payment for that loan, assuming maximum periodic increases in the rate. In calculating the maximum payments the financial institution shall assume that the interest rate increases as rapidly as possible

under the loan program and the maximum payment disclosure should reflect the amortization of the loan during the period. If the loan program includes a discounted initial rate, the most recent rate shown in the historical example should be discounted by the amount of the discount reflected elsewhere in the disclosure for the purpose of making these calculations.

k. The fact that the loan program contains a demand feature (Note: This would also have to be disclosed in the standard disclosures given later).

l. The type of information which will be provided in Notices of Adjustments and the timing of such notices (see section E).

m. A statement that disclosure forms are available for the financial institution's other variable rate loan programs. A financial institution must inform the consumer that other closed-end variable rate programs exist if they in fact do.

4. The Official Commentary provides sample language which may be used to meet these disclosure requirements.

D. The "Standard" or "Conventional" Disclosures

1. These new disclosure requirements have not eliminated the standard or conventional disclosure form which has been around for some time. Thus, as a general rule,

these disclosures must be made anytime before "consummation" of the transaction, except in RESPA transactions. As at present, in RESPA transactions these disclosures must be given not later than three days after the financial institution receives a written application for credit.

2. The variable rate disclosures presently required by Section 226.18 have been renumbered as Section 226.18(f)(1) and the financial institution will be required to disclose only two matters in accordance with the new Section 226.18(f)(2):

- a. That the loan has an adjustable rate feature; and
- b. That the variable rate disclosures have been provided to the consumer earlier.

E. Subsequent or "After Closing" Disclosures.

1. A new provision requires a notice or disclosure to the consumer where an adjustment is made in the interest rate, pursuant to the terms of the program.

2. Generally two timing rules apply to this notice.

- a. If the interest rate may be adjusted more frequently than the payment amount, the financial institution must send at least one notice during any year in which an interest rate adjustment has been made with no corresponding change in the payment amount.

- b. If the payment amount is changed along with the change in the interest rate, the notice/disclosure must be sent each time there is an adjustment. It must be delivered or placed in the mail at least 25, but no more than 120 calendar days, before a payment in the new amount is due. This timing provision is tied to the due date of the payment rather than to the effective date of the interest rate adjustment.
3. The notice/disclosure must contain the following information, as applicable:
 - a. The current and prior interest rates.
 - b. The index values upon which the current and prior interest rates are based.
 - c. The extent to which the creditor has forgone any increase in the interest rate.
 - d. The contractual effect of the adjustment in the rate, including the amount of the payment due after the adjustment is made and a statement of the loan balance.
 - e. The amount of the payment that would be required to fully amortize the loan at the new interest rate over the remainder of the loan term, if the amount of that payment is different from the amount actually required under the contract.

V. FAIR CREDIT AND CHARGE CARD DISCLOSURE ACT -- REGULATION Z

A. SOURCE AND STATUS OF "THE LAW"

1. The Act (HR515) became law on November 3, 1988, and has been numbered PL100-583. Proposed Regulations to implement the Act were published by the Federal Reserve Board on December 22, 1988. 53 FR 51785. The final version is expected by April 3, 1989. Compliance will likely be mandatory on or around August 31, 1989, except for the special requirements governing "applications and solicitations available to the general public other than through the mail or telephone". It is anticipated that those rules will become effective around November 29, 1989.
2. The Act will be implemented by amending Regulation Z and essentially adding one definition to Section 226.2, creating a new Section 226.5a dealing with the disclosure rules, and amending Section 226.9 dealing with subsequent disclosure requirements.
3. The Act includes a definition for "charge card". Charge card is defined in the Act as a credit card (in accordance with the present definition in Section 226.2(a)(15)) but one on which there is no finance charge (as defined in the Regulation) assessed. The Board proposes to modify this definition for clarity so that the term charge card will be defined to mean a credit card for an account on which no periodic rate is used to compute a finance charge.

B. NEW ACCOUNT SOLICITATION DISCLOSURES

1. General Rules

- a. Certain required disclosures must be given in the form of a table and in a prominent location when provided on or with an application or solicitation.
- b. The disclosures must be given on or with the application or with a solicitation which does not require a written application.
- c. If a fee under the plan is determined on a percentage basis, that percentage may be disclosed rather than the equivalent dollar amount.
- d. In a multi-state solicitation, if certain fees vary from state to state, the card issuer may disclose the range of fees instead of the amount of the fees.

2. Direct Mail Applications and Solicitations.

- a. The following disclosures, as applicable, must be included with the application or solicitation:
 - i. "Annual Percentage Rate" and "Variable Rate Information"
 - ii. "Membership Fees" expressed as an annualized amount.
 - iii. "Minimum Finance Charge"
 - iv. "Transaction Fee for Purchases"
 - v. "Grace Period for Purchases"
 - vi. "Balance Calculation Method for Purchases"

vii. A statement that charges incurred by use of a charge card are due upon receipt of the Periodic Statement.

viii. "Transaction Fee for Cash Advances"

ix. "Late Payment Fees"

x. "Over-the-Credit-Limit Fees"

- b. The terminology appearing above in quotations is mandatory and must be used in the disclosures.
- c. The disclosures identified in paragraphs i. through vii. above must be in a tabular format. The disclosures in paragraphs viii. through x. above may be part of or outside of the tabular portion of the disclosures.
3. Telephone Solicitations. In a telephone solicitation to open a credit or charge card account, the card issuer must orally disclose the same information which is required to be in tabular form in a written solicitation. These oral disclosures need not be given if the card issuer does not impose an annual or other periodic fee or does not impose the fee unless the consumer uses the card. In that instance, the card issuer must send written disclosures, conforming to the Regulation, to the applicant with the card.
4. Applications and Solicitations Other than by Mail or Telephone.
- a. In this situation the creditor has three options:

1. The creditor may provide the same disclosures as are provided with a "direct mail" solicitation. These disclosures must be on or with the application and solicitation. In addition, the disclosure statement must indicate that the information was accurate as of the date of printing; the date of printing; that the terms are subject to change after such date; and that the consumer should contact the creditor for any changes in the information disclosed.
2. As an alternative, the creditor may furnish the disclosures which are currently required. If these are provided with the application and in a form that the consumer may keep, then the creditor will have satisfied all of the disclosure requirements of Section 226.6 of the Regulation. In addition to these disclosures, the creditor is required to disclose a toll-free number or a mailing address for use in asking about changes in the information disclosed.
3. As an alternative, the application or solicitation must state in a prominent location that there are costs associated with the use of the credit or charge card and that the applicant should contact the creditor to

request specific information about those costs. The creditor must furnish a toll-free telephone number or an address to which the applicant may write for the additional information. This option is not available if the card issuer includes on the application or solicitation any of the credit disclosures required by the Act.

5. Special Charge Card Rule When Card Issuer and Person Extending Credit Not the Same Person. Special disclosure rules are provided if the card issuer and the person actually extending credit under an open-end plan are not the same person, such as private label cards.

C. SUBSEQUENT DISCLOSURE REQUIREMENTS

1. If card issuer imposes any annual or other periodic fee to renew a credit or charge card account the requirements of this section are triggered.
 - a. Notice must be mailed or delivered to the card holder at least 30 days before the renewal fee is payable. The notice may be made on or with a periodic statement.
 - b. The following information must be included in the notice: when the account will expire if not renewed; the same disclosures as are required on "direct mail" solicitations; how the card holder may terminate the account to avoid paying the renewal fee.

c. The required notice may be provided less than 30 days before the date the renewal fee is payable but must be provided no later than the time the periodic statement first disclosing the fee is mailed or delivered. In this instance, the card issuer must also disclose that the card holder has 30 days to avoid paying the fee and that the card holder may use the card during the interim without paying the fee.

2. Change in Credit Card Account Insurance Provider.

- a. If a card issuer proposes to change the provider of credit insurance, notice of the proposed change must be given not less than 30 days before the change. The notice may be provided on or with the periodic statement.
- b. The notice must include the following, to the extent applicable: any increase in the premium rate or other costs as a result of the proposed change; any substantial decrease or limitation in coverage that will result from the proposed change; and a statement that the card holder may discontinue the insurance.
- c. If the proposed change referred to in the notice above actually occurs, then the card issuer must also provide the card holder with an additional written notice, no later than 30 days after the change, which includes the following: the name and address of the new provider; a copy of

the new policy or group certificate containing the basic terms of the insurance including the premium rate to be charged; and a statement that the card holder may discontinue the insurance.

VI. HOME EQUITY LOAN CONSUMER PROTECTION ACT 1988 -- REGULATION Z

A. SOURCE AND STATUS OF "THE LAW"

1. The Act (HR3011) cleared through Congress on October 21, 1988, and was subsequently signed by the President.
2. On January 19, 1989, the Federal Reserve Board filed proposed amendments to Regulation Z to implement the provisions of the Act. 54 FR 3063. Under the Board filing, the proposal is open for public comment until March 21, 1989.
3. Final adoption of these amendments is expected sometime in May 1989. Immediate compliance by creditors will likely be optional with mandatory compliance "around" October 1, 1989.

B. GENERAL SCHEME -- SCOPE AND COVERAGE

1. The Act and the Regulation cover OPEN-END CONSUMER CREDIT PLANS SECURED BY THE CONSUMER'S PRINCIPAL DWELLING. Open-end credit is defined in Section 226.2(20) of Regulation Z.
2. Dwelling is a defined term under existing Regulation Z Section 226.2(a)(18). In the existing Official Commentary to the sections governing the right of rescission (Section 226.15(a) and 226.23(a)), the Federal Reserve Board took a strong position and declared that a consumer may have only one principal dwelling at a time. This Act, however, furnishes an expanded definition for principal dwelling, as it relates to

an open-end account secured by that dwelling. In Section 2c, the proposal declares that the term principal dwelling includes "any second or vacation home of the consumer". Thus the disclosure obligations of the creditor and the rescission rights of the consumer are expanded to include a second home for this type of account.

3. The general scheme of the Act and Regulation is to require disclosure of specific information at the time an application is furnished to a consumer; to expand the disclosures required for variable interest rate plans, including a fifteen year history of changes in the selected index; to impose duties on third parties who provide applications to consumers; to inject additional disclosures at the "pre-transaction" stage of the relationship; to modify rules relating to advertisements for home equity loans; and to impose certain substantive limitations on the rights of creditors.
4. A creditor's substantive rights are severely limited by the Act. It must follow these restrictions in:
 - a. terminating a plan and/or accelerating payment of the outstanding balance;
 - b. changing the terms of a plan after it has been opened; and
 - c. choosing the index to be used in a variable rate plan.

In addition, an affirmative obligation is created to refund all fees paid by a consumer if he elects not to establish the account because of a change in terms between the time of application and consummation of the arrangement.

C. APPLICATION DISCLOSURES

1. Timing and Format.

- a. In addition to specific disclosures prepared by the creditor, a consumer must also receive a brochure which will be prepared by the Federal Reserve Board (or a substantially similar brochure).
- b. The initial disclosures and the brochure must be furnished to the consumer before or with the initial application for the home equity account. If applications are disseminated by someone other than the creditor or taken by telephone, the creditor must then mail or deliver the disclosures and the brochure to the consumer within three business days after it receives the application from the consumer.
- c. Most of the required disclosures must be grouped together and "segregated" from all other contract terms and material on the disclosure document. While the Board intends to be flexible in allowing explanatory information to be included with the required disclosures, information on other aspects of the plan that is not related to the disclosures,

such as underwriting criteria, will not be permitted.

- d. In the application disclosures, certain of the required disclosure items must be further highlighted by placing them first, before the others. These "preferred" disclosures notify the consumer that he should keep a copy of the disclosure, that he has a right to obtain a refund of fees if terms change and he decides not to enter into the arrangement, that he risks the loss of his dwelling in the event of default and that the creditor may terminate the plan or suspend future advances under certain circumstances.

2. Content of the Disclosures. The creditor must provide the following disclosures, as applicable:

- a. A statement that the consumer should make or otherwise retain a copy of the disclosures (it is not necessary for the creditor to deliver these disclosures to the consumer in a form that he may retain).
- b. A statement of the time by which the consumer must submit an application to obtain the specific terms as disclosed, and an identification of any disclosed terms that are subject to change prior to opening the account. In addition, a statement that if a disclosed term changes prior to opening and the consumer elects not to open the plan, that he

may receive a refund of all fees paid in connection with the application.

- c. A statement that the creditor will acquire a security interest in the consumer's dwelling and that loss of the dwelling may occur in the event of a default.
- d. A statement that the creditor may, under certain circumstances, terminate the plan and require payment of the balance in full; that the creditor may prohibit additional extensions of credit or reduce the credit limit under certain conditions; and that the creditor may modify certain terms. This disclosure must also contain a statement that on request the consumer may receive information about the conditions under which these actions may be taken.
- e. A disclosure of the the payment terms of the plan including the length of the plan and an explanation of how the minimum periodic payments and timing of the payments will be determined. If paying only the minimum periodic payments will not repay the principal, a statement of that fact, as well as a statement that a balloon payment will result. In addition, the disclosure must furnish an example showing the minimum periodic payment and the time it would take to repay \$10,000.00 if the consumer made only the minimum payments and obtained no additional extensions of credit.

- f. A recent annual percentage rate for fixed rate plans and a statement that the rate does not include costs other than interest (for special rules governing variable rate plans, see Section D following).
- g. An itemization of any fees imposed by the creditor stated as a dollar amount or a percentage and when such fees are payable.
- h. An estimate, stated as a dollar amount or range, of any fees that may be imposed by persons other than the creditor, as well as a statement that the consumer may request a good faith itemization of these fees.
- i. If applicable, a statement that negative amortization may occur and that if it does, it will increase the principal balance thus reducing the consumer's equity in his dwelling.
- j. Any limitation on the total number of extensions of credit and the amount of credit that may be obtained during any time period, as well as any minimum outstanding balance or any minimum draw requirements.
- k. A statement that the consumer should consult a tax advisor regarding the deductibility of interest and charges under the plan.

D. SPECIAL DISCLOSURES FOR VARIABLE RATE PLANS.

If the plan includes a variable interest rate then the following additional information must be included on the application disclosure statement.

1. The fact that the annual percentage rate, the payment amount or term may change.
2. A statement that the annual percentage rate does not include costs other than interest.
3. Identification of the index used to make the rate adjustments and a reference to a source of information about the index.
4. An explanation of how the annual percentage rate will be determined, such as by the addition of a margin.
5. A statement that the consumer should ask about the current index value, the margin, and the annual percentage rate.
6. If applicable, a statement that the initial rate is discounted (or that a premium has been added) and the period of time that this different initial rate will be in effect.
7. The frequency of changes in the annual percentage rate.
8. Any rules governing changes in the index value and resulting changes, such as payment increase limitations and interest rate carryover.
9. A statement of the maximum amount that the annual percentage rate may change in any one year period or a statement that no such limitation exists. Also, a

statement of the maximum rate that may be imposed under each payment option.

10. The minimum periodic payment required when the maximum annual percentage rate for each payment option is in effect for a \$10,000.00 outstanding balance and the earliest date that the maximum rate may be imposed.
11. An historical table, based on an \$10,000.00 extension of credit, illustrating how the annual percentage rate and the payments would have been affected by index value changes implemented according to the terms of the plan.
12. A statement that rate information will be provided on or with each periodic statement.

E. THE PRE-TRANSACTION DISCLOSURES.

1. Disclosures must be given to the consumer again at the "closing" or at sometime prior to the first transaction on the account. These disclosures are not governed by the new "segregation rule" but they must be in a form that the consumer may keep.
2. At this point, the creditor must provide all of the pre-application disclosures again along with the disclosures currently required for open-end credit, to the extent that they are not duplicative.
3. In addition, at this point the creditor must also disclose a list of conditions under which the creditor will be permitted to terminate the plan (those conditions, of course, are subject to the new limitations imposed by the Act). This requirement can

be met by providing a separate list or by identifying those provisions in the contract which contains such provisions.

F. DUTIES OF THIRD PARTIES.

1. A duty to provide the early disclosures is imposed on third parties who provide applications to a consumer. In addition to the disclosures, the third party must also deliver the brochure.
2. A third party would be required to provide disclosures only if that party has the disclosures for a creditor's particular plan in its possession. Third parties would not have an affirmative duty to obtain the disclosures or to create a set of disclosures based on the information which they possess about the program. On the other hand, if a creditor supplies those disclosures to the third party along with its application forms, then the third party has the duty to deliver them.
3. Third parties who distribute applications but have no disclosures must still give brochures to the consumer.
4. In all cases the creditor must mail or deliver the disclosures to the consumer within three days after the creditor receives the application.

G. LIMITATIONS ON CREDITORS RIGHTS AND NEW OBLIGATIONS.

These new provisions generally go well beyond provisions usually found in normal disclosure laws. Congress included in the Act rather severe limitations on certain rights which

some creditors previously enjoyed under state law, and in addition imposed an obligation to refund application and origination fees in some circumstances.

1. Some portions of the Act are couched in language referring to a creditor's actions, and other portions refer to limitations on what may be contained in the creditor's contract. Under the Board's proposal, these substantive limitations would apply to both actions that creditors may take and to provisions that may be set out in the contract. These limitations equally apply to assignees of the original creditor or any holders of the contracts.
2. Choice of index. If the annual percentage rate may change after the plan is opened, that change or the calculation of that change must be based on an index which is outside of the creditor's control and which is readily available to the public. This provision obviously prohibits a creditor from using its own prime rate as the index or simply retaining the right to change the rate at its discretion.
3. Terminating an account and/or accelerating payment of the outstanding balance prior to the scheduled expiration of the plan. The Act specifically prohibits the creditor from taking this type of action subject to three exceptions:

- a. The plan may be terminated if there has been fraud or material misrepresentation by the consumer in connection with the plan.
- b. A creditor may terminate the plan if the consumer has failed to meet the payment terms of the agreement. The failure to make payments must be actual failure as opposed to a simple error, like sending the payment to an erroneous address.
- c. The plan may be terminated if the consumer acts or fails to act in a way that adversely affects the creditor's security interest. For example, termination would be permitted if the consumer transfers title to the dwelling without permission of the creditor or if the consumer fails to maintain required insurance.

If any of these three conditions exists, a creditor may also be able to take action short of terminating an account or accelerating payment. These three events would likely constitute circumstances permitting a creditor to prohibit additional extensions or to reduce the credit limit. Finally, a creditor would not be permitted to specify other events in the contracts which would permit terminating an account or accelerating payment. For example, the contract may not provide that the account will be terminated and the balance accelerated if a judgment is obtained against a consumer by another creditor.

4. Change in Terms. Generally, a creditor may not unilaterally change the terms of the plan after the account is opened. There are several exceptions to this rule:

- a. Events provided for in the contract. The Board feels the legislative history makes it clear that the Act did not intend to prohibit a creditor from implementing specific changes that are contemplated by the parties upon the occurrence of a specific event. However, both the triggering event and the resulting modification must be set out with specificity. The Board proposes two limitations in this area. First, that the creditor would not be permitted to include "boiler plate" language reserving the right to make changes. Second, creditors would not be permitted to include any events which the Regulation expressly limits or restricts.
- b. Changes made by mutual written agreement. The proposed Regulation allows the terms of the plan to be changed if the consumer expressly agrees in writing to the change.
- c. Insignificant changes. Changes in insignificant terms would be allowed. This proposal is aimed at operational problems such as changing the address of the creditor for the purpose of sending payments.

- d. Substitution of index. The Regulation proposes that the creditor may change the index or margin if the original index becomes unavailable, so long as the new index and margin result in a rate similar to the rate in effect at the time the original index became unavailable.
 - e. Beneficial changes. Creditors would be permitted to make any changes that "unequivocally benefit" the consumer so long as that change is beneficial for the entire term of the agreement.
 - f. Changes due to default and other events. The creditor may prohibit additional extensions or reduce the credit limit in four circumstances: if the value of the dwelling declines significantly below the property's appraised value as used for the plan; if the creditor reasonably believes the consumer will be unable to fulfill the repayment obligations under the plan due to a material change in his financial circumstances; if the consumer is in default of any material obligation under the agreement; or because action by a governmental body precludes the creditor from imposing the agreed upon annual percentage rate.
5. Refund of fees. If a disclosed term (other than a variable interest rate) changes between the time the disclosures are provided to the consumer and the time the plan is opened and, as a result of the change, the

consumer elects not to enter into the plan, then the creditor must refund any fees paid in connection with the application, such as credit report fees and appraisal fees, whether paid directly to the creditor or to third parties. Finally, neither the creditor nor any other party may impose a nonrefundable fee in connection with an application until three business days after the disclosures and brochure have been provided to the consumer.

H. ADVERTISING RULES

1. The present advertising rules will be expanded. Any reference to a payment term in a home equity advertisement will "trigger" further disclosures, including loan fees, estimates of other fees and for variable rate plans the maximum rate that may be imposed under the plan.
2. If an advertisement states a payment amount, it must also state, if applicable, that the plan contains a balloon payment.
3. If any of the "triggering terms" are stated affirmatively or negatively, further disclosures must be given. For example, if the creditor states "no annual fees", then the additional disclosures must be included in the advertisement.
4. Creditors are prohibited from misleading advertising, particularly using such terms as "free money".

5. If an advertisement makes any statements regarding tax deductibility of the interest or charges, that advertisement must not be misleading about the deductibility. The Board suggests that such an advertisement should include a statement that the consumer should consult a tax advisor regarding the deductibility of those amounts.

EMPLOYMENT RELATIONS CONCERNS:
THEORIES OF EMPLOYMENT DISCRIMINATION
THAT MAY AFFECT HIRINGS, PROMOTIONS & TERMINATIONS

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SECTION D



THEORIES OF EMPLOYMENT DISCRIMINATION
THAT MAY AFFECT HIRINGS, PROMOTIONS & TERMINATIONS

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THEORIES OF EMPLOYMENT DISCRIMINATION
THAT MAY AFFECT HIRINGS, PROMOTIONS & TERMINATION

I. EMPLOYMENT DISCRIMINATION LAWS

A. State and Federal laws prohibit discrimination in terms and conditions of employment on the basis of race, sex, age, national origin, religion or handicap.

- Covers all employment decisions including compensation, hiring, firing, promotions, transfers, job assignments, discipline, benefits, etc.

B. Federal Statutes

1. Title VII of the Civil Rights Act of 1964, 42 U.S.C. Sec. 2000e et seq.

- a. Protects employees from discharge or discipline because of their race, color, sex, religion or national origin.

2. Civil Rights Act of 1866, 42 U.S.C. Sec. 1981.

- a. The statute gives non-white citizens the right to contract, sue, participate in legal proceedings and enjoy the full benefits of the law. Since employer and employee relationships have been found to be contractual in nature, this statute

has been found to apply to cover employment practices.

3. Civil Rights Act of 1871, 42 U.S.C. Sec. 1983/1985.
 - a. Protects employees from discriminatory employment actions when such actions amount to a deprivation of any right provided under federal law or the constitution, provided that the employer is acting under the color of state law. Covers race and sex discrimination by public employers.

4. Executive order No. 11246.
 - a. Prohibits discrimination in employment, including discharge, on the grounds of race, color, religion, sex and national origin. Covers government contractors and subcontractors holding a contract valued at \$10,000.00 or more per annum.

5. Equal Pay Act of 1964, as amended, 29 U.S.C. Sec. 225
 - a. Prohibits discrimination in compensation on the basis of sex where employees of the opposite sex perform equal work on jobs which require equal skill, effort, and responsibility which are performed under similar working conditions.

6. Age Discrimination in Employment Act of 1967, As Amended, 29 U.S.C. Sec. 621 et seq.

- a. Protects employees between the ages of forty and seventy from discrimination in terms and conditions of employment, including discharge on account of age. Applies to public and private sector employers with twenty or more workers for twenty weeks per year.

7. Rehabilitation Act of 1973, 29 U.S.C. Sec. 701 et seq.

- a. Protects employees from discrimination in terms and conditions of employment, including discharge because of handicapped status. Applies to Federal agencies, executive branch departments and private employers performing under a federal contract or subcontract exceeding \$2,500.00.

C. State Laws and Local Ordinances

1. Fair employment Laws:

- a. Approximately forty five states have their own statutes prohibiting discrimination in employment. In Kentucky, see KRS Chapter 344. As a general rule, these laws are patterned after Title VII, although many are more substantively expansive.

Some states, such as Kentucky, provide for a private right of action in state court. KRS 344.450.

- b. Many metropolitan areas, such as Louisville and Lexington, Kentucky, also have local ordinances prohibiting discrimination in employment.

II. DEFINING UNLAWFUL DISCRIMINATION

A. Disparate treatment

- Intent may be inferred from circumstantial evidence showing that the plaintiff was treated differently than similarly situated persons with other racial, religious, or gender characteristics. (McDonnell Douglas, infra at 411)
- Focus is on actions from which discrimination can be inferred.
- Must be consistent in disciplining employees to avoid disparate treatment claims.
- Court will also look for deviations from established Company policy or practice.

- Must be able to explain and distinguish any deviation from Company policy.

1. Establishing a Prima-Facie Case

The pivotal case addressing Title VII claims is McDonnell Douglas v. Green, 411 U.S. 792 (1973) which laid down a four part test to be utilized in establishing a prima facie discrimination case under Title VII.

- The complainant in a Title VII case carries the initial burden of establishing a prima facie case. A prima facie case may be established by utilizing the following test laid out in McDonnell Douglas.
 - a. Complainant belongs to a racial minority.
 - b. He applied for and was qualified for a job for which the employer was seeking applicants.
 - c. Despite his qualifications, he was rejected; and that,

- d. After his rejection, the position remained open and the employer continued to seek applicants from persons of complainants qualifications.

Note: The formula deals on its face only with refusal to hire. However, it has been held to apply, with appropriate modifications, to discriminatory practices in promotions and terminations.

For example: In Texas Dept. of Community Affairs v. Burdine, 450 U.S. 248 (1981) the court held that "an employer is not required to hire minority group or female applicants whenever that applicant's objective qualifications are equal to those of a white male applicant, but rather the employer has discretion to choose among equally qualified candidates so long as the decision is not based on unlawful criteria". Here, a female employee claimed that her employer's failure to promote, and subsequent decision to terminate her, had been predicated on gender discrimination in violation of Title VII.

B. Disparate Impact

- Unlawful discrimination can be found in a Company policy or practice which is neutral on its face, i.e. applied equally to all employees, but affects minority

or other protected employees at a greater rate (e.g. terminations because of arrest or conviction; requiring high school diploma)

- If minorities or other protected groups are disproportionately affected then policy must be job related and justified by business necessity.

For example, in Griggs v. Duke Power Co., 402 U.S. 424 (1971) the court held that "an employer violated Title VII by requiring a high school education or passing a standardized general intelligence test as a condition of employment in or transfer of jobs, where (1) neither requirement is shown to be significantly related to successful job performance, (2) both requirements operate to disqualify Negro applicants at substantially higher rate than white applicants, and (3) jobs in question formerly had been filled only by white employees as part of long-standing practice of giving preference to whites". The court determined that the company had openly discriminated against blacks due to the disparate impact of the educational and testing requirements of the company. See also, Connecticut v. Teal, 457 U.S. 440 (1982).

In Watson v. Ft. Worth Bank & Trust, ___ U.S. ___ 47, FEP Cases 103 (1988), the U.S. Supreme court was faced with

addressing the issue of whether or not an employer's policy of leaving promotion decisions to the unchecked discretion of lower-level supervisors raised an inference of discriminatory conduct. The court reasoned that "the necessary premise of the disparate impact approach is that some employment practices, adopted without deliberately discriminatory motives, may in operation be functionally equivalent to intentional discrimination". (Watson at 105).

- Of major significance in the Watson case is the determination that the disparate impact analysis is no less applicable to subjective employment criteria than to objective or standardized tests. This was the first case in which the court approved the use of disparate impact analysis in evaluating subjective selection practices.

C. Retaliation

- Title VII and the ADEA prohibit employers from retaliating in any way against an employee who has filed an EEO charge or had complained to management about alleged discrimination. See, 42 U.S.C. Sec. 2000e(a) (1982) and 29 U.S.C. Sec. 23(d).
- Complainant could win underlying charge and lose on retaliation claim.

- Must treat charging party the same as other employees.
- Can still discipline and/or discharge if necessary so long as consistent with company policy (such actions should be reviewed with your attorney).
- In Holsey v. Armour & Co, 683 F.2d 864, 1064 (1984) the court determined that an employee who was forced to terminate his employment with Armour & Co., due to the employer's adverse employment actions against the complainant, was a violation of Section 704(a) of Civil Rights Act of 1964. The record disclosed that the employer's adverse employment actions toward the employee were in retaliation for the employee's exercise of rights protected by the Act. In this case, the employee had filed charges with the EEOC alleging that the company's policies and practices were discriminatory in relation to its hiring, promotions and other terms of employment because of the employee's race. The district court found that "because of Holsey's race and his efforts to challenge Armour's racial practices, Armour denied him the opportunity to exercise his bumping privileges in the sausage department to avoid a layoff in the beef department". Armour at 1070; see also, Day v. Wayne County Board of Auditors 749 F.2d 1199 (1984).

D. Sexual Harassment

1. Two forms

a. Where the employee is threatened with or suffers a tangible job detriment in retaliation for refusing to accede to sexual demands ("quid pro quo" cases); and,

b. Where no tangible job loss occurs, but the harassment creates an offensive or abusive environment (hostile work environment).

- Sexual harassment includes unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature. Such activity is considered harassment when,

a. submission to such conduct is explicitly or implicitly a term or condition of employment;

b. submission to or rejection of such conduct is a basis for employment decisions affecting the employee; and,

- c. such conduct has the purpose or effect of unreasonably interfering with an individual's work performance or creating an intimidating, hostile, or offensive work environment. (EEOC Guidelines on discrimination based on sex, 29 CFR 1604.11)

2. Sexual Harassment As Prohibited Activity

In Meritor Savings Bank v. Vinson, 477 U.S. 57 (1986) the U.S. Supreme Court finally put to rest the question of whether sexual harassment is a prohibited activity under Title VII. The court stated that,

- a. Title VII forbids sexual harassment in the form of offensive or abusive work environment, since the law covers "terms and conditions of employment".
- b. In order for the offensive conduct to constitute sexual harassment, it must be sufficiently severe or pervasive to alter the conditions of the recipient's employment and create an abusive working environment.
- c. The crucial issue concerns whether the sexual advances are unwelcomed by the employee and not

whether the employee submitted to the sexual advances voluntarily.

- d. Evidence of the complainant's sexually provocative speech or dress may be relevant and admissible upon discretion of the trial court, in determining if the sexual advances were unwelcomed by the recipient.
- e. Employers are not automatically liable for sexual harassment by supervisors (issue to be addressed on a case by case basis utilizing agency principles). Moreover, failure of the complainant to notify the employer of the sexually harassing conduct does not necessarily insulate the employer from liability.
- f. Whether the company has an appropriate policy and procedure which encourages victims of harassment in coming forward with their complaints is highly relevant in determining employer liability.

3. Elements of "Hostile Work Environment and "Quid Pro Quo" Actions

- In Rabidue v. Osceola Refining Co., 805 F.2d 611 (Sixth Cir. 1986), the court set out the elements which must be proved in a hostile work environment and a quid pro quo case. The court stated that the complainant must prove;
 - a. they belong to a protected group;
 - b. the employee was subjected to unwelcome sexual harassment (that the Employee did not solicit or invite, and regarded the sexual advances as undesirable or offensive);
 - c. that but for the complainant's sex, they would not have been the object of the harassment;
 - d. the harassment affected a term, condition or privilege of employment, which altered the conditions of employment and created an abusive working environment;
 - e. the sexually harassing conduct of supervisors or to workers was known to the employer.

- The circumstances must be viewed from the perspective of a reasonable person's reaction to a similar environment under similar or like circumstances. In addition, the employee must be able to show that she was actually offended by the alleged harassment and suffered some degree of injury as a result of her exposure to the work environment. Highlander v. FCC National Management Company, 805 F.2d 644 (6th Cir. 1986).

- The elements for a "quid pro quo" case are the first three listed above under hostile work environment, and that,
 - a. the employee was deprived of a job benefit that the employee was otherwise qualified to receive based on the employer's utilization of prohibited criterion, or refusal of sexual favors, in making the employment decision.

4. Employer Liability

- The harassment does not have to involve physical assaults or even touching to warrant sanctions.

- An employer may be liable for sexual harassment where the Company was aware of or reasonably should have been aware of such harassment and failed to take action.

- Where the harasser is both an agent and supervisor, the employer is not likely to escape liability on the grounds that it had no knowledge of the conduct. In such cases, the court will impute the agent's knowledge to the employer. Yates v. Avco, 819 F.2d 630 (6th Cir. 1987).

- Harassment could stem from customers.

- a. Prevention
 - (1) Specifically include sexual harassment as a prohibited activity in the employer's written non-discrimination policy. Also provide for specific investigatory procedures to be followed when a complaint is raised.

 - (2) Conduct training programs for supervisors and management to advise them of the law, their responsibility, and the consequences to the

employer and the manager should sexual harassment occur.

- (3) Designate one member of management to receive complaints of sexual harassment. This should not be someone who by his or her position or conduct would discourage employees from coming forward with such complaints. Employees should not be required to take their sexual harassment complaints to their supervisors because the harasser may be the supervisor.
- (4) Establish a procedure for the handling of sexual harassment complaints which includes proper documentation and a thorough investigation. Avoid making the procedure unduly complicated and once it is established, be sure that it is followed in each case.
- (5) Take each complaint seriously. Advise the complainant that an immediate investigation will be conducted.

- (6) Avoid any retaliatory actions against the complainant.
- (7) In conducting an investigation and determining what action should be taken, be fair to both the complainant and the accused.
- (8) When credibility of the complainant and the accused becomes an issue, ask if there are any witnesses to substantiate the employee's charge. If there are no substantiating witnesses, look for other indicia which would support either party's version of what happened. This may require the investigator to talk with people who are familiar with both parties professional conduct.
- (9) If the investigation reveals that a supervisor or other employee is guilty of sexual harassment, appropriate action should be taken immediately, including disciplinary action against the harasser. Appropriate disciplinary action will depend upon the circumstances. Keep a written record of the discipline taken and why, and let the victimized employee know what has been done

to protect his or her rights and personal dignity.

(10) Be discreet in conducting the investigation and do not reveal the complaint or other information gathered during the investigation to anyone in the company who does not need to know.

- All complaints of racial and/or sexual harassment should be investigated thoroughly, expeditiously and seriously.

E. Racial Harassment

- Harassment does not have to involve physical assaults or even touching.
- Discipline has been upheld for the use or making of racial slurs shown or uttered to co-workers.
- Title VII's ban on race bias in terms and conditions of employment extends to psychological as well as economic impact of job. Butler v. Coral Volkswagen, Inc. 629 F.Supp 1034 (1986).

- For example, in Snell v. Suffolk County, 611 F.Supp 521 (1986), the court found that the County Corrections Department violated Title VII by permitting a racially hostile work environment. The facts established that demeaning literature and epithets were sufficiently continuous and pervasive to establish a concerted pattern of harassment against black and hispanic officers.

1. Employer Liability

- However, in Ellison v. C.P.C. International, Inc., Best Foods Div., 837 F.2d 355 (1984), the court ruled that the mere existence of sporadic or isolated racial slurs does not necessarily establish a Title VII violation, particularly where management personnel are not directly involved in making such slurs or in witnessing them. The employer was not liable for any racist atmosphere at its plant, since there was little evidence that management was directly involved in any racial jokes or that in any way condoned or tolerated such behavior.

- Racially derogatory language in workplace can be evidence of biased atmosphere, but isolated racial slurs do not necessarily constitute Title VII

violation. Powell v. Missouri State Highway
Transportation Dept., 822 F.2d 798 (1987)

F. Age Discrimination

- Employers are prohibited by the Age Discrimination in Employment Act from discriminating against workers who are 40 years of age or older.

1. Purpose of Act:

a. Promote employment of older persons based on ability rather than age;

b. Prohibit arbitrary age discrimination in employment.

2. Prohibited activities:

a. Failure or refusal to hire, to discharge or otherwise discriminate against any individual with respect to compensation, terms, conditions or privileges of employment because of such individuals age;

b. Operate a seniority system or employee benefit plan that requires or permits involuntary retirement.

- For example, in Metz v. Transit Mix, 646 F.Supp. 286 (1987), the court found that cost cutting is not a "legitimate, non-discriminatory reason" for discharging an older employee while retaining younger, lower paid employees who hold the same or similar positions with the company. If the employer had terminated other employees who were similarly situated and not members of the protected group, due to the need to reduce costs, then the employer prima facially would not have violated the ADEA. Here, the court recognized the employers need to control costs, but added that less burdensome measures should be adopted before resorting to "industrial capital punishment".

- However, in DeSoignies v. Credit Lyonnais, 617 F.Supp 707 (1985), the court found that the employer, a bank, had not acted in a discriminatory manner when it discharged an older female bank employee. The court noted that the employee had received several poor performance reviews and was discharged based on her

unsatisfactory work performance, and not because of her age.

3. Bona Fide Occupational Qualification Exception

- If an individual is denied employment rights or privileges due to his or her age, based on a bona fide occupational qualification for a particular job, it is not a violation of the ADEA (i.e. the position is physically demanding).

- For example, in EEOC v. Missouri State Highway Patrol, 742 F.2d 447, sub nom, Price V. Witmer, cert denied, 474 U.S. 828 (1985), the court held that the maximum hiring age of 32 for state highway patrolmen is a bona fide occupational qualification ("BFOQ"), where this maximum age insures that the patrol can take advantage of the physical skills and abilities of younger persons and also provide them with enough experience while still relatively young to compensate for their reduction in physical skills and abilities due to their aging. The court reasoned that by hiring patrolmen at a young age, they will gain enough experience to compensate for their decreasing physical abilities due

to aging. Therefore, the court held the age requirement to be a BFOQ.

G. Handicap Discrimination

- The Vocational Rehabilitation Act of 1973 prohibits discrimination against handicapped persons under any program or activity receiving Federal financial assistance and federal contractors.

1. Requirements of the Act

- a. Federal contractors must act affirmatively in employing handicapped workers.
- b. Handicapped persons not be excluded from participation in, or be denied benefits from, programs solely because of their handicap.
- c. The Act require employers to make reasonable accommodations for handicapped persons.

2. What Constitutes Protected Handicap

- The handicap must be one which substantially limits a life activity. See, Forisi v. Bowen, 749

F.2d 931 (1986), where an employee who suffered acrophobia, fear of heights, did not have a protected handicap even though his condition prevented him from performing his job as a utility systems repairer. The court found that his handicap did not substantially limit his life activities.

- A person afflicted with a contagious disease can be considered a handicapped person under the Act. (School Board of Nassau County v. Arline, 457 U.S. 1118 (1987) - a school teacher with recurring bouts of tuberculosis was found to be protected and was reinstated to her teaching position.)

Note: However, the Civil Rights Restoration Act of 1988, (Pub. Law 100-259 amending Title IX of the Education Amendments of 1972, The Rehabilitation Act of 1973, The Age Discrimination Act of 1975, and Title VII of the Civil Rights Act of 1964) exempts individuals with contagious diseases from protection if they would constitute a direct threat to the health or safety of others.

3. "Otherwise Qualified Person"

- If an individual is an otherwise qualified person who can perform the essential functions of the job, the employer must provide the individual with a job he is qualified for.

4. Reasonable Accommodation

- If the individual is not able to perform the essential functions of the position, the employer is obligated to reasonably accommodate the individual to enable him/her to perform those functions. (Accommodation is not reasonable when it imposes undue financial and administrative burdens on the employer. See, Arline, supra, at 81).
- Employer generally not required to find another job for an employee who is not qualified for the job he was doing. Rehabilitation Act does not contemplate reassignment as reasonable accommodation. See, Dancy v. Kline, 639 F.Supp. 1076 (1987).

For example, in Simon v. St. Louis County, Missouri, 735 F.2d 1082 (1984), a police department's forceful arrest and transfer requirements, which were the basis for the department refusing to reinstate a paraplegic former officer, were necessary to the essential functions of the job, and therefore, the refusal to hire the handicapped former officer was not a discriminatory action by the department.

H. Discrimination Based On Religious Beliefs or Practices

- Title VII, as amended in 1972, affords protection against discrimination in employment based on a person's sincerely held religious beliefs or practices.

1. Establishing A Prima Facie Case

- a. Employee holds a bona fide religious belief that conflicts with employee's job.
- b. Employee informed employer of the conflict and of the religious nature of his beliefs and activities. Turpin v. Missouri-Kansas-Texas R. Co., 736 F.2d 1022, 1026; See also, EEOC Guidelines Sec. 1605.2(c)(1).

2. Sincerely Held Beliefs

- Religious practices and observances include moral or ethical beliefs as to what is right and wrong which are sincerely held with the strength of traditional religious views. See, U.S. v. Seeger, 380 U.S. 163 (1965).

3. Reasonable Accommodation

- It is an unlawful employment practice for an employer to fail to reasonably accommodate the religious practices of an employee or applicant, unless the employer demonstrates that accommodation would result in undue hardship to the employer. Trans World Airlines, Inc. v. Hardison, 432 U.S. 63 (1977).
- Employer must reasonably accommodate the employee's sincerely held religious beliefs - no requirement that the company accept the employee's proposed accommodations. Ansonia Board of Education v. Philbrook, 479 U.S. 60 (1986).

- The employer is not required to do more than de minimus and requiring more than that is an "undue hardship". (See, Trans World, supra at 64).
- An employer is not required to force other employees to change shifts to provide work hours that would accommodate another employee. Everly v. MBank Dallas, 843 F.2d 172 (1988).

4. Unemployment Compensation

- An employee who quits a job due to the employer's failure to accommodate a sincerely held religious belief is entitled to unemployment compensation in Kentucky. Lincoln v. True, 408 F.Supp. 22 (D.C. Ky 1975).

I. Pregnancy Discrimination

- Discrimination based on pregnancy became an unlawful employment activity in 1978 when the Pregnancy Discrimination Act came into effect.

1. The Act requires

- a. Employers to treat pregnancy and childbirth the same as other causes of disability under fringe benefit plans and all other terms and conditions of employment.
- b. Prohibits terminating or refusing to hire or promote a woman because she is pregnant.
- c. Bars mandatory leaves for pregnant women arbitrarily set at a certain time in their pregnancy. The woman's ability or inability to perform a certain job function may not be determined by the employer, instead it is up to the woman's doctor to determine when she should be able to work or not work.
- d. Protects reinstatement rights of women on leave for pregnancy related reasons (including accrued retirement benefits and accumulated seniority). EEOC Guidelines-Discrimination Based on Sex, 29 CFR Sec. 1604, appendix.

2. Abortion Exception

An employer is not required to pay health insurance benefits for an abortion, unless the life of the mother would be endangered by carrying the fetus full term or where complications have arisen from a previous abortion. EEOC Guidelines-Discrimination Based on Sex, 29 CRR Sec 1604, appendix.

III. EMPLOYMENT AT WILL

- Traditional American Rule

An employee without a contract for a definite term can be discharged for good cause, no cause, or even a morally wrong cause. Production Oil Co. v Johnson, 313 S.W.2d 411 (1958).

- Kentucky adheres to the Employment at Will doctrine with only specific exceptions.

A. Public Policy Exception

- The Kentucky Supreme court has held that discharged at-will employees may maintain a civil action against their former employers, based on a public policy exception to the at-will doctrine, where;

1. the alleged reason for the discharge was either the employee's failure or refusal to violate the law in the course of employment; or
 2. the discharge was for the employee's exercise of a right conferred by a well established legislative enactment. Grzyb v. Evans, 700 S.W.2d 399 (1985).
- In Firestone Textile Co v. Meadows, 666 S.W.2d 730 (1983), the Kentucky Supreme Court ruled that "Kentucky continues to recognize the terminable at-will doctrine except where the employer's conduct violates constitutionally protected activity or public policy as established by legislative determination". The plaintiff had been injured at work and was discharged in retaliation for asserting his right to medical treatment and compensation under the Kentucky Worker's Compensation Act. The court determined that the employee had a right to bring a tort action against his former employer for wrongful discharge, since the employer's conduct violated public policy of Kentucky against having injured employees becoming public charges. According to the Kentucky Supreme Court, "although the Worker's Compensation Act does not

specifically prohibit an employer from discharging an employee for filing a claim, such a provision is implied. If it were otherwise, the beneficent purposes of the Act would often be effectively frustrated by merely threatening employees with discharge".

(Firestone, supra at 667)

B. Employment Contracts

- Vague, ambiguous, and general terms are usually too indefinite to take an employee out of an at-will status. Putnam v. Producers' Livestock Marketing Association, 75 S.W.2d 1075, 1076 (1934).

 - Offers of permanent or lifetime employment are not enough to create an employment contract. Clay v. Louisville & N.R. Co., 71 S.W.2d 617, 619 (1934); see also, Shah, infra at 491.
1. Creating an employment contract
 - Employers and employees may enter into a written agreement terminable only in accord with the express terms of the contract by clearly stating their intention to do so, even though there is no

other consideration than services to be performed, or promised, as expected by the employer, and performed by the employee. Where such an intention has been expressed, a definite term of employment has been created. Shah v. American Synthetic Rubber Corp., 655 S.W.2d 489 (1983).

- The duration of an employment contract must be determined by the circumstances of each case, depending on the understanding of the parties as ascertained by inference from their written or oral negotiations and agreements, the usage of business, the situation and objectives of the parties, the nature of the employment and all circumstances surrounding the transaction. Putnam v. Producer's Live Stock Marking Association, 75 S.W.2d 1075, 1076 (1934).

- Based on the above referenced cases, an employment contract may exist even in the absence of a formal document.

2. Oral assurances altering employee's at-will status

- In Hammond v. Heritage Communications, 756 S.W.2d 152 (Ky. Ct. App 1988), the court determined that

an at-will employee had the right to establish that her status was altered by oral assurances from her employer and that she was working thereafter under the terms of an oral contract for a specific period of time. The facts established that Shah's supervisor told her that she would not lose her job if her photograph appeared in "Playboy Magazine". When the photo was released, Shah was terminated.

- Thus, an employers failure to abide by his oral or written representation concerning terms and conditions of employment may result in a wrongful termination claim against the employer.

C. Handbook Cases

- A majority of states have taken the position that company manuals or handbooks constitute implied contracts to which an employer is legally bound to adhere.
- However, where the provisions in a manual or handbook are too indefinite, vague, or lacking in specific contractual terms, the manual will not establish

contractual rights or obligations on the parties.

(Nork, infra at 825)

- The mere declaration of the employer's general approach to specific employment situations will not create an employment contract. (Nork infra at 825)

- In Nork v. Fetter Printing Co, AND Scheurich v. Cross Motors AND Baker v. Wal-mart Stores, Inc., 738 S.W.2d 824 (1987), the Kentucky Court of Appeals looked at whether an employee handbook did, in fact, constitute a contract of employment in three separate cases which were consolidated on appeal.

- In Nork, an employee filed a wrongful discharge claim against Fetter Printing Company stating that the employee handbook issued by Fetter created a contract implied in fact. A section of the handbook prohibited the employer from terminating the employee in the manner he was terminated. The court held that the statements in the handbook were not tantamount to express a contractual agreement such that the employee's at-will position of employment was altered. The handbook contained the following disclaimer, "It is further agreed that this contract may be terminated at will by either the employer or employee. The court

held that disclaimers in such documents are effective, valid and binding.

- In Scheurich, the court again looked to the express language of the handbook which provided clearly that the handbook was not a contract of employment and that as such, employment was terminable at will by either the employee or the employer.
- In Baker, the court noted the absence of any specific "employment at will" language in the handbook but held that the statements contained therein clearly stated that continued employment depended on successful performance and needs of the company. In so finding, the court held that the language in the handbook did not constitute a contract.
- The dismissal of all three cases was affirmed. In its holding, the Court of Appeals looked to the earlier Shah case which essentially held that in order for the contract of employment to exist between an employer and an employee, there had to be clear evidence of intent on the part of both parties to create a contract.
- From the Nork decision it appears that handbooks and policy manuals may constitute binding contracts between

employers and employees if it is demonstrated that a contractual relationship was the clear intention of the participants. However, also apparent from the Nork decision, to avoid possibly being subject to the provisions of these types of documents, an employer should include a clear disclaimer of any contractual agreement between the parties.

IV. POTENTIAL LIABILITY TO COMPANY FOR UNLAWFUL DISCRIMINATION

- Backpay and lost benefits.
- Attorneys fees.
- Compensatory and punitive damages, humiliation damages.

V. PREVENTING AND STAYING AHEAD OF EEO COMPLAINTS AND UNJUST DISCHARGE CLAIMS.

A. Designate someone to oversee discharge and disciplinary actions.

- Someone has to take responsibility for assuring that Company policies and procedures are adhered to.
- More input and authority should be given to the personnel manager or other individual in charge of employee relations.

1. Managers and supervisors must be given training in how to handle personnel decisions
 - Employment action is frequently taken by manager with little or no knowledge of the EEO laws or little appreciation for the overall ramifications of his or her decision.
 - Frequently managers and supervisors are not even familiar with company policies and procedures.
 - The education of supervisors with respect to company personnel policies and procedures and the various types of discrimination can go a long way toward preventing a successful EEO charge.
 - Supervisors should be warned that internal memoranda can make or break a case.
 - Managers and supervisors should be sensitized to the fact that any references to age, sex, race, religion, etc., in connection with an employment decision, including those made in offhand comments or informal communications, can provide basis for a complaint - (e.g. old fashioned, new blood, etc.)

B. Company policies and procedures should be reviewed and updated periodically

- In light of the developing trend in some jurisdictions of finding employee handbooks, etc. as part of the employment contract, it is essential that employers periodically review their policies and procedures to assure that Company is in compliance with EEO laws.
- Work rules and company policies should be job related and should not penalize employees unfairly.
- Policies and procedures should include an equal employment opportunity policy and should be widely and frequently disseminated.

C. Treat Employee Fairly and Consistently

- Consistent and uniform treatment is the key.
- Compliance by supervisory personnel should be monitored.
- Even when an employee is unhappy with a management decision, if the employee is convinced that he was

treated consistent with other employees and that an effort was made by management to consider his side fairly and to promptly report back to him, he is more apt to accept management's decision than if management simply refused to listen or failed to follow through with the employee.

- Be candid in dealing with problem employees and poor performers.
- One of the biggest problems is the difficulty some managers have in telling someone face to face why he is unhappy with the employee or why the employee is being disciplined, denied a promotion, etc.
- Managers should be direct with employees, without using makeshift excuses, yet diplomatic and positive to the extent possible

D. Establishment of an effective employee performance appraisal system

- Many employment discrimination and unjust discharge claims arise as a result of the lack of an effective system for appraising employee performance.

- Because of a desire to avoid upsetting an employee or to not interfere with friendship or an employee's advancement, supervisors frequently fail to bring job performance problems to the attention of the employee or the company.

- 1. The performance appraisal system can more readily be defended in court if it meets the following characteristics:
 - a. Individuals responsible for evaluating employees are given specific instructions on how to complete the appraisals;
 - b. the appraisal system should be behavior oriented rather than training oriented;
 - c. job analysis was used to develop the content of the appraisal system;
 - d. employee's performance is evaluated by more than one supervisor;
 - e. the appraisals are not totally subjective;

f. the results of the appraisals are reviewed with each employee.

- Where the discharge was based on poor performance, employers always stand a better chance of prevailing in an unlawful discharge claim if the employer can demonstrate that the employee was given notice of his performance problems and an opportunity to improve.

E. Other preventive measures

- Eliminate any reference to just cause, permanent employment, etc., from company policy statement or employee handbooks.
- Qualify statements contained in personnel manuals with explicit disclaimers and expressions regarding management's rights to abandon or change policies and procedures.
- Require employees to sign a contract or statement, either on application or at time of hiring, acknowledging that employment is at-will and that the employee can be fired at any time for any reason.

- Caution: These actions may create employee morale problems and make it difficult to recruit new employees; could lead to union organizational effort; may not absolve the employer of liability where an oral representation was made to the contrary or the employer breached the covenant of good faith and fair dealing. See, Schipani v. Ford Motor Co., 102 Mich.App. 606, 302 N.W.2d 307 (1981); National Cash Register Co., 364 N.E.2d 1251 (Mass. 1977).

1. The following are some POSITIVE actions that can be taken which not only lessen the risk of a wrongful or discriminatory discharge, but should also improve employee morale:
 - a. Follow the guidelines referenced above.
 - b. Review the company's recruiting and hiring process. Caution recruiters to avoid making statements in the recruiting process that could be later used to imply contractual obligations on the part of the employer. A checklist should be provided to all interviewers to insure that accurate information is consistently provided to all potential employees.

- c. Employees should be given prior warning, preferably in writing, when their work performance, attendance record, etc. is below acceptable standards or is in any way jeopardizing their continued employment. A failure to adequately communicate such problems to employees has always been costly in terms of employee relations and effective management. Now, such failure creates potential exposure in employment termination litigation. See, Chamberlain v. Bissell, Inc., 547 F.Supp. 1067 (W.D.Mich. 1982) (employer liable for negligent failure to apprise employee of substandard performance).

- d. Once a decision has been made to terminate an employee, the employee's personnel file should be fully documented showing the basis or specific grounds for the decision and any progressive discipline given.

- e. When communicating the decision to the employee, be sure to give the true reason for the termination even if it is unpleasant at the time. The termination, of course, should be based on legitimate, non-discriminatory business reasons.

Caution: Don't say too much, state only what is necessary to explain the reasons for the termination. Employers frequently get into trouble by saying too much or giving a different reason in an attempt to soften the blow. For an example of a case in which too much was said see Fernandez v. Wynn Oil Co., 20 EPD 30, 237 (D.C.Cal. 1979). A highly-qualified male was promoted to director of international sales over, among others, a far less qualified female. In notifying the female of its decision, the company listed among the many reasons for its decision, the belief that its customers in Latin America and the Far East would find it culturally difficult to deal with a woman. As a result of this statement, the employee brought a sex discrimination suit and the company suffered through long and expensive litigation. Litigation may have been avoided if the employer had simply stated that the male was more qualified. Similarly, when a false reason is given for the termination (E.G., the employee is told he is being laid off due to lack of work when, in fact, he is being terminated for poor performance), any efforts by the employer to explain the true reason during litigation always appears to be pretextual or a subterfuge for discrimination.

f. The courts usually look favorably upon discharge procedures which require several levels of approval. This can help to avoid arbitrary terminations. The personnel director should obtain the employee's explanation of the events leading to the dismissal. This may alert the employer to the possibility of potential litigation and provide an opportunity for remedial action if it appears appropriate.

The company may want to consider establishing some type of internal grievance or dispute resolution procedure. This would give employees who feel they have been wrongfully or unfairly terminated an opportunity to have the decision reviewed by someone outside their supervisory chain of command. An internal grievance or review procedure would also go a long way toward convincing a judge or jury that the employee was given fair treatment.

g. The employer may want to consider granting severance pay or some other type of benefit, which the employee is not otherwise entitled to, in return for a full release of all claims from the employee. Voluntary releases supported by valid consideration have been found binding in

employment discrimination cases. See, Cox v. Allied Chemical Corp., 538 F.2d 1094 (5th Cir. 1976). Any release should be prepared or approved by legal counsel.

h. Warn supervisors and the personnel department of the possibility of defamation claims based on derogatory statements made about the employee to others in the company or as part of an employment reference. The qualified business privilege is limited only to those in the company who need to know and statements made without malice.

- Just about any action which adversely affects an employee can give rise to a claim of unfair or unjust treatment, "abusive discharge", or the filing of an employment discrimination claim. A consistent, set termination process may cost the company very little, but may save a lot of time and money by avoiding litigation. Managers and supervisors should be trained to insure a fair organizational climate. Undertaking certain relatively inexpensive steps now may also avoid having perhaps more onerous burdens imposed upon employers by state or federal legislators.

VI. WHAT TO DO WHEN THE INEVITABLE EEO COMPLAINT IS FILED.

- Following all the proper procedures will not necessarily prevent an EEO charge or unjust discharge claim, but will minimize the risk of a violation being found.
- Strongly recommend use of counsel who should be called immediately upon receipt of the charge.
- If it is to be handled in house, designate one person as the company's official contact with the investigating agency.
- Interview all supervisory and management personnel with knowledge of the incidents alleged in the complaint - develop all facts and circumstances as quickly as possible.
- Use great caution in interviewing non-supervisory employees and/or complaining party - potential retaliation claim.
- Evaluate the strengths and weaknesses of the company's position.
- If your case is very weak, consider a pre-determination settlement - always obtain separate release (drafted by your attorney).

- There are advantages to pre-determination settlement as compared to conciliation.
- Any offer of reinstatement should be documented for purposes of mitigating backpay.
- If the company desires to fight the case, a written statement of position should be submitted in response to the complaint.
- If employee who has been discharged also files for unemployment, it is important for the company to take a consistent position regarding lack of discrimination while proceeding before the Commission. Important to attend unemployment hearing and establish a good record of testimony; this an opportunity to have free discovery of what the former employee is claiming.



EMPLOYMENT RELATIONS CONCERNS:

EMPLOYEE DEFALCATION, DISHONESTY AND TESTING

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SECTION E



EMPLOYMENT RELATIONS CONCERNS:

EMPLOYEE DEFALCATION, DISHONESTY AND TESTING

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Exhibit A	Criminal Referral Form (Short Form), Office of the Comptroller of the Currency	E- 6
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I. INTRODUCTION:

- A. FDIC estimates that in a recent two-year period, 33% of all bank failures were due to internal fraud.
- B. More than 250 S & L's failed in 1988, a 500+% increase over 1987.
- C. The General Accounting Office looked at 26 randomly selected failed S & L's and found internal fraud in every one.
- D. Staff of the House Government Operations Committee has called the current S & L situation an "epidemic of fraud."
- E. Robert Clarke, Comptroller of the Currency, found that less than 10% of all bank failures under his jurisdiction came solely from economic pressures.

II. REPORTING RESPONSIBILITIES:

A. National Banks (reports to the Comptroller of the Currency)

- 1. Must report known or suspected criminal activity on the part of an employee, officer, director or agent, regardless of the amount.
- 2. Must report mysterious disappearances or unexplained shortages where there are no suspects and the amount is \$5,000 or more.
- 3. Optional - may report unexplained shortages less than \$5,000.

(See Exhibits A & B, Criminal Referral Short Form and Criminal Referral Long Form)

B. Insured State Banks (reports to the FDIC)

- 1. Must report known or suspected criminal activity on the part of an employee, officer, director or agent, regardless of the amount.
- 2. Must report mysterious disappearances or unexplained shortages where there are no suspects and the amount is \$2,500 or more.
- 3. Optional - may report unexplained shortages of less than \$2,500.

(See Exhibits C & D, Report of Apparent Crime Short Form and Report of Apparent Crime Long Form)

C. Insured S & L's (reports to the Federal Home Loan Bank Board)

1. Must report known or suspected criminal activity on the part of an employee, officer, director or agent, regardless of the amount.
2. Must report mysterious disappearances or unexplained shortages where there are no suspects and the amount is \$5,000 or more.
3. Optional - may report unexplained shortages less than \$5,000.

(See Exhibit E, Federal Home Loan Bank Board, Criminal Referral Form)

D. Any of the above Criminal Referral Forms must also be submitted to:

1. The nearest FBI Office
2. The nearest office of the U.S. Attorney
3. IRS Criminal Investigations Division, if the alleged activity involves the Currency Transactions Bank Secrecy Act (and no employee is involved).
4. The nearest office of Secret Service, if the alleged activity involves credit card fraud or computer fraud (and no employee is involved).
5. May also send a copy of the referral form to the nearest state prosecuting attorney.

III. PRINCIPAL FEDERAL AND STATE LAWS RELATING TO EMPLOYEE THEFT AND INSIDER FRAUD:

A. Federal Statutes

1. Title 18, U.S. Code, Section 656 & 657

Whoever, being an officer, director, agent or employee of . . . any member bank, national bank or insured bank . . . who embezzles, abstracts, purloins or willfully misapplies any of the moneys, funds or credits of such bank . . . shall be fined not more than \$5,000 or imprisoned not more than five years or both . . .

2. Title 18, U.S. Code, Section 1005 & 1006

Whoever, being an officer, director, agent or employee . . . makes any false entry in any book, report or statement . . . with intent to injure or defraud such bank . . . a corporation or any individual person . . . or to deceive any officer of such bank . . . shall be fined not more than \$5,000 or imprisoned not more than five years or both.

(Section 1006 refers to credit unions and S & L's and calls for a penalty of up to a \$10,000 fine or up to five years in jail or both).

3. Title 18, U.S. Code, Section 215

Whoever . . . as an officer, director, employee, agent or attorney of a financial institution, corruptly solicits or demands for the benefit of any person, or corruptly accepts or agrees to accept anything of value from any person, intending to be influenced or rewarded in connection with any business or transaction of such institution shall be fined not more than \$5,000 . . . or imprisoned not more than five years or both.

B. State Statutes

1. KRS 514.040

A person is guilty of theft by deception when he obtains property or services of another by deception with intent to deprive him thereof.

2. KRS 514.030

A person is guilty of theft by unlawful taking or disposition when he unlawfully takes or exercises control over movable property with intent to deprive him thereof.

3. KRS 514.070

A person is guilty of theft by failure to make required disposition of property received when he obtains property by agreement or subject to a known legal obligation to make specified payment or other disposition . . . and he intentionally deals with the property as his own and fails to make the required payment or disposition . . . as officer or employee . . . of a financial institution is presumed . . . to have dealt with the property as his own when he fails to account or pay upon lawful demand or an audit reveals a shortage or falsification of accounts.

IV. POTENTIAL PROBLEMS FOR FAILURE TO REPORT KNOWN OR SUSPECTED CRIMINAL ACTIVITY:

- A. Sanctions and possible money penalties from the regulatory agency.
- B. Possible criminal prosecution as an Accessory After the Fact or Misprision of a Felony.

1. Title 18, U.S. Code, Section 3

Whoever, knowing that an offense against the United States has been committed . . . comforts and assists the offender in order to hinder or prevent his apprehension, trial or punishment, is an accessory after the fact.

2. Title 18, U.S. Code, Section 4

Whoever, having knowledge of the actual commission of a felony . . . conceals and does not as soon as possible make known the same to some judge or . . . civil authority . . . shall be fined not more than \$500 or imprisoned not more than three years or both.

V. EMPLOYEE POLYGRAPH PROTECTION ACT OF 1988

A. Prohibits any employer engaged in interstate commerce from:

- Requiring, requesting, suggesting or causing any employee or prospective employee to take a polygraph test;
- using or inquiring about the results of a polygraph test on an employee or prospective employee;
- discharging, disciplining or discriminating against any employee or prospective employee who refuses to take a polygraph test or as a result of a polygraph test.

B. Exemptions

1. Government Employers - the Act does not apply to the U.S. Government, any state or local government or any political subdivision of any state or local government.
2. National Defense & Security - the Act does not apply to consultants and contractors involved with the Federal Government in counter-intelligence activities, atomic energy defense activities or who has access to classified information.
3. Applicant testing is allowed for Security Services which provide armored car personnel, personnel engaged in design, installation and maintenance of security alarm systems, or uniformed or plainclothes security personnel, but only if they are assigned to the protection of electric or nuclear power facilities, public water supply facilities, shipments of radioactive or other toxic waste materials or currency, negotiable securities, precious commodities or instruments or proprietary information.
4. Applicant testing is allowed for Drug Companies where the employee will have direct access to the manufacture, storage, distribution or sale of a controlled substance.
5. Ongoing Investigations - In the case of economic loss or injury due to theft, embezzlement, misappropriation or an act of industrial espionage or sabotage, an employee can be requested to take a polygraph exam under the following conditions:
 - a) The employee had access to the property that is the subject of the investigation;
 - b) The employer has reasonable suspicion that the employee is involved;
 - c) The employee is furnished a written statement at least 48 hours prior to the test citing the specific loss under investigation, that the employee had access and the reasonable suspicion developed which indicates that that employee is involved. This statement must be signed by a company official (other than the polygraph examiner) and retained for at least three years.



Control No. (Agency Use Only)
**CRIMINAL REFERRAL FORM
 (SHORT FORM)**

Comptroller of the Currency
 Administrator of National Banks

A National Bank is required by 12 C.F.R. §21.11 to report on the applicable long or short OCC Criminal Referral Form, within 30-calendar days following the detection of a loss or suspected violation, all known or suspected crimes and/or losses involving financial transactions at the bank.

Required Reporting

- any known or suspected theft, embezzlement, check kiting operation, misapplication, or other financial crime involving any dollar amount where a bank employee, officer, director, or agent is suspected.
- any known or suspected criminal activity, or pattern of criminal activities, involving or aggregating \$1,000 or more, where the bank has a substantial basis for identifying a possible suspect or group of suspects.
- any known or suspected criminal activity, mysterious disappearance, or unexplained shortage, involving or aggregating \$5,000 or more, where the bank has no substantial basis for identifying a possible suspect or group of suspects.
- any known or suspected criminal activity involving a financial transaction which uses the bank as a conduit for such criminal activity (such as structuring transactions to evade Bank Secrecy Act reporting requirements or laundering monetary instruments).

Optional Reporting

- any known or suspected criminal activity involving or aggregating less than \$1,000, where the bank has a substantial basis for identifying a possible suspect or group of suspects.
- any known or suspected criminal activity involving or aggregating less than \$5,000, where the bank has no substantial basis for identifying a possible suspect or group of suspects.

Forms to be Used

File this *Short Form* within 30-calendar days of detection of:

- known or suspected criminal activity involving \$0 to \$10,000 where a bank employee or agent is suspected.
- known or suspected criminal activity involving financial transactions at the bank where a suspect or group of suspects has been identified and the criminal activity involves or aggregates between \$1,000 and \$10,000.
- known or suspected criminal activity involving financial transactions at the bank of between \$5,000 and \$10,000 (before reimbursement or recovery), where a suspect has not been identified.
- mysterious disappearances or unexplained shortages of between \$5,000 and \$10,000.

The *Long Form* is to be filed in each case, regardless of amount, involving an executive officer, director or principal shareholder of the institution as those terms are defined by 12 C.F.R. §215.2 and in each case where the mysterious disappearance, unexplained shortage or suspected criminal activity exceeds \$10,000.

Other Reports

Report robberies and burglaries directly to the appropriate law enforcement agencies. See 12 C.F.R. §21.5(c). Report information concerning lost, missing, counterfeit or stolen securities to the SEC's designee, the Securities Information Center, pursuant to the requirements of 17 C.F.R. §240.171-1. In those two situations, a Criminal Referral Form is not required.

Purpose of Forms

The purpose of this form is to provide a consistent means by which financial institutions make referrals of known or suspected criminal activity perpetrated against or taking advantage of the institutions either by insiders or by those outside the institution. The form provides an effective means to notify appropriate law enforcement and supervisory authorities of both losses and criminal activity involving the affairs of the bank. Institutions should use care in completing this form and should insure that it is filled out in as complete a manner as is practicable under the circumstances.

**Paperwork Reduction Act and Privacy Act Notices
 Criminal Referral Form**

The Paperwork Reduction Act of 1980 says we must tell you why we are collecting this information, how we will use it, and whether you have to give it to us. We ask for this information to carry out our supervisory responsibilities for national banks. We need it to monitor crimes involving national banks, to evaluate losses and evaluate a bank's internal controls. You are required by 12 C.F.R. §21.11 to give us this information. In addition, the information in this referral may be subject to the applicable provisions of the Privacy Act of 1974, 5 U.S.C. §552a and 31 C.F.R. §1.20 et seq. of the Department of Treasury's Rules and Regulations.

1. Name, Location and Charter Number of Financial Institution

NAME _____
LOCATION _____
STREET CITY ST ZIP
CHARTER NUMBER _____ If transaction occurred at branch office(s), please identify _____

2. Asset Size of Financial Institution _____

3. Approximate date and dollar amount of transaction

DATE _____ AMOUNT _____
Month Day Year

4. Summary characterization of the transaction. Check appropriate box(es)

- Defalcation/Embezzlement Bribery/Gratuity Check Fraud
- False Statement Misuse of Position or Self Dealing Credit Card Fraud
- Check Kiting Mysterious Disappearance Money Laundering
- Other (Describe) _____

Applicable Section(s) of the U.S. Code (if known). (See list on page 5) _____

5. This matter is being referred to the FBI/Secret Service/IRS (circle one or more) in _____ CITY ST
and the U.S. Attorney in _____ CITY ST JUDICIAL DISTRICT (if known)

5. Person(s) suspected of criminal activity (if more than one, use continuation sheet)

a. NAME _____ FIRST MI LAST
ADDRESS _____ STREET CITY ST ZIP
DATE OF BIRTH _____ SOCIAL SECURITY NO. _____
(if known) Month Day Year (if known)

b. Relationship to the financial institution (check all applicable blocks)
 Officer Employee Broker Shareholder Account Holder
 Director Agent Borrower Other, Specify _____

c. Is person still affiliated with the financial institution Yes No
If no, terminated resigned. DATE _____
Month Day Year
Describe Circumstances (if necessary, use continuation sheet) _____

d. Prior or related referrals Yes No. (If yes, please identify.) _____

e. Is person affiliated with any other financial institution Yes No or business enterprise Yes No. (If yes to either or both, please identify.) _____

7. Explanation/Description of transaction. Give brief summary of the transaction explaining what is unusual or irregular about it. List all applicable account numbers. (If necessary, use continuation sheet.)

8. Has suspected individual(s) made any admissions? Yes No If so, by whom? _____

9. Offer of Assistance

The individuals listed below are authorized to discuss this referral with appropriate law enforcement officials and to assist in locating or explaining any documents pertinent to this referral, **provided that contact is first made with**

Name _____ Position _____
Phone No. _____

Name _____ Tele. No. _____

Name _____ Tele. No. _____

Name _____ Tele. No. _____

10. Form Prepared by _____

Position _____

Agency/Instution _____

Phone No. _____ Date _____

DISTRIBUTION INFORMATION

BANK REFERRALS

1. Retain one copy in the bank's files.
2. Send one copy to appropriate OCC District Office, Attn: District Counsel.
3. Send one copy to the nearest Office of the Federal Bureau of Investigation.
4. Send one copy to the nearest Office of the U.S. Attorney.
5. In cases involving the unauthorized use of a credit card or credit card number (18 U.S.C. §1029) or computer fraud (18 U.S.C. §1030), perpetrated without any apparent complicity of a bank employee or officer, in lieu of sending a copy to the F.B.I., send one copy to the nearest Office of the U.S. Secret Service.
6. In cases involving known or suspected violations of the bank secrecy laws (31 U.S.C. §§5311 and 5324), send one copy to the nearest office of the Internal Revenue Service—Criminal Investigation Division, and one copy to the Office of Financial Enforcement, Treasury Department, 1500 Pennsylvania Avenue, Washington, D.C. 20220.
7. In cases involving a suspected violation of state criminal law, consider sending one copy to the appropriate state or local prosecuting authority.

OCC EXAMINER REFERRALS

Examiner

1. Retain one copy in work papers.
2. Where appropriate, provide one copy to bank for its criminal referral file.
3. Send one copy to bank's Supervising Office.
4. Send one copy to District Office, Attn: District Counsel, with recommendation for referral.

District Counsel

5. Send one copy to the nearest Office of the Federal Bureau of Investigation.
6. Send one copy to the nearest Office of the U.S. Attorney.
7. In cases involving the unauthorized use of a credit card or credit card number (18 U.S.C. §1029) or computer fraud (18 U.S.C. §1030), perpetrated without any apparent complicity of a bank employee or officer, in lieu of sending a copy to the F.B.I., send one copy to the nearest Office of the U.S. Secret Service.
8. In cases involving known or suspected violations of the bank secrecy laws (31 U.S.C. §§5311 and 5324), send one copy to the nearest office of the Internal Revenue Service—Criminal Investigation Division, and one copy to the Office of Financial Enforcement, Treasury Department, 1500 Pennsylvania Avenue, Washington, D.C. 20220.
9. In cases involving a suspected violation of state criminal law, consider sending one copy to the appropriate state or local prosecuting authority.

CONTINUATION SHEET

Item No.	Remarks

CRIMINAL STATUTES

- 18 U.S.C. 2 To "aid, abet, counsel, command, induce or procure" the commission of a federal offense.
- 18 U.S.C. 201 Bribery of public officials, including elected representatives, jurors and employees of any department or agency of the federal government and witnesses in official proceedings, e.g., anyone who gives, offers or promises anything of value to a public official or a witness with the intent to influence that person's official functions.
- 18 U.S.C. 215 Kickbacks, bribes. Makes it unlawful for any officer, director, employee, agent or attorney to corruptly solicit, offer, accept or receive anything of value with the intent to influence, be influenced, or be rewarded in connection with any transaction or business of any financial institution.
- 18 U.S.C. 371 Conspiracy of two or more persons to either commit a federal offense or to defraud the United States (or any agency of the U.S.)
- 18 U.S.C. 656 Theft, embezzlement or misapplication of bank funds, willfully, by an officer, director, agent or employee of a bank, with intent to injure or defraud the bank. Can infer intent to injure from the fact of injury or from acts knowingly done in reckless disregard for the interests of the bank.
- 18 U.S.C. 709 False advertising or misuse of words "National," "Federal Reserve," "Deposit Insurance," etc., to convey impression of federal agency affiliation.
- 18 U.S.C. 1001 General false statements statute—knowingly and willfully falsifying or concealing a material fact or making a false statement or making or using false writing knowing it to be false.
- 18 U.S.C. 1005 False entries and reports or statements, including material omissions, with intent to injure or defraud the bank..the OCC (or Fed or FDIC), bank examiners or other individuals or companies.
- 18 U.S.C. 1014 False statements (oral or written) e.g., loan application, made knowingly for the purpose of influencing any bank whose deposits are federally insured, upon any application, purchase agreement, commitment, loan (or any change or extension of same) including willfully over-valuing land, property or security.
- 18 U.S.C. 1029 Credit Card fraud—knowingly and with intent to defraud, produce, use or traffic in counterfeit access devices.
- 18 U.S.C. 1030 Computer fraud—knowingly accessing a computer without authorization, or using it for unauthorized purposes, including obtaining information contained in records of financial institutions.
- 18 U.S.C. 1341 Mail fraud—scheme or artifice to defraud that makes use of the Postal Service.
- 18 U.S.C. 1343 Wire fraud—scheme or artifice to defraud using transmission by wire, radio or TV for the purpose of carrying out the scheme.
- 18 U.S.C. 1344 Bank fraud—scheme or artifice to defraud a federally insured institution or take money, funds, credits, assets, securities or other property by misrepresentation.
- 18 U.S.C. 1621 Perjury/false statement made under oath (if false statement is not made under oath, individual may still be prosecuted under 18 U.S.C. 1001 or 1014).
- 18 U.S.C. 1951 Racketeer Influenced and Corrupt Organizations ("RICO") statutes. Investing in any enterprise affecting interstate commerce if the funds for the investment are derived from "a pattern of racketeering activity" (these activities are defined to include: murder, drug dealing, bribery, robbery, extortion, counterfeiting, mail fraud, wire fraud, embezzlement from pension funds, obstruction of criminal investigations, fraud in the sale of securities, etc.).
- 18 U.S.C. 1958 Laundering of monetary instruments. Includes knowing conduct designed to avoid Federal or State transaction reporting requirements.
- 18 U.S.C. 1957 Engaging in monetary transactions in property known to have been derived from specified unlawful activity. Includes knowing engagement in monetary transactions (including deposits, withdrawals, transfers, or exchanges), by, through, or to a financial institution.
- 31 U.S.C. 5311 Bank Secrecy Act/31 C.F.R. 103 reporting and recordkeeping violations.
- 31 C.F.R. 103
- 31 C.F.R. 5234 Structuring a financial transaction to evade transaction reporting requirements.
- 15 U.S.C. 78dd-2 Foreign Corrupt Practices Act of 1977. Payment of anything of value to any foreign official, foreign political party or candidate or "any other person where the American corporation knows or has reason to know the thing of value would be offered to a foreign official, foreign political party or candidate for foreign political office."
- 15 U.S.C. 78ff Criminal penalty provisions of securities laws.

OCC DISTRICT OFFICES

Northeastern District
1211 Avenue of the Americas
Suite 4250
New York, NY 10036
212-944-3495

Southeastern District
Marquis One Tower
Suite 600
245 Peachtree Center Avenue, N.E.
Atlanta, GA 30303
404-659-8855

Central District
One Financial Place
Suite 2700
440 South LaSalle Street
Chicago, IL 60605
312-663-8000

Midwestern District
2345 Grand Avenue
Suite 700
Kansas City, MO 64108
816-556-1800

Southwestern District
1600 Lincoln Plaza
500 North Akard
Dallas, TX 75201-3394
214-720-0656

Western District
50 Fremont Street
Suite 3900
San Francisco, CA 94105
415-545-5900

**CRIMINAL REFERRAL FORM
(LONG FORM)**

Comptroller of the Currency
Administrator of National Banks

A National Bank is required by 12 C.F.R. §21.11 to report on the applicable long or short OCC Criminal Referral Form, within 30-calendar days following the detection of a loss or suspected violation, all known or suspected crimes and losses involving financial transactions at the bank.

Required Reporting

- any known or suspected theft, embezzlement, check kiting operation, misapplication, or other financial crime involving any amount where a bank employee, officer, director, or agent is suspected.
- any known or suspected criminal activity, or pattern of criminal activities, involving or aggregating \$1,000 or more, where the bank has a substantial basis for identifying a possible suspect or group of suspects.
- any known or suspected criminal activity, mysterious disappearance, or unexplained shortage, involving or aggregating \$5,000 or more where the bank has no substantial basis for identifying a possible suspect or group of suspects.
- any known or suspected criminal activity involving a financial transaction which uses the bank as a conduit for such criminal activity (such as structuring transactions to evade Bank Secrecy Act reporting requirements or laundering monetary instruments).

Optional Reporting

- any known or suspected criminal activity involving or aggregating less than \$1,000, where the bank has a substantial basis for identifying a possible suspect or group of suspects.
- any known or suspected criminal activity involving or aggregating less than \$5,000, where the bank has no substantial basis for identifying a possible suspect or group of suspects.

Forms to be Used

File this *Long Form* within 30-calendar days of detection of:

- a mysterious disappearance or unexplained shortage exceeding \$10,000 or where known or suspected criminal activity which involves the affairs of the bank exceeds \$10,000 (before reimbursement or recovery).
- each case, regardless of amount, involving an executive officer, director or principal shareholder of the institution as those terms are defined by 12 C.F.R. §215.2.

The *Short Form* is to be filed in all other reportable situations involving \$10,000 or less—including those situations where crimes such as bank bribery or the structuring of financial transactions to evade currency reporting requirements are suspected but no loss to the bank is involved.

Other Reports

Report robberies and burglaries directly to the appropriate law enforcement agencies. See 12 C.F.R. §21.5(c). Report information concerning lost, missing, counterfeit or stolen securities to the SEC's designee, the Securities Information Center, pursuant to the requirements of 17 C.F.R. §240.171-1. In those situations, a Criminal Referral Form is not required.

Purpose of Forms

The purpose of this form is to provide a consistent means by which financial institutions make referrals of known or suspected criminal activity perpetrated against or taking advantage of the institutions both by insiders and by those outside the institution. The form provides an effective means to notify appropriate law enforcement and supervisory authorities of both losses and criminal activity involving the bank. Institutions should use care in completing this form and should insure that it includes as much information as is practicable under the circumstances.

**Paperwork Reduction Act and Privacy Act Notices
Criminal Referral Form**

The Paperwork Reduction Act of 1980 says we must tell you why we are collecting this information, how we will use it, and whether you have to give it to us. We ask for the information to carry out our supervisory responsibilities for national banks. We need it to monitor crimes involving national banks, to evaluate losses and evaluate a bank's internal controls. You are required by 12 C.F.R. §21.11 to give us this information. In addition, the information in this referral may be subject to the applicable provisions of the Privacy Act of 1974, 5 U.S.C. §552a and 31 C.F.R. §1.20 *et seq.* of the Department of Treasury's Rules and Regulations.

1. Name, Location and Charter Number of Financial Institution

NAME _____
LOCATION _____
STREET CITY ST ZIP
CHARTER NUMBER _____ If transaction occurred at branch office(s), please identify _____

2. Asset Size of Financial Institution _____

3. Approximate date and dollar amount (prior to any allowance for restitution or recovery) of transaction

DATE _____ AMOUNT _____
Month Day Year

4. Summary characterization of the transaction. Check appropriate box(es)

- Defalcation/Embezzlement Bribery/Gratuity Check Fraud
- False Statement Misuse of Position or Self Dealing Credit Card Fraud
- Check Kiting Mysterious Dissappearance Money Laundering
- Other (Describe) _____

Applicable Section(s) of the U.S. Code (if known). (See list on page 7) _____

5. This matter is being referred to the FBI/Secret Service/IRS (circle one or more) in _____ CITY ST

and the U.S. Attorney in _____ CITY ST JUDICIAL DISTRICT (if known)

6. Person(s) suspected of criminal activity. Complete subparagraphs (a) through (e) on each individual suspected of criminal activity (if more than one, use continuation sheet). Include primary suspects only. Individuals who may have knowledge of the loss but who are not themselves suspected of being involved should be listed as witnesses under Item 10. Provide any additional details known with respect to prior referrals or affiliations.

a. NAME _____
FIRST MI LAST

ADDRESS _____
STREET CITY ST ZIP

DATE OF BIRTH _____ SOCIAL SECURITY NO. _____
(if known) Month Day Year (if known)

b. Relationship to the financial institution (check all applicable blocks)

- Officer Employee Broker Shareholder Account Holder
- Director Agent Borrower Other, Specify _____

c. Is person still affiliated with the financial institution Yes No

If no, terminated resigned. DATE _____
Month Day Year

Describe Circumstances (if necessary, use continuation sheet) _____

d. Prior or related referrals Yes No. (If yes, please identify.)

e. Is person affiliated with any other financial institution Yes No or business enterprise Yes No. (If yes to either or both, please identify.)

7. a. Provide a brief narrative description of the activity giving rise to the referral, explaining what is unusual or irregular about the transaction. Details will be required later in the form. The purpose of this paragraph is to provide a summary description of the overall transaction. (List applicable account numbers.)

- b. Give a chronological and complete account of the suspected violation. (Use continuation sheets, if necessary.)
- Relate key events to documents and attach copies of those documents.
 - Explain who benefited, financially or otherwise, from the transaction, how much and how.
 - Furnish any explanation of the transaction provided by the suspect and indicate to whom and when it was given.
 - Furnish any explanation of the transaction provided by any other person.
 - Furnish any evidence of cover-up or evidence of an attempt to deceive federal or state examiners or others.
 - Indicate where the suspected violation took place (e.g., main office, branch, other).
 - Suggest any further investigation that might assist law enforcement in fully examining the potential violation.

THIS SECTION OF THE REFERRAL IS CRITICAL. It should be as detailed as circumstances permit. The care with which this section is written may make the difference in whether or not the described conduct and its criminal nature are clearly understood. The discussion points listed in this section are not exhaustive. They should be covered but to the extent additional explanation would be useful as to any particular item or to the extent an additional category should be addressed, it should be done here. Feel free to use attachments or to continue the description on a separate sheet. Include any suggestions for the interviewing of any witnesses, gathering of any documents, or other suggestions which might prove useful in following up on the referral (e.g., tracing of proceeds).

c: Indicate whether the transaction appears to be an isolated incident or whether it relates to other transactions.
(Explain)

8. Exclusion of information from the Referral

Has any pertinent information been excluded from this referral as a result of any legal or other restraint? Yes No
If so, why? _____

Has the excluded information, or documents, been segregated for later retrieval? Yes No

9. Has suspected individual(s) made any admissions? Yes No If so, by whom? _____

10. Witnesses

List any witnesses who might have information about the suspected violation and describe their position or employment. Indicate if they have been interviewed. (Use continuation sheet if necessary.)

	<u>Name</u>	<u>Position</u>	<u>Address</u>	<u>Tele.</u>	<u>Interviewed</u>	
					Yes	No
1.	_____	_____	_____	_____	<input type="checkbox"/>	<input type="checkbox"/>
2.	_____	_____	_____	_____	<input type="checkbox"/>	<input type="checkbox"/>
3.	_____	_____	_____	_____	<input type="checkbox"/>	<input type="checkbox"/>
4.	_____	_____	_____	_____	<input type="checkbox"/>	<input type="checkbox"/>
5.	_____	_____	_____	_____	<input type="checkbox"/>	<input type="checkbox"/>

11. Discovery and Reporting

a. Who discovered the transaction and when?

b. Has the transaction been reported to the Board of Directors? Yes No By whom and when?

c. Has the Board of Directors taken action? Yes No If so, what and when?

d. Has the transaction previously been reported to federal or local law enforcement or to any federal or state supervisory agency? Yes No If so, by whom, to whom, and when?

2. Loss
- a. Amount of loss known \$ _____
 - b. Restitution by _____
In the amount of \$ _____
 - c. Name of Surety Bond Company (if applicable) _____
 - d. Amount of Bond \$ _____
 - e. Amount of Deductible \$ _____
 - f. Was claim filed? Yes No
 - g. Settlement by Surety Company \$ _____
 - h. Total restitution and settlement to date \$ _____
 - i. Net Loss (after subtracting any amount paid in the form of restitution or settlement) \$ _____
 - j. Is additional loss suspected? Yes No (if yes, explain)
- k. Has the suspected violation had a material impact on or otherwise affected the financial soundness of the institution? If so, please explain.

13. Offer of Assistance
The individuals listed below are authorized to discuss this referral with appropriate law enforcement officials and to assist in locating or explaining any documents pertinent to this referral. **provided that contact is first made with**
- | | |
|-----------------|-----------------|
| Name _____ | Position _____ |
| Phone No. _____ | |
| Name _____ | Tele. No. _____ |
| Name _____ | Tele. No. _____ |
| Name _____ | Tele. No. _____ |
- 14 Form Prepared by _____
Position _____
Agency/Institution _____
Phone No. _____ Date _____

DISTRIBUTION INFORMATION

BANK REFERRALS

1. Retain one copy in the bank's files.
2. Send one copy to appropriate OCC District Office. Attn: District Counsel.
3. Send one copy to the nearest Office of the Federal Bureau of Investigation.
4. Send one copy to the nearest Office of the U.S. Attorney.
5. In cases involving the unauthorized use of a credit card or credit card number (18 U.S.C. §1029) or computer fraud (18 U.S.C. §1030), perpetrated without any apparent complicity of a bank employee or officer, in lieu of sending a copy to the F.B.I., send one copy to the nearest Office of the U.S. Secret Service.
6. In cases involving known or suspected violations of the bank secrecy laws (31 U.S.C. §§5311 and 5324), send one copy to the nearest office of the Internal Revenue Service—Criminal Investigation Division, and one copy to the Office of Financial Enforcement, Treasury Department, 1500 Pennsylvania Avenue, Washington, D.C. 20220.
7. In cases involving a suspected violation of state criminal law, consider sending one copy to the appropriate state or local prosecuting authority.

OCC EXAMINER REFERRALS

- Examiner**
1. Retain one copy in work papers.
 2. Where appropriate, provide one copy to bank for its criminal referral file.
 3. Send one copy to bank's Supervising Office.
 4. Send one copy to District Office, Attn: District Counsel, with recommendation for referral.
- District Counsel**
5. Send one copy to the nearest Office of the Federal Bureau of Investigation.
 6. Send one copy to the nearest Office of the U.S. Attorney.
 7. In cases involving the unauthorized use of a credit card or credit card number (18 U.S.C. §1029) or computer fraud (18 U.S.C. §1030), perpetrated without any apparent complicity of a bank employee or officer, in lieu of sending a copy to the F.B.I., send one copy to the nearest Office of the U.S. Secret Service.
 8. In cases involving known or suspected violations of the bank secrecy laws (31 U.S.C. §§5311 and 5324), send one copy to the nearest office of the Internal Revenue Service—Criminal Investigation Division, and one copy to the Office of Financial Enforcement, Treasury Department, 1500 Pennsylvania Avenue, Washington, D.C. 20220.
 9. In cases involving a suspected violation of state criminal law, consider sending one copy to the appropriate state or local prosecuting authority.

CONTINUATION SHEET

Item No.	Remarks

INSTRUCTIONS FOR EXAMINERS

Examiners should fill out this form whenever suspected criminal activity has been independently discovered by the examiner and has not been reported by the institution or the referral made by the institution is deemed to be inadequate. It is important to note that this form should be filled out whenever criminal activity is suspected; examiners are not required to make any initial finding that such referrals would, if pursued, result in a criminal conviction. That judgment will be made by responsible law enforcement authorities. Any questions regarding whether or not any particular activity would constitute a crime for purposes of making a criminal referral should be resolved through communications with District Counsel.

The purpose of this referral is to provide appropriate law enforcement authorities with complete and accurate information relating to suspected criminal activity. All information requested within the body of the form should be supplied at the time of the referral unless such information is not known or can only be supplied at a later date by operation of The Right to Financial Privacy Act. In the latter case, documents not provided with this form should be segregated and safeguarded in order that they may be subsequently supplied in accordance with the provisions of The Right to Financial Privacy Act. In filling out this form, examiners should avoid overly technical descriptions or terminology which might not be readily understood by law enforcement authorities unfamiliar with banking operations.

CRIMINAL STATUTES

- 18 U.S.C. 2** To "aid, abet, counsel, command, induce or procure" the commission of a federal offense.
- 18 U.S.C. 201** Bribery of public officials, including elected representatives, jurors and employees of any department or agency of the federal government and witnesses in official proceedings. e.g., anyone who gives, offers or promises anything of value to a public official or a witness with the intent to influence that person's official functions.
- 18 U.S.C. 215** Kickbacks, bribes. Makes it unlawful for any officer, director, employee, agent or attorney to corruptly solicit, offer, accept or receive anything of value with the intent to influence, be influenced, or be rewarded in connection with any transaction or business of any financial institution.
- 18 U.S.C. 371** Conspiracy of two or more persons to either commit a federal offense or to defraud the United States (or any agency of the U.S.)
- 18 U.S.C. 656** Theft, embezzlement or misapplication of bank funds, willfully, by an officer, director, agent or employee of a bank, with intent to injure or defraud the bank. Can infer intent to injure from the fact of injury or from acts knowingly done in reckless disregard for the interests of the bank.
- 18 U.S.C. 709** False advertising or misuse of words "National," "Federal Reserve," "Deposit Insurance," etc., to convey impression of federal agency affiliation.
- 18 U.S.C. 1001** General false statements statute—knowingly and willfully falsifying or concealing a material fact or making a false statement or making or using false writing knowing it to be false.
- 18 U.S.C. 1005** False entries and reports or statements, including material omissions, with intent to injure or defraud the bank, the OCC (or Fed or FDIC), bank examiners or other individuals or companies.
- 18 U.S.C. 1014** False statements (oral or written) e.g., loan application, made knowingly for the purpose of influencing any bank whose deposits are federally insured, upon any application, purchase agreement, commitment, loan (or any change or extension of same) including willfully overvaluing land, property or security.
- 18 U.S.C. 1029** Credit Card fraud—knowingly and with intent to defraud, produce, use or traffic in counterfeit access devices.
- 18 U.S.C. 1030** Computer fraud—knowingly accessing a computer without authorization, or using it for unauthorized purposes, including obtaining information contained in records of financial institutions.
- 18 U.S.C. 1341** Mail fraud—scheme or artifice to defraud that makes use of the Postal Service.
- 18 U.S.C. 1343** Wire fraud—scheme or artifice to defraud using transmission by wire, radio or TV for the purpose of carrying out the scheme.
- 18 U.S.C. 1344** Bank fraud—scheme or artifice to defraud a federally insured institution or take money, funds, credits, assets, securities or other property by misrepresentation.
- 18 U.S.C. 1621** Perjury/false statement made under oath (if false statement is not made under oath, individual may still be prosecuted under 18 U.S.C. 1001 or 1014).
- 18 U.S.C. 1951** Racketeer Influenced and Corrupt Organizations ("RICO") statutes. Investing in any enterprise affecting interstate commerce if the funds for the investment are derived from "a pattern of racketeering activity" (these activities are defined to include: murder, drug dealing, bribery, robbery, extortion, counterfeiting, mail fraud, wire fraud, embezzlement from pension funds, obstruction of criminal investigations, fraud in the sale of securities, etc.).
- 18 U.S.C. 1956** Laundering of monetary instruments. Includes knowing conduct designed to avoid Federal or State transaction reporting requirements.
- 18 U.S.C. 1957** Engaging in monetary transactions in property known to have been derived from specified unlawful activity. Includes knowing engagement in monetary transactions (including deposits, withdrawals, transfers, or exchanges), by, through, or to a financial institution.
- 31 U.S.C. 5311** Currency Transactions/Bank Secrecy Act.
- 31 C.F.R. 103**
- 31 U.S.C. 5324** Structuring a financial transaction to evade transaction reporting requirements.
- 15 U.S.C. 78dd-2** Foreign Corrupt Practices Act of 1977. Payment of anything of value to any foreign official, foreign political party or candidate or "any other person where the American corporation knows or has reason to know the thing of value would be offered to a foreign official, foreign political party or candidate for foreign political office."
- 15 U.S.C. 78ff** Criminal penalty provisions of securities laws.

OCC District Offices

Northeastern District
1211 Avenue of the Americas
Suite 4250
New York, NY 10036
212-944-3495

Southeastern District
Marquis One Tower
Suite 600
245 Peachtree Center Avenue, N.E.
Atlanta, GA 30303
404-659-8855

Central District
One Financial Place
Suite 2700
440 South LaSalle Street
Chicago, IL 60605
312-663-8000

Midwestern District
2345 Grand Avenue
Suite 700
Kansas City, MO 64108
816-556-1800

Southwestern District
1800 Lincoln Plaza
500 North Akard
Dallas, TX 75201-3394
214-720-0656

Western District
50 Fremont Street
Suite 3900
San Francisco, CA 94105
415-545-5900



REPORT OF APPARENT CRIME
(SHORT FORM)

Federal Deposit Insurance Corporation

ATTENTION:

Use this form only if suspected criminal activity (see 12 C.F.R. §353.1) involves actual or probable loss of less than \$10,000 (prior to any recovery or reimbursement) not involving an executive officer, director or principal shareholder of the institution within the meaning of 12 C.F.R. §215.2 (with the term "member bank" deemed to mean "insured non-member bank"). All other referrals should be submitted on FDIC Form 6710/06A, Report of Apparent Crime (Long Form). For purposes of this form, "suspected criminal activity" implies that there is a reasonable basis for believing that a crime has occurred, is occurring or may occur.

This form should be promptly filed by the bank, but no later than thirty days following discovery of the suspected violation. Where appropriate, law enforcement authorities should be immediately notified by telephone or other expeditious means.

The information in this report is confidential and subject to the applicable provisions of the Privacy Act of 1974, 5 U.S.C. 552a and Part 310 (12 C.F.R.) of the FDIC's Rules and Regulations.

1. Name and Location of Financial Institution

NAME _____
LOCATION _____
STREET _____ CITY _____ ST _____ ZIP _____
CERTIFICATE NUMBER _____ If activity occurred at branch office(s) please identify _____

2. Asset Size of Financial Institution (millions of dollars) _____

3. Approximate date and dollar amount of suspected violation

DATE _____ AMOUNT (thousands of dollars) _____
Month Day Year

4. Summary characterization of the suspected violation. Check appropriate box(es)

Defalcation/Embezzlement Bribery/Gratuity Other (Describe) _____
 False Statement Misuse of Position or Self Dealing _____
 Check Kiting Mysterious Disappearance _____

Applicable Section(s) of the U.S. Code (if known). (See list on page 4) _____

5. This matter is being referred to the FBI in _____

CITY _____ ST _____
and the U.S. Attorney in _____
CITY _____ ST _____ JUDICIAL DISTRICT (if known) _____

6. Person(s) Suspected of Criminal Violation (if more than one, use continuation sheet)

a. NAME _____
FIRST MI LAST
ADDRESS _____
STREET CITY ST ZIP
DATE OF BIRTH _____ SOCIAL SECURITY NO _____
(if known) Month Day Year (if known)

b. Relationship to the financial institution (check all applicable blocks)

Officer Employee Broker Shareholder
 Director Agent Borrower Other. Specify _____

c. Is person still affiliated with the financial institution Yes No

If no, terminated resigned. DATE _____
Month Day Year

Describe Circumstances (if necessary, use continuation sheet) _____

d. Prior or related referrals Yes No. If yes, please identify _____

e. Is person affiliated with any other financial institution Yes No or business enterprise Yes No. If yes to either or both, please identify _____

7. Explanation/Description of Suspected Violation. (Give brief summary of the suspected violation, explaining what is unusual or irregular about the transaction.) (If necessary, use continuation sheet.)

8. Has there been a confession? Yes No. If so, by whom? _____

9. Offer of Assistance

The individuals listed below are/will be authorized to discuss this referral with FBI and Department of Justice officials and to assist in locating or explaining any documents pertinent to this referral, provided that contact is first made with

Name _____ Position _____
Phone No _____

Name _____ Tele No _____

Name _____ Tele No _____

Name _____ Tele No _____

10. Form Prepared by _____

Position _____

Agency/Institution _____

Phone No _____ Date _____

CONTINUATION SHEET

Item No.	Remarks

PRINCIPAL CRIMINAL STATUTES

- 18 U.S.C. 2 To aid, abet, counsel, command, induce or procure the commission of federal offense
- 18 U.S.C. 201 Bribery of public officials including elected representatives, jurors and employees of any department or agency of the federal government and witnesses in official proceedings e.g. anyone who gives offers or promises anything of value to a public official or a witness with the intent to influence that person's official functions
- 18 U.S.C. 215 Kickbacks, bribes. Makes it unlawful for any officer, director, employee, agent or attorney to solicit, accept or give anything of value in connection with any transaction or business of any financial institution
- 18 U.S.C. 371 Conspiracy of two or more persons to either commit a federal offense or to defraud the United States (or any agency of the U.S.)
- 18 U.S.C. 656 Theft, embezzlement or misapplication of bank funds willfully by an officer, director, agent or employee of a bank with intent to injure or defraud the bank. Can infer intent to injure from the fact of injury or from acts knowingly done in reckless disregard for the interests of the bank
- 18 U.S.C. 709 False advertising or misuse of words National, Federal Reserve, Deposit Insurance, etc. to convey impression of federal agency affiliation
- 18 U.S.C. 1001 General false statements statute - knowingly and willfully falsifying or concealing a material fact or making a false statement or making or using false writing knowing it to be false
- 18 U.S.C. 1005 False entries and reports or statements including material omissions with intent to injure or defraud the bank, the OCC (or Fed or FDIC), bank examiners or other individuals or companies
- 18 U.S.C. 1014 False statement (oral or written) e.g. loan application made knowingly for the purpose of influencing any bank whose deposits are federally insured upon any application, purchase agreement, commitment, loan (or any change or extension of same) including willfully overvaluing land, property or security
- 18 U.S.C. 1029 Credit Card fraud - knowingly and with intent to defraud produce, use or traffic in counterfeit access devices
- 18 U.S.C. 1030 Computer fraud - knowingly accessing a computer without authorization or using it for unauthorized purposes including obtaining information contained in records of financial institutions
- 18 U.S.C. 1341 Mail fraud - scheme or artifice to defraud that makes use of the Postal Service
- 18 U.S.C. 1343 Wire fraud - scheme or artifice to defraud using transmission by wire, radio or TV for the purpose of carrying out the scheme
- 18 U.S.C. 1344 Bank fraud - scheme or artifice to defraud a federally insured institution or take money, funds, credits, assets, securities or other property by misrepresentation
- 18 U.S.C. 1621 Perjury/false statement made under oath (if false statement is not made under oath, individual may still be prosecuted under 18 USC 1001 or 1014)
- 18 U.S.C. 1951 Racketeer Influenced and Corrupt Organizations (RICO) statutes investing in any enterprise affecting interstate commerce if the funds for the investment are derived from a pattern of racketeering activity (these activities are defined to include murder, drug dealing, bribery, robbery, extortion, counterfeiting, mail fraud, wire fraud, embezzlement from pension funds, obstruction of criminal investigations, fraud in the sale of securities, etc.)
- 18 U.S.C. 1961 Racketeer Influenced and Corrupt Organizations (RICO) statutes investing in any enterprise affecting interstate commerce if the funds for the investment are derived from a pattern of racketeering activity (these activities are defined to include murder, drug dealing, bribery, robbery, extortion, counterfeiting, mail fraud, wire fraud, embezzlement from pension funds, obstruction of criminal investigations, fraud in the sale of securities, etc.)
- 18 U.S.C. 5311 Currency Transactions Bank Secrecy Act
- 18 U.S.C. 5312 Currency Transactions Bank Secrecy Act
- 18 U.S.C. 78dd Foreign Corrupt Practices Act of 1977 Payment of anything of value to any foreign official, foreign political party or candidate or any other person where the American corporation knows or has reason to know the thing of value would be offered to a foreign official, foreign political party or candidate for foreign political office
- 18 U.S.C. 78ff Criminal violations of securities laws
- 18 U.S.C. 78x Criminal penalty provisions of securities laws

INSTRUCTIONS FOR FILING THE SHORT FORM

The purpose of this report is to provide a consistent means by which financial institutions can make referrals of known or suspected criminal activity perpetrated against the institutions whether by insiders or those outside the institution. The report will provide an effective means by which appropriate law enforcement and supervisory authorities will be made aware of known or suspected criminal activity. Institutions should use care in filling out this report and should insure that it is filled out in as complete a manner as practicable under the circumstances.

When a financial institution concludes that a crime has probably occurred involving less than \$2,500 where the institution has no basis for identifying a possible suspect or group of suspects (as often occurs with a check forgery or an unauthorized use of a credit card), then reporting the violation to the United States Attorney and federal law enforcement is optional. But if (1) the apparent crime involves \$2,500 or more or (2) the institution has a reasonable basis for identifying the suspect or group of suspects, *regardless of the dollar amount involved in the apparent crime*, then reporting is mandatory.

DISTRIBUTION:

1. Retain one copy in bank's files.
2. Send one copy to Regional Director, Division of Bank Supervision, Federal Deposit Insurance Corporation.
3. Send one copy to the nearest office of the FBI.
4. Send one copy to nearest office of the U.S. Attorney.
5. If the violation involves 31 C.F.R. 103, send one copy to the local IRS office, Criminal Investigation Division.
6. In cases involving the unauthorized use of a credit card or credit card number (18 U.S.C. §1029) or computer fraud (18 U.S.C. §1030), perpetrated without any apparent complicity of a bank employee or officer, the financial institution should send the form to the local office of the Secret Service in lieu of sending the referral to the FBI.
7. If also a criminal violation of state law, consider sending the form to the appropriate state prosecuting authority.

**REPORT OF APPARENT CRIME
(LONG FORM)**



Federal Deposit Insurance Corporation

ATTENTION:

Use this form in all cases where suspected criminal activity (see 12 C.F.R. §353.1) involves probable loss (before reimbursement or recovery) of \$10,000 or greater and in all cases, regardless of amount, involving an executive officer, director or principal shareholder of the institution within the meaning of 12 C.F.R. §215.2 (with the term "member bank" deemed to mean "insured nonmember bank"). For purposes of this form, "suspected criminal activity" implies that there is a reasonable basis for believing that a crime has occurred, is occurring or may occur.

This form should be promptly filed by the bank, but no later than thirty days following discovery of the suspected violation. Where appropriate, law enforcement authorities should be immediately notified by telephone or other expeditious means.

The information in this report is subject to the applicable provisions of the Privacy Act of 1974, 5 U.S.C. 552a and Part 10 (12 C.F.R.) of the FDIC's Rules and Regulations.

Name and Location of Financial Institution

NAME _____

LOCATION _____
STREET CITY ST ZIP

CERTIFICATE NUMBER _____ If activity occurred at branch office(s) please identify _____

Asset Size of Financial Institution (millions of dollars) _____

Approximate date and dollar amount (prior to any allowance for restitution or recovery) of suspected violation

DATE _____ AMOUNT (thousands of dollars) _____
Month Day Year

Summary characterization of the suspected violation Check appropriate box(es)

- Defalcation/Embezzlement
- False Statement
- Check Kiting
- Bribery/Gratuity
- Misuse of Position or Self Dealing
- Mysterious Disappearance
- Other (Describe) _____

Applicable Section(s) of the U.S. Code (if known). (See list on page 7) _____

This matter is being referred to the FBI in _____
CITY ST

and the US Attorney in _____
CITY ST JUDICIAL DISTRICT (if known)

- b. Give a chronological and complete account of the suspected violation (Use continuation sheet, if necessary)
- Relate key events to documents and attach copies of those documents
 - Explain who benefited, financially or otherwise, from the transaction, how much, and how
 - Furnish any explanation of the transaction provided by the suspect and indicate to whom and when it was given
 - Furnish any explanation of the transaction provided by any other person.
 - Furnish any evidence of cover-up by the suspect or evidence of an attempt to deceive federal or state examiners or others
 - Indicate where the suspected violation took place (eg. main office, branch, other)
 - Recommend any further investigation that might assist law enforcement in fully examining the potential violation

THIS SECTION OF THE REFERRAL IS CRITICAL. It should be as detailed as circumstances permit. The care with which this section is written may make the difference in whether or not the described conduct and its criminal nature are clearly understood. The discussion points listed in this section are not exhaustive. They should be covered but to the extent additional explanation would be useful as to any particular item or to the extent an additional category should be addressed it should be done here. Feel free to use attachments or to continue the description on a separate sheet. Include any suggestions for the interviewing of any witnesses, gathering of any documents or methods of investigation which might prove useful in following up on the referral (eg. tracing of proceeds).

c Indicate whether the suspected violation appears to be an isolated incident or whether it relates to other transactions (Explain)

Exclusion of Information from the Referral

Has any pertinent information been excluded from this referral as a result of any legal or other restraint? Yes No
If so why? _____

Have the excluded information or documents been segregated for later retrieval? Yes No

Has there been a confession? Yes No If so by whom? _____

Witnesses

List any witnesses who might have information about the suspected violation and describe their position or employment. Indicate if they have been interviewed (Use continuation sheet if necessary)

	<u>Name</u>	<u>Position</u>	<u>Address</u>	<u>Tele</u>	<u>Interviewed</u>	
					Yes	No
1	_____	_____	_____	_____	_____	_____
2	_____	_____	_____	_____	_____	_____
3	_____	_____	_____	_____	_____	_____
4	_____	_____	_____	_____	_____	_____
5	_____	_____	_____	_____	_____	_____

Discovery and Reporting

a Who discovered the suspected violation and when?

b Has the suspected violation been reported to the Board of Directors? Yes No By whom and when?

c Has the Board of Directors taken action? Yes No If so, what and when?

d Has the suspected violation previously been reported to federal or local law enforcement or to any federal or state supervisory agency? Yes No If so, by whom, to whom, and when?

Loss

- a Amount of loss known \$ _____
- b Restitution by _____
In the amount of \$ _____
- c Name of Applicable Surety Bond Company _____
- d Amount of Bond \$ _____
- e Amount of deductible \$ _____
- f Was claim filed? Yes No
- g Settlement by Surety Company \$ _____
- h Total restitution and settlement to date \$ _____
- i Net loss (after subtracting any amounts paid in the form of restitution or settlement) \$ _____
- j Is additional loss suspected? Yes No (If yes explain)

k. Has the suspected violation had a material impact on or otherwise affected the financial soundness of the institution? If so, please explain.

Offer of Assistance

The individuals listed below are/will be authorized to discuss this referral with FBI and Department of Justice officials and to assist in locating or explaining any documents pertinent to this referral **provided that contact is first made with**

Name _____ Position _____
Phone No _____

Name _____ Tele No _____

Name _____ Tele No _____

Name _____ Tele No _____

Form Prepared by _____

Position _____

Agency/Institution _____

Phone No _____ Date _____

CONTINUATION SHEET

Item No	Remarks

INSTRUCTIONS FOR FILING THE LONG FORM

The purpose of this report is to provide a consistent means by which financial institutions can make referrals of known or suspected criminal activity perpetrated against the institutions whether by insiders or those outside the institution. The report will provide an effective means by which appropriate law enforcement and supervisory authorities will be made aware of known or suspected criminal activity. Institutions should use care in filling out this report and should insure that it is filled out in as complete a manner as practicable under the circumstances.

All information requested within the body of the report should be supplied at the time of the report unless such information is not known or can only be supplied at a later date. Documents not provided with this report should be segregated and safeguarded in order that they might be subsequently supplied upon request or service of subpoena.

DISTRIBUTION:

1. Retain one copy in bank's files.
2. Send one copy to Regional Director, Division of Bank Supervision, Federal Deposit Insurance Corporation.
3. Send one copy to the nearest office of the FBI.
4. Send one copy to nearest office of the U.S. Attorney.
5. Send one copy to the State Banking Authority.
6. If the violation involves 31 C.F.R. 103, send one copy to the local IRS office, Criminal Investigation Division.
7. In cases involving the unauthorized use of a credit card or credit card number (18 U.S.C. §1029) or computer fraud (18 U.S.C. §1030), perpetrated without any apparent complicity of a bank employee or officer, the financial institution should send the form to the local office of the Secret Service in lieu of sending the referral to the FBI.
8. If also a criminal violation of state law, consider sending the form to the appropriate state prosecuting authority.

ADDITIONAL INSTRUCTIONS FOR EXAMINERS

Examiners should fill out this report whenever suspected criminal activity has been identified in a banking institution and either has not yet been reported by the institution or the report made by the institution is deemed to be inadequate. It is important to note that this report should be filled out whenever criminal activity is suspected; examiners are not required to make any initial finding that such reports would, if pursued, result in a criminal conviction. That judgment will be made by responsible law enforcement authorities. Any questions regarding whether or not any particular activity would constitute a crime for purposes of making a criminal referral should be resolved through communications with the Regional Office. In filling out this report, examiners should avoid overly technical descriptions of transactions which might not be readily understood by law enforcement authorities unfamiliar with banking operations.

DISTRIBUTION BY EXAMINER/REGIONAL OFFICE

Examiner

1. Retain one copy in field office file under name of the bank.
2. Send original to the Regional Office.

Regional Office

3. Retain one copy in Regional Office under name of the bank.
4. Send one copy to the Chief, Special Activities Section, Washington, D.C. 20429, accompanied by a signed cover letter indicating, in appropriate cases, the priority to be given the referral.
5. Send one copy to the nearest office of the FBI.
6. Send one copy to the U.S. Attorney.
7. If violation of state law, consider sending the referral to the appropriate state prosecuting authority.
8. If the violation involves 31 C.F.R. 103, send one copy to the local IRS office, Criminal Investigation Division.
9. Send a copy to the State Banking Authority.

PRINCIPAL CRIMINAL STATUTES

- .S.C. 2 "To aid abet counsel command induce or procure the commission of federal offense
- .S.C. 201 Bribery of public officials including elected representatives jurors and employees of any department or agency of the federal government and witnesses in official proceedings eg anyone who gives offers or promises anything of value to a public official or a witness with the intent to influence that persons official functions
- .S.C. 215 Kickbacks bribes Makes it unlawful for any officer director employee agent or attorney to solicit accept or give anything of value in connection with any transaction or business of any financial institution
- .S.C. 371 Conspiracy of two or more persons to either commit a federal offense or to defraud the United States (or any agency of the US)
- .S.C. 856 Theft embezzlement or misapplication of bank funds willfully by an officer director agent or employee of a bank with intent to injure or defraud the bank Can infer intent to injure from the fact of injury or from acts knowingly done in reckless disregard for the interests of the bank
- .S.C. 709 False advertising or misuse of words 'National Federal Reserve Deposit Insurance etc to convey impression of federal agency affiliation
- .S.C. 1001 General false statements statute- knowingly and willfully falsifying or concealing a material fact or making a false statement or making or using false writing knowing it to be false
- .S.C. 1005 False entries and reports or statements including material omissions with intent to injure or defraud the bank the OCC (or Fed or FDIC) bank examiners or other individuals or companies
- .S.C. 1014 False statement (oral or written) eg loan application made knowingly for the purpose of influencing any bank whose deposits are federally insured upon any application purchase agreement commitment loan (or any change or extension of same) including willfully overvaluing land property or security
- .S.C. 1029 Credit Card fraud- knowingly and with intent to defraud produce use or traffic in counterfeit access devices
- .S.C. 1030 Computer fraud - knowingly accessing a computer without authorization or using it for unauthorized purposes including obtaining information contained in records of financial institutions
- .S.C. 1341 Mail fraud - scheme or artifice to defraud that makes use of the Postal Service
- .S.C. 1343 Wire fraud - scheme or artifice to defraud using transmission by wire radio or TV for the purpose of carrying out the scheme
- .S.C. 1344 Bank fraud - scheme or artifice to defraud a federally insured institution or take money funds credits assets securities or other property by misrepresentation
- .S.C. 1621 Perjury/false statement made under oath (if false statement is not made under oath individual may still be prosecuted under 18 USC 1001 or 1014)
- .S.C. 1951 Racketeer Influenced and Corrupt Organizations (RICO) statutes Investing in any enterprise affecting interstate commerce if the funds for the investment are derived from a pattern of racketeering activity (these activities are defined to include murder drug dealing bribery robbery extortion counterfeiting mail fraud wire fraud embezzlement from pension funds obstruction of criminal investigations fraud in the sale of securities etc)
- .S.C. 5311 Currency Transactions Bank Secrecy Act
- F.R. 103
- .S.C. 78dd Foreign Corrupt Practices Act of 1977 Payment of anything of value to any foreign official foreign political party or candidate or any other person where the American corporation knows or has reason to know the thing of value would be offered to a foreign official foreign political party or candidate for foreign political office
- .S.C. 78ff Criminal violations of securities laws
- .S.C. 78x Criminal penalty provisions of securities laws

FEDERAL HOME LOAN BANK BOARD CRIMINAL REFERRAL FORM

INSTRUCTIONS

INTRODUCTION. The purpose of this form is to provide a consistent means by which financial institutions can make referrals of known or suspected criminal activity perpetrated against the institutions whether by insiders or those outside the institution. The form will provide an effective means by which appropriate law enforcement and supervisory authorities will be made aware of known or suspected criminal activity. Institutions should use care in filling out this form and should ensure that it is filled out in as complete a manner as practicable under the circumstances.

THE FOLLOWING INSTRUCTIONS SHOULD BE REFERRED TO WHEN FILLING OUT THE ITEMS REFERENCED:

ENTER ON PAGES 2 THROUGH 5, IN THE SPACE ALLOTTED AT THE TOP OF EACH PAGE, THE DOCKET NUMBER OF THE FINANCIAL INSTITUTION.

SECTION A - TO BE COMPLETED IN ALL REFERRAL CASES

ITEMS 1 THROUGH 3. Self-explanatory.

ITEM 4. Enter a check mark next to those descriptions in 4 which most generally describe the nature of the criminal activity. Use the list of criminal statutes provided on page 2 of the Instructions as an aid to filling out the applicable sections of Title 18.

ITEM 5. The term "confession" includes admissions made to the institution's personnel or to others.

ITEM 6. Provide a brief narrative description of the activity giving rise to the referral. Details will be provided later in the form in Section B. The purpose of this paragraph is to provide a summary description of the overall transaction.

ITEM 7. Complete subparagraphs (a) through (g) on each individual suspected of criminal activity. This list should include primary suspects only. Individuals who may have knowledge of the suspected criminal activity but who are not themselves suspected of being involved should be listed as witnesses under Item 4 of Section B. Provide any additional details known with respect to prior referrals or affiliations.

ITEMS 8 THROUGH 10. Self-explanatory.

SECTION B

This section should be completed in all cases where suspected criminal activity involves probable loss (before reimbursement or recovery) of \$10,000 or greater or in all cases, regardless of amount, involving an

affiliated person within the meaning of 12 C.F.R. § 661.29.

ITEM 1. THIS PART OF THE REFERRAL IS CRITICAL.

It should be as detailed as circumstances permit. The care with which this section is written may make the difference in whether the conduct and its possible criminal nature are clearly understood. The discussion points listed in this part are not exhaustive. They should be covered, but to the extent additional explanation would be useful as to any particular item or to the extent an additional category should be addressed, it should be done here. Feel free to use attachments or to continue the description on a separate sheet. Include any suggestions for the interviewing of any witnesses or the gathering of any documents or method of investigation which might prove useful in following up on the referral (e.g., tracing of proceeds). **ITEMS 2 THROUGH 7.** Self-explanatory.

ADDITIONAL INSTRUCTIONS FOR EXAMINERS

Examiners should fill out this form whenever suspected criminal activity has been identified in an insured institution and either has not yet been reported by the institution or the referral made by the institution is deemed to be inadequate. It is important to note that this form should be filled out whenever criminal activity is suspected; examiners are not required to make any initial finding that such referrals would, if pursued, result in a criminal conviction. That judgment will be made by responsible law enforcement authorities. Any questions regarding whether or not any particular activity would constitute a crime for purposes of making a criminal referral should be resolved through communications with the Director of Examinations.

The purpose of this referral is to provide appropriate law enforcement authorities with complete and accurate information relating to suspected criminal activity. ALL information requested within the body of the form should be supplied at the time of the referral unless such information is not known or can only be supplied at a later date by operation of The Right to Financial Privacy Act. In the latter case, documents not provided with this form should be segregated and safeguarded in order that they might be subsequently supplied in accordance with the provisions of The Right to Financial Privacy Act. In filling out this form, examiners should avoid overly technical descriptions of transactions which might not be readily understood by law enforcement authorities unfamiliar with the operations of financial institutions.

DISTRIBUTION

ATTENTION: When making distribution, send the entire form (Sections A and B, when applicable) to each location, as instructed below.

IF REFERRAL IS MADE BY AN INSURED INSTITUTION

1. Retain one copy in the files.
2. Send one copy to
Director of Examinations,
Federal Home Loan Bank
for the District in which the Institution is located.
(See Federal Home Loan Bank Address List below.)
3. If Section B is required to be completed, send one copy to Director, Enforcement Division,
Federal Home Loan Bank Board
Washington, D.C. 20552.
4. Send one copy to the appropriate local office of the FBI.
5. Send one copy to the appropriate U.S. Attorney.
If also a criminal violation of state law, consider sending the referral to the appropriate state prosecuting authority.

IF REFERRAL IS MADE BY FHLBANK EXAMINER/EMPLOYEE

- Examiner**
1. Retain one copy in the examiner's files under the name of the institution.
 2. Send four copies to the Director of Examinations,
District Bank
 3. Retain one copy in the District Bank under the name of the institution.
 4. If Section B is required to be completed, send one copy to Director, Enforcement Division,
Federal Home Loan Bank Board
Washington, D.C. 20552.
 5. Send one copy to the appropriate local office of the FBI.
 6. Send one copy to the appropriate U.S. Attorney. If also a criminal violation of state law, consider sending the referral to the appropriate state prosecuting authority.

FEDERAL HOME LOAN BANK OFFICES

District 1
Federal Home Loan Bank of Boston
P.O. Box 9106 GMF
Boston, Massachusetts 02206

District 4
Federal Home Loan Bank of Atlanta
P.O. Box 34327
Peachtree Center Station
Atlanta, Georgia 30343

District 7
Federal Home Loan Bank of Chicago
111 East Wacker Drive, Suite 600
Chicago, Illinois 60601

District 10
Federal Home Loan Bank of Topeka
P.O. Box 176
Topeka, Kansas 66601

District 2
Federal Home Loan Bank of New York
One World Trade Center, Floor 103
New York, NY 10048

District 5
Federal Home Loan Bank of Cincinnati
P.O. Box 506
Cincinnati, Ohio 45201

District 8
Federal Home Loan Bank of Des Moines
507 Walnut Street
Des Moines, Iowa 50309

District 11
Federal Home Loan Bank of San Francisco
P.O. Box 7946
San Francisco, California 94120

District 3
Federal Home Loan Bank of Pittsburgh
20 Starvue Street
One Riverfront Center
Pittsburgh, Pennsylvania 15222-4883

District 6
Federal Home Loan Bank of Indianapolis
P.O. Box 60
Indianapolis, Indiana 46206

District 9
Federal Home Loan Bank of Dallas
500 E. Jean Carpenter Freeway
P.O. Box 619026
Dallas/Fort Worth, Texas 75261-9026

District 12
Federal Home Loan Bank of Seattle
600 Stewart Street
Seattle, Washington 98101

**SUMMARY OF
CRIMINAL STATUTES**

- 12 U.S.C. § 1725(g) Falsely advertising (1) that one is insured by or affiliated with the FSLIC or (2) the extent or manner of FSLIC insurance.
- 18 U.S.C. § 2 Aiding, abetting, counseling, commanding, inducing or procuring the commission of a federal offense.
- 18 U.S.C. § 201 Bribery of public officials, including elected representatives, jurors and employees of any department or agency of the federal government, and witnesses in official proceedings: e.g., anyone who gives, offers or promises anything of value to a public official or a witness with the intent to influence that person's official functions.
- 18 U.S.C. § 215 Kickbacks and bribes - makes it unlawful for any officer, director, employee, agent or attorney to solicit, accept or give anything of value in connection with any transaction or business of any financial institution.
- 18 U.S.C. § 371 Conspiracy of two or more persons to either commit a federal offense or to defraud the United States (or any agency of the U.S.).
- 18 U.S.C. § 657 Theft, embezzlement or willful misapplication of an insured institution's funds by an officer, director, agent or employee with intent to defraud the institution.
- 18 U.S.C. § 1001 General false statements statute - knowingly and willfully falsifying or concealing a material fact or making a false statement or making or using false writing knowing it to be false.
- 18 U.S.C. § 1006 False entries and reports or statements including material omissions, with intent to injure or defraud an insured institution or deceive a Federal Home Loan Bank examiner; receipt of any benefits by an officer, agent or employee of the institution from a transaction of the institution with intent to defraud by the individual.
- 18 U.S.C. § 1008 False statements made to induce FSLIC insurance of accounts, passing false documents in order to influence the FSLIC.
- 18 U.S.C. § 1009 Transmittal of untrue and derogatory statements concerning the financial condition of the FSLIC.
- 18 U.S.C. § 1014 False statement, oral or written (e.g., loan applications); made knowingly for the purpose of influencing the FHLBB or any institution whose deposits are federally insured upon any application, purchase agreement, commitment, loan (or any change or extension of same), including willfully overvaluing land, property or security.
- 18 U.S.C. § 1029 Credit card fraud - knowingly and with intent to defraud, producing, using or trafficking in counterfeit access devices.
- 18 U.S.C. § 1030 Computer fraud - knowingly accessing a computer without authorization or using it for unauthorized purposes, including obtaining information contained in records of financial institutions.
- 18 U.S.C. § 1306 Participation of an insured institution in lotteries or related activities.
- 18 U.S.C. § 1341 Mail fraud - scheme or artifice to defraud that makes use of the Postal Service.
- 18 U.S.C. § 1343 Wire fraud - scheme or artifice to defraud using transmission by wire, radio or TV for the purpose of carrying out the scheme.
- 18 U.S.C. § 1344 Bank fraud - scheme or artifice to defraud a federally insured institution or take money, funds, credit, assets, security or other property by misrepresentation.
- 18 U.S.C. § 1621 Perjury/false statements made under oath. (If false statement is not made under oath, individual may still be prosecuted under 18 U.S.C. § 1001 or 1014.)
- 18 U.S.C. § 1905 Disclosure of confidential information by a federal government employee.
- 18 U.S.C. § 1961 Racketeer Influenced and Corrupt Organizations ("RICO") statutes - investing in any enterprise affecting interstate commerce if the funds for the investment are derived from a pattern of racketeering activity. These activities include murder, drug dealing, bribery, robbery, extortion, counterfeiting, mail fraud, wire fraud, embezzlement from pension funds, obstruction of criminal investigation, fraud in the sale of securities, etc.
- 18 U.S.C. § 2113 Robbery of a savings and loan, bank or credit union and incidental crimes, including taking of any property in excess of \$100 in value belonging to a savings and loan, bank or credit union and receiving, possessing, or disposing of same.
- 31 U.S.C. § 5311
31 C.F.R. § 103 Currency Transactions/Bank Secrecy Act.
- 15 U.S.C. § 78dd Foreign Corrupt Practices Act of 1977 - Payment of anything of value to any foreign official, foreign political party or candidate or any other person where an American corporation knows or has reason to know the thing of value would be offered to a foreign official, foreign political party or candidate for foreign political office.
- 15 U.S.C. § 78ff Criminal violations of securities laws.
- 15 U.S.C. § 78z Criminal penalty provisions of securities laws.

**FEDERAL HOME LOAN BANK BOARD
CRIMINAL REFERRAL FORM**

**SECTION A
TO BE COMPLETED FOR ALL CRIMINAL REFERRALS**

1. Name, Location and Docket Number of Financial Institution

Name _____

Location _____
Street
City
State
Zip

Docket Number _____ If activity occurred at branch office(s), please identify _____

2. Asset Size of Financial Institution (millions of dollars) _____

3. Approximate date and dollar amount (prior to any allowance for restitution or recovery) of suspected violation

Date _____ Amount (thousands of dollars) _____
Month
Day
Year

4. Summary characterization of the suspected violation. Check appropriate box(es)

- | | | |
|---|---|---|
| <input type="checkbox"/> Defalcation/Embezzlement | <input type="checkbox"/> Bribery/Gratuity | <input type="checkbox"/> Other (Describe) _____ |
| <input type="checkbox"/> False Statement/Fraud | <input type="checkbox"/> Misuse of Position or Self Dealing _____ | |
| <input type="checkbox"/> Check Kiting | <input type="checkbox"/> Unexplained Loss _____ | |

Applicable Section(s) of Title 18, U.S. Code (if known)
 (see list on page 2 of Instructions) _____

5. Has there been a confession? Yes No If so, by whom? _____

6. Explanation/Description of Suspected Violation (Give a brief summary of the suspected violation, explaining what is unusual or irregular about the transaction.) (If necessary, use Continuation Sheet.)

**FEDERAL HOME LOAN BANK BOARD
CRIMINAL REFERRAL FORM**

FHLBB DOCKET NUMBER OF
THE FINANCIAL INSTITUTION _____

**SECTION A - CONTINUED
TO BE COMPLETED FOR ALL REFERRAL CASES**

7. Person(s) Suspected of Criminal Violation (If more than one, use Continuation Sheet.)

a. Name _____
First Middle Last

b. Address _____
Street City State Zip

c. Date of Birth _____ Social Security Number _____
(if known) Month Day Year (if known)

d. Relationship to the financial institution. Check all applicable box(es)

- | | | |
|-----------------------------------|-----------------------------------|---|
| <input type="checkbox"/> Officer | <input type="checkbox"/> Agent | <input type="checkbox"/> Shareholder |
| <input type="checkbox"/> Director | <input type="checkbox"/> Broker | <input type="checkbox"/> Savings Customer |
| <input type="checkbox"/> Employee | <input type="checkbox"/> Borrower | <input type="checkbox"/> Other, Specify _____ |

e. Is person still affiliated with the financial institution? Yes No
If no, Terminated Resigned Date _____
Month Day Year

If no, describe circumstances. (If necessary, use Continuation Sheet.)

f. Prior or related referrals? Yes No If yes, please identify _____

g. Is person affiliated with any other financial institution? Yes No
or business enterprise? Yes No If yes to either or both, please identify

8. This matter is being referred to the FBI in _____
City State
and the U.S. Attorney in _____
City State Judicial District (if known)

9. Offer of Assistance
The individuals listed below are/will be authorized to discuss this referral with FBI and Department of Justice officials and to assist in locating or explaining any documents pertinent to this referral, provided that contact is first made with

Name _____	Position _____
Phone No. _____	
<u>Authorized Individuals</u>	
Name _____	Phone No. _____
Name _____	Phone No. _____
Name _____	Phone No. _____

10. Form Prepared By _____
Position _____
Agency/Institution _____
Phone No. _____ Date _____
Month Day Year

ATTENTION

COMPLETE SECTION B OF FHLBB FORM 366 AND SUBMIT WITH THIS SECTION IN ALL CASES WHERE SUSPECTED CRIMINAL ACTIVITY INVOLVES PROBABLE LOSS (BEFORE REIMBURSEMENT OR RECOVERY) OF \$10,000 AND GREATER OR IN ALL CASES, REGARDLESS OF AMOUNT, INVOLVING AN AFFILIATED PERSON WITHIN THE MEANING OF 12 C.F.R. § 561.29.

**FEDERAL HOME LOAN BANK BOARD
CRIMINAL REFERRAL FORM**

FHLBB DOCKET NUMBER OF
THE FINANCIAL INSTITUTION _____

SECTION B

TO BE COMPLETED IN REFERRAL CASES WHERE SUSPECTED CRIMINAL ACTIVITY INVOLVES PROBABLE LOSS (BEFORE REIMBURSEMENT OR RECOVERY) OF \$10,000 OR GREATER OR IN ALL CASES, REGARDLESS OF AMOUNT, INVOLVING AN AFFILIATED PERSON WITHIN THE MEANING OF 12 C.F.R. § 561.29.

1. Give a chronological and complete account of the suspected violation. (If necessary, use Continuation Sheet.)
- Relate key events to documents and attach copies of those documents.
 - Explain who benefited, financially or otherwise, from the transaction, how much and how.
 - Furnish any explanation of the transaction provided by the suspect and indicate to whom and when it was given.
 - Furnish any explanation of the transaction provided by any other person.
 - Furnish any evidence of cover-up by the suspect or evidence of an attempt to deceive federal or state examiners or others.
 - Indicate where the suspected violation took place (e.g., main office, branch, other).
 - Recommend any further investigation that might assist law enforcement authorities in fully examining the potential violation.

2. Indicate whether the suspected violation appears to be an isolated incident or whether it relates to other transactions. (Explain)

3. Exclusion of Information from the Referral

Has any pertinent information been excluded from this referral as a result of any legal or other restraint? Yes No If yes, why? _____

Have the excluded information or documents been segregated for later retrieval? Yes No

SECTION B

TO BE COMPLETED IN REFERRAL CASES WHERE SUSPECTED CRIMINAL ACTIVITY INVOLVES PROBABLE LOSS (BEFORE REIMBURSEMENT OR RECOVERY) OF \$10,000 OR GREATER OR IN ALL CASES, REGARDLESS OF AMOUNT, INVOLVING AN AFFILIATED PERSON WITHIN THE MEANING OF 12 C.F.R. § 561.22.

4. Witnesses

List any witnesses who might have information about the suspected violation and describe their position or employment. Indicate whether they have been interviewed. (If necessary, use Continuation Sheet.)

	<u>Name</u>	<u>Position</u>	<u>Address</u>	<u>Phone No.</u>	<u>Interviewed?</u>	
					Yes	No
a.	_____	_____	_____	_____	<input type="checkbox"/>	<input type="checkbox"/>
b.	_____	_____	_____	_____	<input type="checkbox"/>	<input type="checkbox"/>
c.	_____	_____	_____	_____	<input type="checkbox"/>	<input type="checkbox"/>
d.	_____	_____	_____	_____	<input type="checkbox"/>	<input type="checkbox"/>
e.	_____	_____	_____	_____	<input type="checkbox"/>	<input type="checkbox"/>

5. Discovery and Reporting

a. Who discovered the suspected violation and when? _____

b. Has the suspected violation been reported to the Board of Directors? Yes No
 By whom and when? _____

c. Has the Board of Directors taken action? Yes No If so, what and when?

d. Has the suspected violation previously been reported to federal or local law enforcement authorities or to any federal or state supervisory agency? Yes No If so, by whom, to whom, and when?

6. Loss			
a. Amount of loss known		\$	f. Name of surety bond company
b. Restitution by :			
	\$		g. Amount of bond \$
	\$		h. Amount of deductible \$
c. Settlement by surety company	\$		i. Was claim filed? <input type="checkbox"/> Yes <input type="checkbox"/> No if yes, when
d. Total restitution and settlement to date		\$	
e. Total loss to date		\$	j. Is additional loss suspected? <input type="checkbox"/> Yes <input type="checkbox"/> No (If yes, explain in Item 1, Section B.)

7. Has the suspected violation had a material impact on or otherwise affected the financial soundness of the institution? Yes No If yes, please explain.

CONTINUATION SHEET

FHLBB DOCKET NUMBER OF
THE FINANCIAL INSTITUTION _____

ITEM NO.	REMARKS

INTERNAL FRAUD: It's Money Down the Drain

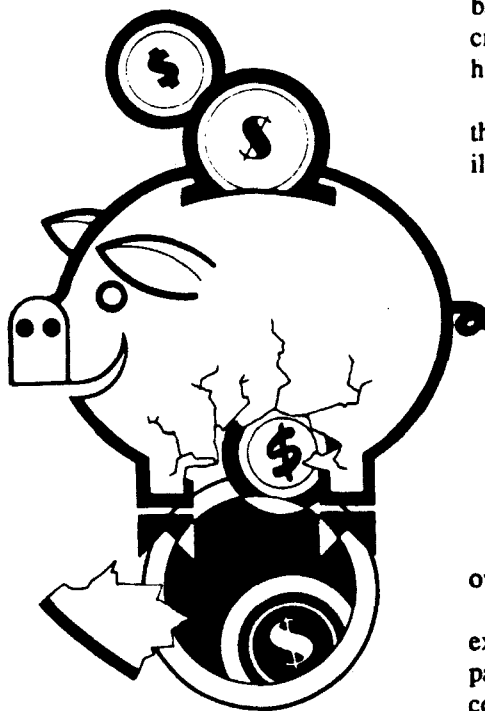
By James E. Sniegocki

The call came into the FBI office one morning at about 9 a.m. The bank executive sounded desperate. "Karen has locked herself in the ladies room and refuses to come out until you get here," he said. The agent had spent the previous day interviewing bank tellers concerning a \$5,000 shortage. Karen had become a suspect when someone saw her put something wrapped in a white napkin in her purse. She had been very cooperative, appeared honest and denied she took the money.

When the agent arrived at the bank, Karen came out of the rest room, to the relief of the bank executives. She happily said that she had "found" the missing cash—at home in her bedroom. She said she frequently "finds" missing things in her room and had no explanation as to how they get there.

The cash was still in a bank wrapper, nothing had been spent. Further investigation revealed, surprisingly, that Karen was a confirmed, medically diagnosed Kleptomaniac—working as a bank teller.

Another time, a bank officer embarrassingly told the FBI that they had several hundred dollars missing from the cash that tellers practice with



in tellers training school. Someone couldn't even wait to get assigned to a branch!

In still another case, the FBI agent was preparing a signed statement from the teller who just admitted stealing about \$10,000. When asked his name, he gave one different from his personnel file. When questioned about this, the teller stated he was using his brother's name. He couldn't use his real name, he logically explained, since the

bank would have found out about his criminal record and may not have given him the job.

The above cases are true, as are all the examples used in this article. They illustrate the importance of a thorough background check of all applicants for positions in the bank.

Even if all your employees and officers are carefully selected and screened, you may still have problems. Do any of them have personal financial problems? What about drugs? Alcohol? Gambling? And if you're sure about your employees, what about their spouses, boyfriends and girlfriends? Could they influence your employees to "go over the edge?"

Any CEO, financial officer or bank executive who doesn't realize the impact of internal fraud on the financial community and on his own bank is doing a great disservice to his institution. The US Chamber of Commerce stated that fraud was a major factor in the closing of 100 banks over a 20 year period. The Federal Deposit Insurance Corporation found fraud in 10 percent of all its examinations and in 33 percent of all bank failures during the last two years.

While eliminating fraud completely may be impossible, cutting it in

(continued from page 6)

half or minimizing your exposure to fraud is an attainable goal and might be accomplished through some basic and common sense changes in operating procedures.

In this article, therefore, we will attempt the following:

—Explain some varieties of internal bank fraud so you can recognize the schemes;

—give you some tips on what to look for or how to spot a fraud in progress;

—advise you on important steps once you get suspicious; and finally

—suggest ways to prevent an internal fraud in your bank.

Varieties of Fraud

A branch manager and the security officer of the bank were both suspicious when a new customer, a "college student" (according to his new account card) began depositing large amounts of \$50 and \$100 bills through the automatic teller machines late at night. A call to the FBI and some preliminary investigating quickly identified the "college student" as a vault supervisor of a neighboring bank. But there was no report of missing funds and it certainly is not illegal to make \$10,000, \$20,000, or \$30,000 cash deposits to your own checking account.

The interview with the vault supervisor began slowly. He spoke freely about his job, his wife and child and his "inheritance," the source of his recent wealth. Slowly, bit by bit, this story started to unravel. Comments about his family did not make sense and details of the inheritance were vague.

Finally he admitted to carrying briefcases full of cash out of the bank—a total of \$250,000. He led the FBI to his home where \$140,000 was immediately recovered. He kept his activities from the auditors by manipulating paperwork thus keeping the total amount of the embezzlement "in transit" between departments during audits.

One unusual aspect—aside from enriching himself with a new car, furniture, oil paintings and a rare book col-

lection—was that he also contributed much of the stolen funds to churches, local and national charities and, unbelievably, to build a law library at Eddyville State Prison, a location where he would soon take up residence.

Although most cash thefts (called "mysterious disappearances" by the FBI) are for smaller amounts, any cash shortage should be looked at carefully. Investigators frequently find one teller having a series of \$5 and \$10 cash shortages leading to a \$100 or \$200 shortage and finally, a missing \$5,000 or \$10,000.

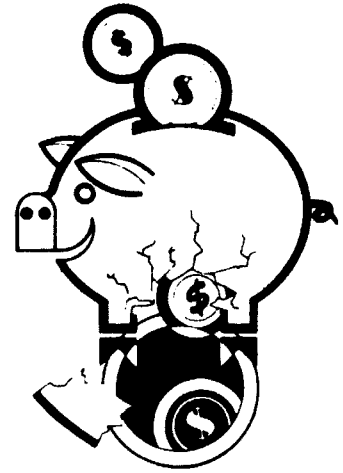
While cash shortages may not cause a bank to liquidate, they may indicate sloppy operating procedures or ineffective internal controls. This situation then becomes ripe for more complex schemes which would definitely have an affect on the bank's balance sheet.

In a large metropolitan area, the police sifted through the records of the gambling operation they had just raided. They saw the usual collection of "professional" sports bettors. Then, an unknown name caught their eye, an individual betting up to \$30,000 a day. Investigation disclosed he was a teller supervisor at a bank with a salary of less than \$30,000 a year.

A complicated computerized "lapping" scheme was uncovered netting the employee \$1.5 million over a three year period. Using his banks computers, he would transfer sums of money into his personal account, then a day or two later transfer a larger sum to cover the amounts taken previously, placing the difference again into his personal account. By repeating this procedure frequently none of the accounts affected were out of balance for more than a short period of time.

A head teller, employed by a New England bank for 15 years, was tapping dormant savings accounts and giving the cash to her unemployed boyfriend, who gambled the money away. The teller prepared and kept a set of fictitious account records to show customers, if they got suspicious.

She and her boyfriend hatched the plan one August, and over the next six months they skimmed and gambled



away \$250,000.

Fraudulent or questionable loans seem to be the most frequent cause of bank financial problems and in many cases, bank liquidations.

Several years ago, in Northern Kentucky, a bank failure resulted in the conviction in Federal Court of two of the bank's officers. The federal government claimed, and the jury agreed, that the officers were responsible for a \$3.6 million loss, primarily through loans to themselves, their business ventures and their friends.

On the West Coast, a bank manager and three of his friends were indicted in a \$2.3 million fraudulent loan scheme. Using "straw borrowers" whom they paid from \$50 to \$300 apiece for the use of their names and credit data, the three friends applied for 49 loans. Not only did the bank manager approve the loans, but he made sure that the paperwork was appropriately hidden within the bank and that the loans did not go through normal channels.

In a fraudulent loan scheme to beat all others, Jake Butcher pleaded guilty in 1985 to defrauding his various banks of \$40.8 million. Loans were obtained from banks in Kentucky and Tennessee and were made to non-existent companies. Funds were used to finance a luxurious life-style and for high-risk business ventures.

A bank's bookkeeping department can be a source of many types of internal fraud, especially if the employee's

(continued from page 8)

duties are not strictly defined, if there's not a regular rotation of duties or if the transaction handling, posting and reconciliation assignments are not separated.

Add to the above situation a board of directors disinterested in internal audit functions and generally poor morale among the employees, and you have the situation found recently in a small bank in Eastern Kentucky. It should have been no surprise, then, when the external auditor found that the bank was missing \$1 million.

A lengthy FBI investigation determined a fraudulent scheme underway for at least five years involving the head bookkeeper, several other employees and several customers. The scheme involved non-sufficient fund checks which were pulled out of the system and held, or in some cases destroyed, rather than being returned to the payee or charged to the employee's or customer's account causing that account to be overdrawn.

They used a data center to process their daily work. It was determined that the head bookkeeper not only worked out of her own cash drawer, but sometimes worked on the posting machine, opened new accounts, prepared the work for the data center, received and handled the work from the data center, handled the daily list of non-sufficient fund items, reconciled the data center account and finally, prepared the daily bank balance.

Some personal and business checking accounts went months without a deposit while hundreds of checks were written. This case brought a whole new meaning to the often used promotional term, "unlimited checking."

A discussion of varieties of fraud would not be complete without the mention of electronic fund transfers. A 1986 US Department of Justice study said that in a recent year, there were 60 million wire transfers involving \$117 trillion. A survey of 16 large US banks revealed 139 cases of wire fraud averaging \$833,279. At that time, the bankers estimated that the dollar amount of electronic fund transfers

would increase by 70 percent by 1990.

Bankers know that in this day and age there is no other way to move large blocks of funds across the country or around the world. Despite all the internal controls built into the system, passwords, personal identification numbers, call back instructions etc..., law enforcement personnel know that the human factors make the system only as strong as its weakest link. Employees get bored, sloppy or inefficient; go on vacation or get sick and are replaced with others who may not be as dedicated or a familiar with procedures. The rules and regulations give way to short-cuts.

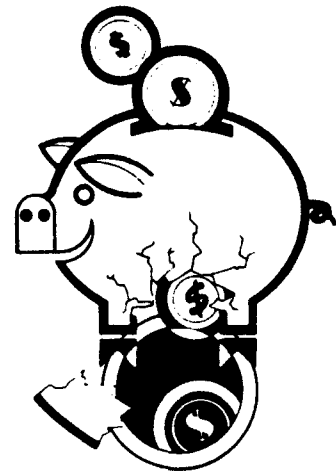
Add to this the possibility of collusion between two or more employees or an employee and an outsider; or the possibility of a data line interception by a computer wizard and you have the makings of a major fraud.

Detecting Internal Fraud (What to Look For)

One of the first things an internal fraud consultant or investigator will do when arriving at your bank will be to assess the "fraud climate." As morale goes down, the fraud climate increases. Do your employees have a "they don't care about me, why should I care about them" attitude? Is sick leave abused? Are they running out the door at quitting time leaving jobs unfinished? Are they concerned about their work product? Is there hostility regarding bank policies?

Law enforcement authorities agree that low morale leads to a high incidence of employee theft and fraud. A banker would be amazed to hear the justification given by an employee caught stealing. Everything from "bonuses" they should have received to "informal loans" absent the paperwork.

Be alert for personal problems of your employees. If the personnel department did their job, the bank did not hire crooks and thieves. But even good solid people have a breaking point. Is there a medical problem causing a financial hardship? Drugs, alcohol and gambling are problems that need to be addressed. Senior executives, stressed over their increasing responsibilities,



are particularly susceptible.

Investigators use the formula "opportunity + need = suspect" when initiating an investigation.

Alert management can many times identify these problems early, deal with them directly and straightforwardly, prevent a theft or fraud from occurring and "save" a good employee.

Lifestyle changes should always be looked at carefully. You have a right and an obligation to examine the work of an employee in a sensitive position who is suddenly living above his or her means.

The bank vault supervisor who stole \$250,000 bought a car, clothes and jewelry; he also bought expensive furniture and original oil paintings for his office at the bank. All this was noted by his superiors, but no questions were ever asked.

The head bookkeeper (involved in the non-sufficient fund check scheme) and her husband owned six cars, three motorcycles and a truck—and she didn't even drive!

Utilize your internal auditor effectively. He is in the best position to spot a fraud underway. Make sure he is trained properly and has all the tools necessary to do his job. Carefully review his reports, reviews and analyses. If he spots something suspicious or out of the ordinary, have him make some additional discreet checks to confirm or reject the suspicion.

(continued from page 10)

Keep in mind that an internal theft comes in two parts—stealing the money and altering the records to cover it up. It's rare to catch someone stealing money. One way to detect the theft is to be alert for the cover-up.

In order to spot a fraud, we sometimes have to think like a thief. Some of us find that easier to do than others.

Which records or accounts might be used in your bank to cover up a fraud? Over and short records and dormant accounts come to mind immediately. Be careful of taxes, interest, bank expense, travel and entertainment accounts.

Because of large daily deposits and numerous checks, large commercial accounts are frequently used in lapping schemes.

Is your overdraft list reviewed by an officer daily? In-transit or other "holding" accounts are other possibilities.

Other tips to watch for:

—Do any of your employees re-write their records "for neatness?" Look for two sets of records.

—Do customers complain about mistakes on their accounts? See if the same employee is always involved.

—Is anyone overly protective of their records or procedures? You have a right to see what's going on.

—Do you have employees who refuse a vacation? Don't let them.

—Do some employees have a constant backlog of entries to be made so that the records are never up to date? This may be intentional.

Since fraudulent loans have played such a large part in bank failures, this area demands particular attention. To spot fraud in your loan department, look for procedures that vary from the norm.

Are loan applications properly filled out and checked? Is information obtained independently and verified with that on the application? Is collateral physically checked? Are the financial statements submitted to the bank current? Do most of the assets on the financial statement consist of stock in closely held corporations or other assets which are difficult to value?

Are certain customers loan files kept locked in the loan officers desk instead of being filed normally? Are authorization limits adhered to? Is the loan officer and the borrower particularly cozy—spending considerable time together out of the bank? Do they have an outside business relationship? Are loans rolled over repeatedly without principal payments for some customers, but not others?

Despite recent changes in external auditing guidelines giving more responsibility to the external auditor in identifying fraud, the internal auditor and the alert bank executive still have the best chance to spot a fraud in progress—and do something to stop it before it gets out of hand.

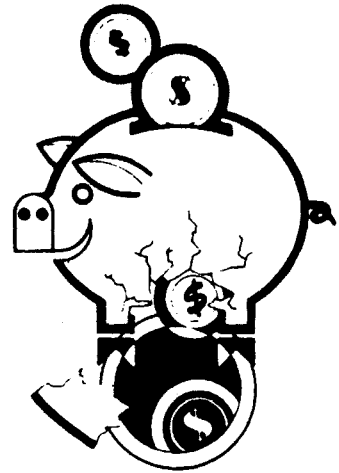
Once You've Identified a Fraud

If you have concrete evidence that an employee or officer has stolen money or is involved in a fraudulent scheme, your steps are laid out for you in your regulatory guideline. Your bank's attorney will advise you regarding the notification process, but you will have to write the appropriate regulatory agency, the US Attorneys Office and the nearest FBI office.

The FBI investigation can take one day or several years depending on the amount of money involved and the complexity of the case. Generally their technique is slow, methodical and thorough with much attention to the detailed collection of documentary evidence knowing that most complex cases end up in court.

A problem may arise when you find something suspicious, but just aren't sure. You or your internal auditor may make some discreet inquiries or review some additional records to resolve the matter.

Extreme caution should be used, however, before attempting your own internal investigation unless you have the training and experience to do so. Accusing an employee may result in a nasty lawsuit. An internal investigation may stop whatever is going on, but may cause records and evidence to be destroyed before the scope of the fraud is determined. Tipping your hand too



early may also permit other participants in the scheme, both inside and outside the bank, to get together and prepare a cover story.

The FBI is always willing to discuss your suspicions and advise you as to when they can enter a case.

An alternative procedure, if you do not have trained investigators on your staff, is to engage a white collar crime investigator/consultant who can look into the matter for you on either an overt or covert basis. His goal would be to determine if, in fact, a crime has been committed, the extent of the crime and the number of participants. He could then advise you as to which documents should be protected as potential evidence. He could act as your representative in dealing with law enforcement authorities throughout the investigation and, if necessary, the trial. This individual could also assist in your bond claim and make recommendations for improving your internal security.

Preventing Internal Fraud

In order to minimize your exposure to a fraudulent scheme, the following steps are necessary:

1) Most importantly, you must have a good employee selection and screening program. Check with a personnel consultant and get some expert advice if this process needs upgrading.

Start with a detailed resume and application, but remember that experts claim 30 percent of all resumes contain

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material misrepresentations.

Although pre-employment polygraph testing has been outlawed by Congress, pencil and paper honesty tests and other psychological testing is still permitted. These tests have been found to be relatively reliable, anti-discriminatory, inexpensive and will assist in screening out undesirable applicants.

An initial interview could be important, but given the ability of many people to lie convincingly, the skill of the interviewer determines the success of this step.

Background checks are important, but an attempt should be made to go beyond the usual reference, credit and criminal checks. References are prepped by the applicant to make favorable comments. Many criminal activities do not result in convictions. Former employers, in fear of lawsuits, may be unwilling to tell the truth about the applicant.

A second or final interview should be conducted by a different interviewer in order to go over any problems or questions raised during the previous steps.

2) Once you've hired a good solid employee, proper training is the next most important step. A well-trained employee will have confidence in himself, have a feeling of self-worth and that he or she is part of the team. Those individuals will be more inclined to be proud of his or her contribution and work for the benefit of all.

3) Keep morale high. A fair wage, appropriate benefits and good communication between all officers and employees will keep your "fraud climate" low. Involve employees in the decision making process. Consider a newsletter, a suggestion box, an open door policy for the president or CEO.

4) Establish good and effective internal controls. Make sure your internal auditor has the proper training and tools to do his job. Your external accountants or federal examiners will point out internal control deficiencies. Listen to them.

Between the annual audits, carefully monitor your controls to insure that shortcuts aren't being taken and

controls bypassed.

Think like a thief and watch the areas that are susceptible to being used in an internal fraud.

5) Establish an anti-theft policy. You wouldn't really need one since federal regulations require you to report any employee theft to several federal agencies, but it's important that your employees know where you stand on this issue. You will report any theft in any amount by any employee or officer. Don't try to play judge and jury. The Federal Judicial System is set up to accommodate first time offenders, extenuating circumstances etc.... Your employees should know when hired that you will administer this policy fairly and unequivocally.

Finally, with all the problems facing bankers today including increased competition, additional regulation and attempts to squeeze an extra percent from investments, you just don't need the hassle of an internal fraud. Hopefully, with an alert and informed management using common sense and fol-

lowing strict internal control guidelines, your bank will not become just another white-collar crime statistic.



James E. Sniegocki, a retired FBI agent, is president of DATAQUEST, Inc., a white-collar crime consulting/ investigative firm located in Louisville, Ky. He will be the featured speaker at the KBA's "Bank Internal Security Seminar" on December 6, at the Marriott in Lexington.

REPORTING TO
AND
RESPONDING TO INQUIRIES FROM
REGULATORY, INVESTIGATORY AND JUDICIAL AUTHORITIES

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SECTION F



REPORTING TO
AND
RESPONDING TO INQUIRIES FROM
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SECTION F

I. The Right of Financial Privacy In General.

A. A bank customer has no federal constitutional right of financial privacy with respect to records maintained by a bank concerning his personal affairs.

1. In California Bankers Association v. Schultz, 416 U.S. 21 (1974), the Supreme Court rejected the argument that a bank customer's constitutional rights precluded the bank from complying with the recordkeeping requirements with respect to the customer's transactions under the federal Bank Secrecy Act.

2. In United States v. Miller, 425 U.S. 435 (1976), the Supreme Court rejected the argument that the protections of the Fourth Amendment of the United States Constitution extended to bank records concerning a customer's accounts maintained pursuant to the Bank Secrecy Act. A customer does not have a reasonable expectation of privacy in customer related documents because those documents are business records of the bank.

B. A number of federal statutes impose requirements on a bank with respect to disclosures about its customer to federal authorities. These include:

1. The Financial Privacy Act of 1978, which generally gives a customer a right of action against the bank for disclosures to federal agencies unless made in compliance with special statutory procedures.

2. The sections of the Internal Revenue Code of 1986 which, in addition to requiring, among other things, reports of interest paid to or by customers and backup withholding from interest or moneys paid under certain circumstances, contain procedures for requiring banks, as third-party recordkeepers, to produce information about the affairs of a customer whose tax liability is at issue.

3. The Bank Secrecy Act, including the Currency and Foreign Transactions Reporting Act, which imposes reporting and recordkeeping requirements on banks with respect to their customers transactions.

C. The question of a bank's disclosure of information about its customer to state or local authorities or private individuals will be controlled by state law.

II. Right of Financial Privacy Act of 1978 (codified at 12 U.S.C. §§3401-3422)

A. General Rule: Financial institutions are prohibited from disclosing information in customer records to federal governmental authorities, and federal governmental authorities are prohibited from obtaining access to such information, except pursuant to:

1. The customer's written authorization

- a. Under 12 U.S.C. §3404, must identify the records to be disclosed, and the purposes for which and governmental authority to which records may be disclosed, and must be revocable and not authorize disclosure beyond 3 months.
- b. Authorization cannot be required as a condition of doing business.

2. Administrative subpoenas and summonses

- a. Under 12 U.S.C. §3405, there must be reason to believe that the records sought are relevant to a legitimate law enforcement inquiry.
- b. Waiting period after notice to customer during which customer has an opportunity to contest.

3. Search warrants

- a. Under 12 U.S.C. §3406, the governmental authority must obtain the search warrant under the Federal Rules of Criminal Procedure and generally must provide customer with notice within 90 days after it has been served.
- b. Court may prohibit financial institution from disclosing that records have been disclosed or that search warrant has been executed.

4. Judicial subpoenas

- a. Under 12 U.S.C. §3407, the subpoena must be authorized by law and there must be reason to believe that the records sought are relevant to a legitimate law enforcement inquiry.
- b. Waiting period after notice to customer during which customer has an opportunity to contest.

5. Formal written requests

- a. May be used where no administrative summons or authority reasonably appears to be available.
- b. 28 CFR Part 47 contains Department of Justice regulations for use of formal written request procedure.
- c. Waiting period after notice to customer during which customer has an opportunity to contest.

B. Financial institutions covered by the rule:

Banks, savings banks, credit card issuers under the Consumers Credit Protection Act, industrial loan companies, trust companies, savings and loan, building and loan or homestead associations (including cooperative banks), credit unions and consumer finance institutions located in any state or territory of the United States, the District of Columbia, Puerto Rico, Guam, American Samoa or the Virgin Islands.

C. Customers protected by the rule:

1. Only individuals or partnerships of five or fewer individuals are entitled to protection under the Act.
2. The "customer" relationship can be based on the utilization of services of the financial institution or the maintenance of an account for which the financial institution acts (or has acted) as a fiduciary.

D. Governmental authorities bound by the rule:

1. The Financial Privacy Act applies only to agencies and departments of the United States and their officers, employees and agents.
2. The Financial Privacy Act does not apply to state or local governmental authorities or to private persons. State law controls as to these issues.

E. Information subject to the rule:

Any information known to be derived from a record held by a financial institution pertaining to a customer's relationship with it.

F. Duties of the financial institution under the Act:

1. Before releasing the information, the financial institution must obtain a written certificate (the compliance certificate) from the governmental authority seeking the information that it has complied with the applicable provisions of the Financial Privacy Act.
2. Upon receipt of an administrative or judicial subpoena, the financial institution should (unless otherwise provided by law) proceed to assemble the information and be prepared to deliver it upon receipt of a compliance certificate (Section 3411).
3. The governmental authority must reimburse the financial institution for costs reasonably necessary and directly incurred to assemble and provide information under Act.
 - a. Regulation S promulgated by the Federal Reserve establishes the rates at which financial institutions will be reimbursed:
 - personnel time is reimbursed at \$10 per hour;
 - actual cost of computer time;
 - copying costs at \$.15 per page;
 - actual transportation costs.
 - b. The financial institution complying with the legal process or formal written request or customer authorization should submit an itemized statement to the government to obtain reimbursement. It can obtain reimbursement for assembling information even if the information is never disclosed because the administrative process, request or authorization is withdrawn or successfully challenged.
4. Absent special circumstances found by a court (Section 3409), the customer will receive advance notice of the governmental authority's request for disclosure pursuant to administrative or judicial subpoena or by formal written request and of the procedures pursuant to which the customer may object to disclosure.
 - a. Information cannot be obtained until 10 days have expired from the date of service of the notice or 14 days from the date notice was mailed.

- b. During the waiting period, the customer may challenge (and stay) the disclosure by filing a sworn statement and an application to enjoin the governmental authority in the appropriate court or complying with the statutory customer challenge provisions.
 - c. The customer challenge provisions are set out at 12 U.S.C. §3410 and represent the sole judicial remedy available to a customer to oppose disclosure.
5. The Financial Privacy Act will not prevent a financial institution (or its officers, employees or agents) from:
- a. Notifying a governmental authority that it has information that may be relevant to a possible violation of statute or regulation but the information can include only the name or other identifying information concerning the individual or account involved and the nature of any suspected illegal activity; or
 - b. Providing information to a court or governmental authority incident to perfecting a security interest, proving a claim in bankruptcy or collecting a debt (Section 1103(c) and (d)).
- G. Liability of the financial institution under the Financial Privacy Act.
- 1. 12 U.S.C. §3417 sets out the exclusive judicial remedies and sanctions for violations of the Act.
 - 2. A financial institution disclosing information in violation of the Act is liable to the customer in an amount equal to the sum of:
 - a. \$100;
 - b. Actual damages suffered by the customer as a result of the disclosure;
 - c. punitive damages allowed by the court, if the violation is found to be willful or intentional; and
 - d. costs and reasonable attorney's fees if the customer is successful in the action to enforce liability.
 - 3. Financial institutions disclosing information pursuant to the Financial Privacy Act in good faith reliance upon a certificate of compliance are

protected from liability to the customer for disclosure.

- a. To meet the good faith test, the financial institution should examine the document requiring the disclosure to determine whether, on its face, it is valid under the Act (for example, that the summons has been properly issued and doesn't require disclosure prior to the expiration of the statutory waiting period).
- H. 12 U.S.C. §3413 contains a laundry list of exceptions to the Financial Privacy Act. The following are examples:
1. Examinations or disclosures by supervisory agencies (e.g., Federal Deposit Insurance Corporation (FDIC), Federal Savings and Loan Insurance Corporation (FSLIC), Federal Home Loan Bank Board (FHLBB), Board of Governors of the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency (OCC), Securities and Exchange Commission (SEC), state banking or securities agencies and the Secretary of Treasury under the Bank Secrecy Act and the Currency and Foreign Transactions Reporting Act) in the exercise of their supervisory, regulatory or monetary functions with respect to the financial institution.
 2. Disclosures in accordance with the procedures authorized by the Internal Revenue Code.
 3. Information required to be reported in accordance with federal statutes or rules or in accordance with the rules of criminal or civil procedure in connection with litigation between the governmental authority and the customer.
 4. Disclosures in connection with the governmental authority's consideration or administration of assistance to the customer in the form of government loan, loan guaranty or loan insurance programs.
 - a. The financial institution must, however, record the date and governmental authority to which a disclosure was made in connection with a governmental loan, loan guaranty or loan insurance program (12 U.S.C. §3413(h)(6)).
 5. Subpoenas or court orders issued in connection with grand jury proceedings.
- I. Special procedures apply to information requested by government authorities authorized to conduct foreign counter and foreign positive intelligence activities and

the Secret Service in connection with its protective functions (Section 3414) and to governmental investigations directed at the financial institution or a legal entity which is not a customer.

III. Disclosures Pursuant to Third Party Summons Under the Internal Revenue Code

- A. Section 7609 of the Internal Revenue Code of 1986 contains special procedures for summons served upon third-party recordkeepers. These procedures generally require that the IRS give the taxpayer timely notice of the summons and impose a waiting period during which the taxpayer can contest the summons.
- B. "Third-party recordkeepers" covered by the section include:
 - 1. Banks, mutual savings banks, cooperative banks, building and loan and savings and loan associations and credit unions
 - 2. Consumer reporting agencies
 - 3. Persons extending credit through credit cards
 - 4. Brokers
 - 5. Attorneys
 - 6. Accountants
- C. The special procedures apply to summonses which:
 - 1. Require the production of records (including the giving of testimony relating to records)
 - 2. Made or kept of the business transactions or affairs
 - 3. Of another person who is identified in the description of the records in the summons
- D. Under Section 7602, a summons may be issued if the purpose of the inquiry is to determine or collect a tax liability or to inquire into an offense connected with the internal revenue laws. However, no summons can be issued and no enforcement proceeding commenced if there is a Justice Department referral in effect.
- E. Summons excepted from the special procedures: Section 7609 does not apply to summons:
 - 1. Issued solely to determine the identity of a numbered account or similar arrangement with a financial institution;

2. Issued to aid in the collection of a tax liability already determined by assessment or judgment;
3. Issued to determine whether or not records of an identified person have been made or kept; or
4. Served on the taxpayer whose liability is at issue.

F. Statutory procedures which must be followed:

1. The summons must identify the taxpayer to whom the summons relates or the other person to whom the records pertain (the target) and must provide such other information as will enable the third-party recordkeeper to locate the records required under the summons.
 - a. Exception for John Doe summons: The summons need not identify the person with respect to whose liability the summons is issued if the IRS has established in an ex parte court proceeding:
 - the summons relates to an investigation of a particular person or ascertainable group;
 - there is a reasonable basis for belief that the person or group may violate or may have violated any internal revenue law; and
 - the information sought and the identity of the person(s) are not readily available from other sources.
2. The target must be notified of the summons within 3 days of service and at least 23 days before the date the records are to be examined. The notice:
 - a. Can be served, mailed by certified or registered mail to the customer's last known address or left with the third-party recordkeeper if there is no last known address, and
 - b. Must be accompanied by a copy of the summons and contain an explanation of the target's right to bring a proceeding to quash the summons
3. The target can stay compliance with the summons by filing a petition to quash the summons in the federal district court in which the third-party recordkeeper "resides or is found."

- a. The proceeding must be brought within 20 days after the date the notice to him is served, mailed or left at his last known address (or if none, with the third-party recordkeeper).
 - b. The target must send by registered or certified mail a copy of the petition to the third-party recordkeeper and the IRS.
 - c. The third-party recordkeeper can intervene in the proceeding to quash the summons. It will be bound by the court's decision in the proceeding regardless of whether it intervenes.
4. The records required to be produced under the summons cannot be examined:
- a. Until after the close of 23 days after the day notice to the target was served, mailed or left at his last known address (or if none, with the third-party recordkeeper); and
 - b. If the proceeding to quash was timely filed and notice was properly given to the IRS and the third-party recordkeeper, only in accordance with the court's order or with the customer's consent.
5. Special exceptions: The IRS is not required to give notice to the target and the target cannot stay compliance by filing a petition to quash if the court determines, based on the facts and circumstances alleged by the IRS in an ex parte proceeding, that the giving of notice may lead to attempts
- a. to conceal, destroy or alter the records,
 - b. to prevent disclosure through intimidation, bribery or collusion, or
 - c. to flee to avoid prosecution, testifying or production of records.
- G. Duty of third-party recordkeeper:
1. The third-party recordkeeper must proceed to assemble the records requested upon receipt of the summons and be prepared to produce the records on the day they are to be examined.
 2. If the IRS has not complied with the statutory procedures or its summons is otherwise deficient, the third-party recordkeeper may refuse to produce the documents in order to avoid liability to the customer.

- a. Because an IRS summons is not self enforcing, the IRS would have to commence an enforcement proceeding in federal district court (12 U.C.S. §7604). However, if the IRS is successful in the enforcement proceeding, the financial institution could then be held in contempt by the court.
- b. The Supreme Court, in United States v. Powell, 379 U.S. 48 (1964), formulated the four part test for enforcement proceedings:
 - the purpose of the summons is legitimate
 - the inquiry may be relevant to the purpose
 - IRS doesn't already have the information
 - IRS has complied with the administrative steps
- c. The person with respect to whose liability the summons is issued has the right to intervene in any enforcement proceeding (Section 7609(b)(1)).
- d. Compliance certificate: The IRS may issue a certificate to the third-party recordkeeper that the period during which a proceeding to quash could be brought has expired and that no such proceeding was commenced or that the taxpayer consents to the examination. A third-party recordkeeper producing records summoned in good faith reliance on the IRS compliance certificate or a court order requiring production cannot be held liable to any customer or other person for such production.
- e. Third-party recordkeepers will be entitled to reimbursement from the IRS under Section 7610 for reasonable necessary costs which were directly incurred in searching for, reproducing or transporting records required under the summons unless the target has a proprietary interest in the records, or the third-party recordkeeper is the target.
 - i. Under Regulation Section 301.7610-1, a bank can obtain reimbursement for:
 - personnel time required to locate records at \$8.50 per hour;

- computer time at actual costs;
- copying costs at \$.20 per page;
- actual transportation costs incurred;
- attendance fees of \$30 per day or the amount paid to federal court witnesses under 28 U.S.C. §1821(b), whichever is greater;
- a subsistence allowance if overnight stay is required.

ii. To obtain reimbursement, the bank must have "satisfactorily complied with the summons" and must deliver an itemized statement to the IRS agent.

H. Demands of IRS for information must be distinguished from demands for surrender of property for the collection of a tax liability which has already been assessed. Under Sections 6331 and 6332 of the Internal Revenue Code, as amended by the Technical Corrections and Miscellaneous Revenue Act of 1988:

1. Unless IRS finds the collection of the tax is in jeopardy, it must give the taxpayer 30 days notice of the tax due and the demand for payment. The notice must include a brief explanation of, among other things, the procedures for levying on property and the rights and alternatives available to the taxpayer.
2. If IRS levies a bank account, the bank must freeze the account for 21 days. The bank must turn over the deposits (plus interest earned) after 21 days after service of the levy, unless the levy has been released.
3. Unless the funds in the bank account are subject to an attachment or execution under judicial process, a bank that doesn't surrender the funds will be liable to IRS in an amount equal to those funds or the tax liability, together with costs and interest, whichever is less.
4. A bank which surrenders funds to the IRS in accordance with the levy cannot be held liable to the taxpayer or any other person with respect to those funds because of such surrender.
5. Section 6334 outlines property exempt from levy.

- IV. The Bank Secrecy Act (generally, 12 U.S.C. §§1730d, 1829b, 1951-1959 and the Currency and Foreign Transactions Reporting Act (12 U.S.C. §5311 et seq.)).
- A. The Bank Secrecy Act and the Currency and Foreign Transactions Reporting Act, as implemented by the regulations of the Secretary of the Treasury, require financial institutions to maintain records and submit reports to federal agencies for use in criminal, tax or regulatory investigations or proceedings.
 - B. Financial institutions subject to the recordkeeping and reporting requirements include banks, broker/dealers, issuers, sellers and redeemers of traveler's checks and money orders and casinos. The term "bank" is defined broadly to include commercial and private banks, savings and loan and building and loan associations, thrift institutions, and credit unions (31 CFR 103.11(a) and (g)).
 - C. Reporting requirements of banks:
 - 1. Banks are required to file a report of each deposit, withdrawal, exchange of currency or other payment or transfer by, through or to such financial institution which involves a transaction in currency of more than \$10,000 (31 CFR 103.22).
 - a. Currency is defined as coin or paper money of any country that is designated as legal tender and circulated and customarily used and accepted as a medium of exchange in the country of issuance. It includes U.S. silver certificates, U.S. notes and Federal Reserve notes (31 CFR 103.11(d)).
 - b. A transaction in currency involves the physical transfer of currency from one person to another. Wire transfers or transfers of funds by written order which do not involve the physical transfer of currency are not transactions in currency (31 CFR 103.11(p)).
 - c. Multiple currency transactions will be treated as a single transaction if the financial institution has knowledge that they are by or on behalf of any person and result in either cash in or cash out totalling more than \$10,000 during one business day.
 - i. When measuring the cash in or cash out during a business day, transactions at the main and branch offices of the bank will be aggregated.

- d. Before concluding the currency transaction, the financial institution must [1] verify and record the name and address of the individual presenting the transaction and [2] record the identity, account and social security or taxpayer identification number of the person on whose behalf the transaction is to be effected. Verification generally requires separate proof of identification and the manner of verification must be noted in the report.
 - e. The report must be filed with the IRS within 15 days after the day on which the currency transaction occurred.
 - f. "Structuring" occurs when a currency transaction is broken up or divided into one or more transactions for the purpose of evading the reporting requirements. 12 U.S.C. §5324 and 31 CFR 103.53 declare structuring, or attempting to or assisting in structuring, unlawful.
2. Exempt transactions: No currency transaction report is required to be filed:
- a. For transactions with Federal Reserve Banks or Federal Home Loan banks;
 - b. For transactions between domestic banks; or
 - c. By nonbank financial institutions for transactions with commercial banks (but commercial banks will have to report).
3. Exemptible transactions
- a. A bank may exempt from the reporting requirement currency transactions consisting of:
 - i. Deposits or withdrawals of currency from an existing account by an established depositor who is a United States resident and operates:
 - a) a retail type of business in the United States:
 - retail type of business is one primarily engaged in providing goods to ultimate consumers and for which the business is paid in substantial portions by currency.
 - transactions of dealerships which buy or sell motor vehicles, vessels

or aircraft cannot be exempted and must be reported by the bank.

b) a sports arena, race track, amusement park, bar, restaurant, hotel, licensed check cashing service, vending machine company, theater, regularly scheduled passenger carrier or any public utility.

ii. deposits or withdrawals, exchanges of currency or other payments or transfers by local or state governments or the United States or any of its agencies or instrumentalities.

iii. withdrawals for payroll purposes from an existing account by an established depositor who is a United States resident and operates a firm that regularly withdraws more than \$10,000 in order to pay its employees in currency.

b. Conditions for exemption:

i. The transactions must be in amounts which the bank may reasonably conclude do not exceed amounts commensurate with the customary conduct of the lawful domestic business of that customer (or, in case of a governmental entity, customary and commensurate with its authorized activities).

ii. Before granting an exemption, the bank must now obtain in advance a signed written statement from the customer which includes, among other things, a description of the customer's customary conduct of lawful domestic business and detailed reasons why the customer qualifies for exemption. The statement does not relieve the bank of its obligation of verifying independently the activity of the account. The statement must be retained until the customer has been removed from the bank's exempt list for 5 years.

iii. The bank must maintain a centralized list of each exemption. The list must be disclosed to IRS upon request.

c. IRS may rescind exemptions granted by the bank or upon application may give bank additional authority to grant exemptions.

4. Reports are also generally required when a person transports more than \$10,000 currency or other monetary instruments into or out of the United States (31 CFR 103.23), or when a person has a financial interest in or authority over a bank, securities or other financial account in a foreign country (31 CFR 103.24).
5. The Secretary of Treasury has promulgated regulations under which specified financial institutions may also be required to report certain transactions with designated foreign financial agencies (31 CFR 103.25).

D. Recordkeeping requirements imposed on banks:

1. 31 CFR 103.33 and 103.34 impose recordkeeping requirements on banks. These records are required to be maintained for a period of 5 years and must be reasonably accessible (31 CFR 103.38(d)). To comply with these requirements, the bank may use records containing the required information which it keeps in the ordinary course of its business; otherwise, the bank will have to prepare written records.
2. Banks must keep the original or a copy (including a microfilm copy) of:
 - a. A record of each extension of credit in excess of \$10,000 which is not secured by real estate.
 - b. In the case of any transaction intended to result in the transfer of more than \$10,000 in currency or other monetary instruments, checks, investment securities or credit:
 - i. A record of each advice, request or instruction given or received if the transfer is to or from any person, account or place outside the United States.
 - ii. A record of each advice, request or instruction given to another financial institution or other person (wherever located) if the transfer is to a person, account or place outside the United States.
 - c. Each document granting signature authority over a deposit or share account and any notations normally made of specific identifying information verifying the signer's identity.

- d. Each statement or other record on each deposit or share account showing each transaction in, or with respect to, that account.
- e. Each check, clean draft or money order drawn on or issued and payable by the bank which is in excess of \$100 or any other item debiting the customer's account for more than \$100 (other than bank charges), except:
 - i. checks drawn on accounts which can be expected to have, on average, at least 100 checks per month over the calendar year, or
 - ii. on each occasion on which checks are issued, the checks are:
 - dividend checks
 - payroll checks
 - employee benefit checks
 - insurance claim checks
 - medical benefit checks
 - checks drawn on government agency accounts
 - checks drawn by brokers or dealers in securities
 - checks drawn on fiduciary accounts
 - checks drawn on another financial institution
 - pension or annuity checks
- f. Each item, including checks, drafts or transfers of credit, in excess of \$10,000 remitted or transferred to a person, account or place outside the United States.
- g. Records prepared or received by a bank in the ordinary course of business which would be needed to reconstruct a demand deposit account and to trace a check of \$100 deposited in the account through the domestic processing system or to supply a description of such check.
- h. A record containing the name, address and taxpayer identification number, if available,

of the purchaser of each certificate of deposit, together with a description of the instrument, a notation of the manner of payment and the date of the transaction.

- i. A record containing the name, address and taxpayer identification number, if available, of any person presenting a certificate of deposit for payment, and a description of the CD and the date of the transaction.
 - j. Each deposit slip or credit ticket (or the equivalent record for a direct deposit or other wire transfer) reflecting a transaction in excess of \$100.
 - k. Records of certain transactions in excess of \$10,000 involving persons, accounts, financial institutions, brokers or dealers in foreign exchange outside the United States.
3. Within 30 days from selling or redeeming a certificate of deposit or opening a deposit or share account, a bank must secure and maintain a record of the taxpayer identification number (TIN) of the customer involved or, if the certificate or account is in more than one name, the TIN of a person having a financial interest in the account.
- a. A bank that cannot obtain the customer's TIN within 30 days will not be in violation of this recordkeeping requirement if it made a reasonable effort to secure the TIN and maintains a list containing the name, address and account number of all persons from whom it has been unable to obtain a TIN. This information must be made available to the Secretary of Treasury as directed by him.
 - i. Under instructions issued by the Department of Treasury (39 F.R. 32336 (September 6, 1974)), the financial institution has 45 days to obtain a TIN. Reasonable effort by the bank should include mailing to the customer a written request for the TIN and informing the customer of its obligation to maintain (for use of the Department of Treasury) a list of persons for whom it has been unable to obtain TINs.
 - b. If the customer has applied for a TIN, the period for securing the TIN is extended until the customer has had a reasonable opportunity to obtain the TIN and furnish it to the bank.

- c. If a bank, acting as agent, purchases or redeems a CD issued by another bank, it must comply with the recordkeeping requirements. The issuing bank may comply with the requirements by recording the name and address of the agent, a description of the instrument and the date of the transaction.
 - d. 31 CFR 103.34(a)(3) exempts certain accounts or transactions from the TIN recordkeeping requirement. These include accounts or transactions with:
 - governmental agencies and instrumentalities
 - judges, public officials, or clerks of courts of record as custodians of funds in controversy or under the control of the court
 - persons opening a Christmas club, vacation club or similar installment savings program or who are under 18 and open an account as a part of a school thrift savings program, provided in each case annual interest is less than \$10.
 - e. The TIN recordkeeping requirement applies to accounts opened after June 30, 1972 and CDs redeemed or sold after May 31, 1978.
- E. Use of information reported under the Bank Secrecy Act.
- 1. The express purpose of the Bank Secrecy Act is to require banks to maintain records that "have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings." 12 U.S.C. §1829b(a).
 - 2. 31 CFR 103.43 outlines the circumstances in which information in reports filed under the Act can be disclosed to federal, state and local governmental agencies and Congress or congressional committees.
- F. Consequences of a Violation of the Bank Secrecy Act by Financial Institutions:
- 1. The federal banking regulatory agencies are responsible for monitoring compliance with the reporting and recordkeeping requirements under the Bank Secrecy Act by banks (e.g., the Office of the Comptroller in the case of national banks; the Federal Reserve in the case of a state bank which is a member of the Federal Reserve system; the FDIC in the case of a non-member insured state bank; and FHLBB in the case of FSLIC insured thrift institutions) (31 CFR 103.46).

- a. OCC Banking Circulars 49 (April 5, 1972) and 193 (April 24, 1985, as supplemented January 27, 1986, March 28, 1986 and March 16, 1988) address reporting and recordkeeping requirements. Banking Bulletin 86-12 (May 11, 1986) and revised Examining Circular 228 (May 28, 1986) outline OCC examination policies and procedures.
 - b. The OCC, FDIC and Federal Reserve have all notified banks that the Department of Treasury strongly encourages banks to report suspicious activity which is not otherwise reportable under the Bank Secrecy Act.
 - c. Releases and regulations require financial institutions to develop written compliance programs and to educate employees. See 12 CFR 21.21, 208.14, 326.8, 563.17-7.
2. Civil penalties may be imposed for violations of the Bank Secrecy Act requirements. Under 31 CFR 103.47, the current maximum penalties are as follows:
 - a. For any willful violation, civil penalties can be imposed against the bank and any of its partners, directors, officers or employees who participated in the violation.
 - i. For each violation of the recordkeeping requirements, the maximum penalty is \$1,000.
 - ii. For each violation of the reporting requirements, the maximum penalty is generally the greater of the amount involved in the transaction (subject to a \$100,000 maximum) or \$25,000.
 - b. A civil penalty of up to \$500 may be imposed on a bank for each negligent violation of any recordkeeping or reporting requirement.
 3. Criminal penalties may also be imposed for willful violations and for knowingly making false, fictitious or fraudulent reports under the Act (31 CFR 103.49). Penalties range from \$250,000 to \$500,000 maximum fines and 5 to 10 years maximum imprisonment.
 4. Subpart E of Part 103, Title 31 outlines the procedures the Secretary of Treasury (or his delegate) may use to conduct investigations for the purpose of civil enforcement of the Currency and

Foreign Transactions Reporting Act. These regulations, among other things, generally permit the summoning of banks, their employees and their records.

V. The Right to Financial Privacy Under State Law

- A. A bank customer's financial right of privacy and the bank's obligation not to disclose information about its customer
1. Could exist under a state's constitution or statutes
 2. Could arise based on the contract (express or implied) between the bank and its customer
 - a. Cases frequently cite the English case, Tournier v. National Provincial and Union Bank of England, 1 K.B. 461 (1923), in support of the principle that there is an implied term of confidentiality in the bank's contract with its customer. See Suburban Trust Co. v. Waller, 408 A.2d 758 (Md. App. 1979).
 3. Could arise under common law
 - a. Based on a fiduciary duty owed by the bank
 - b. In a tort action, such as a claim for invasion of privacy
- B. Some states have broad financial privacy acts, analogous to the federal Financial Privacy Act of 1978, which establish clear rules concerning when, and how, a financial institution can disclose information about its customer which it has obtained in the course of the banking relationship.
1. Kentucky does not have a comprehensive statutory scheme addressing the bank customer's right of financial privacy.
 2. KRS 287.271(2) requires Kentucky savings and loan associations, and its directors, officers and employees, to keep confidential the books and records pertaining to the accounts and loans of its members except where disclosure is compelled by a court of competent jurisdiction.
 - a. An exception is provided for disclosures pursuant to KRS 205.835. This section generally requires a financial institution to disclose to the Cabinet for Human Resources financial information about its customers who are applicants for or recipients of benefits

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under programs administered by the Cabinet. Applicants and recipients are required to consent in writing to such disclosures.

- b. KRS 289.271(1) gives each member of the association the right to inspect books and records pertaining to his loan or savings account. Otherwise, access is restricted to the Commissioner of the Department of Financial Institutions or his representatives, persons authorized to act for the association or federal agencies with regulatory authority over the association.
 3. For commercial banks, the only confidentiality provisions relate to the regulatory reports of examination.
 - a. A bank officer or director cannot release any information contained in an examination report unless [1] "required in a proper legal proceeding in which a subpoena and protective order insuring confidentiality has been issued by a court of competent jurisdiction," [2] in connection with the referral to a prosecuting attorney for possible criminal proceedings or [3] to persons rendering professional services to the bank or evaluating a possible acquisition of the bank in each case pursuant to written request which has been approved in advance by the bank's board of directors or its executive committee. KRS 287.470.
 4. KRS 131.130 authorizes the Kentucky Revenue Cabinet to examine a third party's records or documents if they will furnish knowledge concerning the tax liability of any taxpayer and to obtain a court order compelling compliance. KRS 131.190 generally requires the Cabinet to treat such records and documents confidentially.
 5. Under Rule 45.04 of the Kentucky Rules of Civil Procedure, a litigant could subpoena records of a bank in conjunction with taking the bank's deposition. Such a subpoena may be issued without court order, but, if the bank timely objects in writing, compliance with the subpoena will be stayed until a court order is obtained.
- C. The only reported case in Kentucky which addresses the relationship of a bank and its customer in the context of information disclosed to the bank is Henkin, Inc. v. Berea Bank & Trust Co., Ky. App., 566 S.W.2d 420 (1978).

1. That case arose in the context of a bank using, for its own proprietary purposes, information obtained from a customer to the detriment of the customer.
 2. The court found that a confidential and fiduciary relationship existed between the bank and its customer. The bank owed a fiduciary duty to the customer and had the duty to treat confidentially the information disclosed by the customer in the course of the banking relationship and could not use such information for its own advantage.
 3. A case of first impression, the court made clear that the absence of precedent in Kentucky is no ground for denying a customer relief for a bank's wrongdoing.
- D. Because of the lack of clear legislative or judicial guidelines in Kentucky, a bank generally should not disclose information about its customers to private parties or state or local agencies unless required to do so by a court order or pursuant to the customer's written consent. In each case, it generally should notify the customer before any disclosures are made so that the customer can litigate the question of whether such disclosures are unlawful.

Bibliography

L. Richard Fischer, The Law of Financial Privacy - A Compliance Guide (1983) and the 1988 Supplement (Warren, Gorham & Lamont)

Professional Bank Services, 1988 IRS Compliance (November 1988)

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Scott B. Schreiber and Richard M. Alexander, "Internal Bank Investigations - A Bank's Voluntarily Initiated Investigation May Forestall Agency Action or Reduce the Severity of Sanctions. Care is Required in Defining the Scope and Manner of Investigation, Determining Whether to Use General Counsel, and Protecting the Attorney-Client and Work-Product Privileges." Vol. 2 No. 19 The Review of Financial Services Regulation (November 12, 1986).

¹ An excellent book and research tool on which a significant portion of this outline was based.

Currency Transaction Report

OMB No. 1545-0183
Expires: 12-31-89
If amended report, see instructions and check here

▶ **File a separate report for each transaction.** ▶ **Please type or print.**
▶ **For Paperwork Reduction Act Notice, see page 3.**
(Complete all applicable parts—See instructions)

Part I Identity of individual who conducted this transaction with the financial institution

1 If multiple individuals involved, see instructions and check here

2 Last name	3 First name	4 Middle initial	5 Social security number
6 Address (number and street)		7 Occupation, profession, or business	
8 City	9 State	10 ZIP code	11 Country (if not U.S.)

12 Method used to verify identity:
b Issued by ▶ c Number ▶

13 Reason items 2-12 are not completed:
a Armored car service (enter name) ▶
b Mail deposit/shipment c Night deposit or ATM transaction d Multiple transactions (see instructions)

Part II Individual or organization for whom this transaction was completed

14 If multiple individuals or organizations are involved, see instructions and check here

15 Individual's last name	16 First name	17 Middle initial	18 Social security number
19 a Name of organization		b Check if: (1) <input type="checkbox"/> broker/dealer in securities, or (2) <input type="checkbox"/> financial institution (see instructions)	20 Employer identification number
21 Address (number and street)		22 Occupation, profession, or business	
23 City	24 State	25 ZIP code	26 Country (if not U.S.)

Part III Customer's account number(s) affected by transaction

27 Savings ▶ Securities ▶ CD/Money market ▶
 Checking ▶ Loan ▶ Other (specify) ▶

Part IV Type of transaction. Check applicable boxes to describe transactions

28 Currency exchange (currency for currency)

29 CASH IN: Deposit Security purchased Check purchased
 CD/Money market purchased For wire transfer Receipt from abroad Other cash in (specify) ▶

30 CASH OUT: Check cashed Security redeemed Withdrawal
 CD/Money market redeemed From wire transfer Shipment abroad Other cash out (specify) ▶

31 Total amount of currency transaction (in U.S. dollars). ▶ \$
32 Amount in item 31 in \$100 bills or higher \$
33 Date of transaction (month, day, and year)

34 If other than U.S. currency is involved, please furnish the following information:
a Exchange made for or from U.S. currency
b Currency name c Country d Total amount of each foreign currency (in U.S. dollars) . . ▶ \$

35 If a check or wire transfer was involved in this transaction, please furnish the following information (see instructions):
a If more than one check or wire transfer is involved, see instructions and check here
b Date of check or wire transfer c Amount of check or wire transfer (in U.S. dollars) \$
d Payee
e Drawer of check f Drawee bank and MICR number

Part V Financial institution where currency transaction took place

36 Check applicable box to indicate type of financial institution
b Savings and loan association c Credit union
a Bank (enter code number from instructions here) ▶
d Security broker/dealer e Other

37 Name of financial institution	38 Employer identification number		
39 Address (number and street)	40 Social security number		
41 City	42 State	43 ZIP code	44 MICR number

Sign Here ▶

45 Signature (preparer)	46 Title	47 Date
48 Type or print preparer's name	49 Approving official (signature)	50 Date

Multiple Transactions

(Complete applicable parts below if box 1, 14, or 35a on page 1 is checked)

Part I Continued—Complete if box 1 on page 1 is checked

2 Last name		3 First name		4 Middle initial	5 Social security number
6 Address (number and street)				7 Occupation, profession, or business	
8 City		9 State	10 ZIP code	11 Country (if not U.S.)	
12 Method used to verify identity:		a Describe ▶		c Number ▶	
b Issued by ▶					

2 Last name		3 First name		4 Middle initial	5 Social security number
6 Address (number and street)				7 Occupation, profession, or business	
8 City		9 State	10 ZIP code	11 Country (if not U.S.)	
12 Method used to verify identity:		a Describe ▶		c Number ▶	
b Issued by ▶					

Part II Continued—Complete if box 14 on page 1 is checked

15 Individual's last name		16 First name		17 Middle initial	18 Social security number
19 a Name of organization			b Check if: (1) <input type="checkbox"/> broker/dealer in securities, or (2) <input type="checkbox"/> financial institution (see instructions)		20 Employer identification number
21 Address (number and street)				22 Occupation, profession, or business	
23 City		24 State	25 ZIP code	26 Country (if not U.S.)	

15 Individual's last name		16 First name		17 Middle initial	18 Social security number
19 a Name of organization			b Check if: (1) <input type="checkbox"/> broker/dealer in securities, or (2) <input type="checkbox"/> financial institution (see instructions)		20 Employer identification number
21 Address (number and street)				22 Occupation, profession, or business	
23 City		24 State	25 ZIP code	26 Country (if not U.S.)	

Part IV Continued—Complete if box 35a on page 1 is checked

35 b Date of check or wire transfer		c Amount of check or wire transfer (in U.S. dollars) \$	d Payee
e Drawer of check		f Drawee bank and MICR number	

35 b Date of check or wire transfer		c Amount of check or wire transfer (in U.S. dollars) \$	d Payee
e Drawer of check		f Drawee bank and MICR number	

General Instructions

Paperwork Reduction Act Notice.—The Paperwork Reduction Act of 1980 says we must tell taxpayers why we are collecting this information, how we will use it, and whether you have to give it to us.

The requested information is useful in criminal, tax, and regulatory investigations. In addition to directing the Federal Government's attention to unusual or questionable transactions, the reporting requirement discourages the use of currency in illegal transactions. Financial institutions are required to provide the information under 31 CFR 103.22, 103.26, and 103.27.

The estimated average time needed to complete this form, depending on individual circumstances, is 41 minutes. If you have comments concerning the accuracy of this time estimate or suggestions for making this form more simple, we would be happy to hear from you. You can write to the Internal Revenue Service, Washington, DC 20224, Attention: IRS Reports Clearance Officer TR:FP; or the Office of Management and Budget, Paperwork Reduction Project, Washington, DC 20503.

Who Must File.—Each financial institution other than a casino must file a Form 4789 for each deposit, withdrawal, exchange of currency, or other payment or transfer, by, through, or to the financial institution, which involves a transaction in currency of more than \$10,000. Multiple transactions by or for any person which in any one day total more than \$10,000 should be treated as a single transaction, if the financial institution is aware of them.

Exemptions.—See 31 CFR 103.22(b) for exemptions from the filing requirements by banks on certain customers.

When and Where to File.—File this form by the 15th day after the date of the transaction with the Internal Revenue Service Detroit Computing Center, P.O. Box 32621, Detroit, MI 48232 ATTN: CTR, or hand carry it to your local IRS office. Keep a copy of each Form 4789 for 5 years from the date you file it.

Penalties.—Civil and criminal penalties (up to \$500,000) are provided for failure to file a report or to supply information, and for filing a false or fraudulent report. See 31 CFR, sections 103.47 and 103.49.

Definitions

Bank.—See 31 CFR 103.11 for the definition of a bank.

Currency.—The coin and currency of the United States or of any other country, which circulate in and are customarily used and accepted as money in the country in which issued. It includes United States silver certificates, United States notes, and Federal Reserve notes, but does not include bank checks or other negotiable instruments not customarily accepted as money.

Financial Institution.—Each agency, branch, or office in the United States of any person doing business in one or more of the capacities following:

- (1) a bank;
- (2) a broker or dealer in securities, registered or required to be registered with SEC under the Securities Exchange Act of 1934;

- (3) a person who engages as a business in dealing in or exchanging currency (for example, a dealer in foreign exchange or a person engaged primarily in the cashing of checks);
- (4) a person who engages as a business in issuing, selling, or redeeming traveler's checks, money orders, or similar instruments, except one who does so as a selling agent exclusively, or as an incidental part of another business;
- (5) a licensed transmitter of funds, or other person engaged in the business of transmitting funds abroad for others.

Person.—An individual, corporation, partnership, trust or estate, joint stock company, association, syndicate, joint venture, or other unincorporated organization or group, and all entities treated as legal personalities.

Transaction In Currency.—A transaction involving the physical transfer of currency from one person to another. A transaction in currency does not include a transfer of funds by means of bank check, bank draft, wire transfer, or other written order that does not include the physical transfer of currency.

Specific Instructions

Amended report.—If this amends a previously filed report, check the box in the upper right corner. Staple a copy of the previously filed report to this amended report and complete only those entries which you are correcting on the amended report.

Part I—Identity of individual who conducted the transaction.—This part must always be completed. If the individual conducts the transaction for another person, be sure to complete Part II also.

Box 1—Multiple individuals.—If two or more individuals conduct a transaction, check Box 1. All individuals must be positively identified. Enter information in Part I for one of the individuals. Complete the entry spaces on the back of the form for the other individuals. For example, a check made out to John Doe and Thomas Smith may be presented for payment at a financial institution. Both of the joint payees are present. Complete Part I on the front of the form for John Doe, and complete Part I on the back for Thomas Smith.

Items 2, 3, and 4—Name of person conducting transaction.—Enter the last name in Item 2, the first name in Item 3, and the middle initial in Item 4.

Item 5—Social security number.—A social security number must be provided if an individual is conducting the transaction for himself or herself. If the individual is conducting a transaction for another person or is a nonresident alien who does not have a social security number, write NONE in the space and complete Item 12.

Items 6, 8, 9, 10, and 11—Address.—Enter the permanent address, including ZIP code, of the individual who entered the financial institution to conduct the transaction. A P.O. Box number is not a street address.

Item 7—Occupation, profession, or business.—Fully identify the occupation, profession or business of the individual conducting the transaction; for example, secretary, carpenter, attorney, etc. Do not use nondescriptive terms such as merchant, self-employed, businessman, etc.

Item 12—Method used to verify identity.—All individuals (except employees of armored car services) conducting a currency transaction for themselves or for another person must be positively identified. For individuals who are established customers, identifying information previously obtained from the customer and in the financial institution's records may be provided. Statements such as "known customer" are not sufficient as identifying information. For U.S. citizens, ask to see and inspect a driver's permit or any other written identification document acceptable to the financial institution in normal check cashing operations. For an alien, ask to see and inspect his or her passport, alien ID card, or other official document showing nationality or residence. Enter the type of document in Item a, such as driver's license, signature card, charge card, passport, etc. Enter in Item b, the name of the state issuing the driver's permit, the name of the bank or store issuing the charge card, etc. Enter the number of the license, account, card, etc., in Item c.

Item 13—Reason Items 2-12 not completed; armored car service, mail, night deposit, or ATM transaction.—Check Box a if the transaction was a delivery by an armored car service licensed by a state or local government. Enter the name of the armored car service in the space provided.

Check Box b if the currency was received or shipped through the U.S. Postal Service.

Check Box c if the transaction was a night deposit or an ATM (automated teller machine) transaction.

Check Box d if this report involves multiple transactions that when totalled became a reportable transaction and the individual(s) who conducted the transactions cannot be identified.

If you check Box a, b, c, or d, you do not have to complete any other entries in Part I. However, be sure to complete Parts II, III, IV, and V.

Part II—Individual or organization for whom transaction was completed.—If the individual in Part I is conducting the transaction for himself or herself, do not complete Part II. In all other cases, including armored car service, mail, night deposit, or ATM transactions, complete Part II.

Box 14—Multiple individuals or organizations.—If this transaction is being conducted for more than one individual or organization, check Box 14, and complete the applicable entries on the back of the form. Do this also if the individual in Part I conducts a transaction that involves both himself or herself and another individual or organization.

Items 15, 16, and 17—Name of individual.—Enter the last name in Item 15, first name in Item 16 and middle initial in Item 17, of the individual for whom the transaction was completed.

Item 18—Social security number.—Enter the social security number of the individual for whom the transaction was completed. You will have this in your records. If the individual is a nonresident alien and does not have a social security number, write NONE in the space for the number.

Items 19 and 20—Organization's name and EIN.—If the transaction involves a business, show the business name in Item 19a, and the employer identification number (EIN) in Item 20. This is a 9-digit number shown as 00-0000000. If the organization does not have an EIN, write NONE in Item 20.

Check Box 19b(1) if the individual or organization is a broker or dealer in securities. Check Box 19b(2) if the individual or organization is a financial institution described in item (3), (4), or (5) under the *Definitions of a Financial Institution* on page 3.

Items 21, 23, 24, 25, and 26—Address.—Enter the permanent address including the ZIP code of the individual or organization for whom the transaction is completed in the appropriate boxes. If the address is outside the U.S., be sure to show the country in Item 26. A P.O. Box number is not a street address.

Item 22—Occupation, profession, or business.—Fully identify the occupation, profession, or business of the individual or organization for whom the transaction was completed. Use descriptive terms, such as securities broker, attorney, auto dealer, etc. Do not use nondescriptive terms, such as self-employed, merchant, businessman, etc.

Part III—Customer's account number affected by the transaction.

Box 27—Type of account and account number.—Check the boxes and enter the account numbers of the accounts affected by the transaction. If a deposit or withdrawal is made from a savings, checking, share, or other account, check the appropriate box and enter the account number. Other accounts would include all accounts with broker-dealers. If the transaction does not affect any account, make no entry in Part III. For example, a cashier's check purchased with cash may not affect any account and does not require any entry in this part. Please note that the code letters before the boxes are for IRS processing purposes.

Part IV—Type of transaction.—Check the boxes that describe the transaction. For international transactions with foreign financial agencies (banks, currency exchange dealers, securities dealers, etc.) involving receipts of currency for deposit, purchases of currency, withdrawal, shipments of currency for deposit, or sales

of currency, check the appropriate box "Receipts from abroad" or "Shipments abroad" in Item 29 or 30.

Box 28—Currency exchange.—Check this box if currency was exchanged for currency. This includes exchanging U.S. currency for foreign currency (be sure to complete Item 34) and vice versa. It also includes exchanging small denomination bills of U.S. currency for large denomination bills of U.S. currency, or vice versa.

Box 29—Cash in.—Check the appropriate box(es) when currency is received by the financial institution as part of a transaction.

Box 30—Cash out.—Check the appropriate box(es) when the financial institution pays out currency as part of a transaction.

Item 31—Total amount of currency.—Enter the total amount of currency in the transaction. If a transaction involves both currency and checks, such as a deposit transaction, enter only the amount of the currency.

Item 32—Amount in \$100 bills or higher.—Enter the amount of the total currency transaction reported in Item 31 that is in denominations of U.S. currency of \$100 or higher. For example, if the total currency transaction is \$100,000 and \$50,000 is in U.S. currency of \$100 or higher denominations, enter \$100,000 in Item 31 and \$50,000 in Item 32.

Item 33—Date.—Enter the month, day, and year of the currency transaction. Use the actual calendar date, not the banking day date.

Item 34—Foreign currency.—If the currency transaction involves a foreign currency, enter the information in the appropriate spaces. Enter the name of the currency in Item b, the country in Item c, and the total amount of the foreign currency in U.S. dollars in Item d. Check the appropriate box in Item a, if foreign currency was exchanged for U.S. currency or U.S. currency was exchanged for foreign currency. For example, a currency transaction involving Italian lira being deposited would have lira entered in Item b, Italy entered in Item c, and the amount, converted into U.S. dollars, entered in Item d. Since currency was not exchanged, no entry is made in item a. If currency of two or more foreign countries is involved in the transaction, attach a separate sheet of paper that clearly identifies the individual or organization for whom the transaction was completed (Items 15 through 20) and report the information for each foreign currency required by Item 34.

Item 35—Check or wire transfer.—If multiple checks or wire transfers are involved in the transaction, check Box a and furnish the information for one of the instruments on the front of the form and for the other instruments on the back of the form in the spaces provided. If you have to report more instruments than there are entry spaces, attach a sheet of paper that

clearly identifies the individual or organization for whom the transaction is completed (Items 15 through 20) and furnish the information for Items b through f for each check or wire transfer.

Date.—Enter the date shown on the check or the wire transfer of funds in Item b.

Amount.—Enter the amount of the check or wire transfer in Item c. Show the amount in U.S. dollars only.

Payee.—Enter the name of the individual or organization to whom the check or wire transfer of funds is made payable in Item d.

Drawer.—Enter the name of the individual or organization that wrote the check or who wire transferred funds in Item e.

Drawee bank and MICR number.—Enter the name of the bank and MICR number on which the check or wire transfer of funds is drawn in Item f.

Part V.—Financial institution where transaction took place.

Box 36—Type of financial institution.—Check the box that describes the type of financial institution you are.

Box 36a—Banks.—Enter the appropriate code number for the Federal agency that performs examinations for compliance with the Bank Secrecy Act regulations:

Code 1—Comptroller of the Currency

Code 2—FDIC

Code 3—Federal Reserve System

Code 4—None of the above

Items 37, 39, 41, 42, 43, and 44—Name, address, and MICR number.—Enter the full legal name, street address, city, State, ZIP code, and MICR number of the financial institution where the transaction occurred. *If the transaction occurred at a branch office, enter the complete street address and MICR number of the branch, not the headquarters' address and MICR number.* A P.O. Box number is not a street address. Enter the MICR number in Item 44.

Item 38—EIN.—Enter the financial institution's employer identification number (EIN).

Item 40—SSN.—If the financial institution does not have an EIN, enter the financial institution owner's social security number.

Items 45, 46, 47, and 48—Preparer's signature, title, and date.—Form 4789 must be signed in Item 45 by an individual authorized or designated by the financial institution to sign it. His or her title should be shown in Item 46 and the date of signature entered in Item 47. This signer's name should be typed or printed legibly in Item 48.

Items 49 and 50—Approving official's signature and date.—The official who reviews and approves the information on the form must sign in Item 49 and enter the date of signing in Item 50.



REGULATORY BODIES FOR FINANCIAL INSTITUTIONS:

FEDERAL ENFORCEMENT POWERS

John C. Deal
Emens, Hurd, Kegler & Ritter
Columbus, Ohio

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SECTION G

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FEDERAL ENFORCEMENT POWERS

By John C. Deal*

- I. Introduction. The Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve system ("Federal Reserve"), the Federal Deposit Insurance Corporation ("FDIC"), the Federal Home Loan Bank Board ("Bank Board"), the National Credit Union Administration ("NCUA"), and the Farm Credit Administration ("FCA") all have similar authority, but with some differences in authority to impose civil penalties or to terminate insurance. Most of the case law has been developed under the Federal Deposit Insurance Act. Citations are to the Federal Deposit Insurance Act or to Title 12, United States Code except where otherwise indicated. The Bank Board's authority is contained in section 5(d) of the Home Owner's Loan Act of 1933, 12 U.S.C. § 1464(d) and section 407 of the National Housing Act, 12 U.S.C. § 1730. The NCUA's authority is codified at 12 U.S.C. § 1786. The FCA's authority is codified at 12 U.S.C. §§ 2261-73.

- II. Involuntary Termination of Deposit Insurance under Section 8(a) of the Federal Deposit Insurance Act (12 U.S.C. § 1818(a)).
 - A. Grounds.
 1. Engaged or engaging in unsafe or unsound practices. The definition of this term has been developed by the courts in the context of cease-and-desist proceedings. Its essence is abnormally risky conduct.
 - a. Definition of "unsafe or unsound practice." The generally accepted view is that "these terms encompass what may be generally viewed as conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder." First National Bank of Eden v. Department of the Treasury, 568 F.2d 610, 611 n.2 (per curiam) (cease-and-desist order); accord, First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 685 (5th Cir. 1983) (cease-and-desist order).

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- b. Vagueness of the definition. The agencies initially tended to take the position that an unsafe or unsound practice was whatever they said it was.
 - i. "[W]hat may be an acceptable practice for an institution with a strong reserve position, such a concentration in higher risk lending, may well be unsafe or unsound for a marginal operation." Financial Institution Supervisory and Insurance Act of 1966: Hearings on S. 3158 Before The House Committee on Banking and Currency, 89th Cong., 2d Sess., 49-50 (1966).
 - ii. The pleadings in First National Bank of Eden v. Department of the Treasury, 568 F.2d 610 (8th Cir. 1978) (per curiam), described as an unsafe or unsound practice the "accumulation of certain unsafe assets in an amount constituting 37% of the Bank's gross capital funds."
 - c. Recent cases. Recent cases have defined the term more specifically.
 - i. Conflicts of interest tend to involve unsafe or unsound practices. E.g., First National Bank of LaMarque v. Smith, 610 F.2d 1258, 1265 (5th Cir. 1980) (credit life insurance). Increasingly, such conflicts of interest are also prohibited by statutes and backed up by civil penalty authority. See also, VII, infra.
 - ii. "The breadth of the 'unsafe or unsound practice' formula is restricted by its limitation to practices with a reasonably direct effect on an association's financial soundness." Gulf Federal Savings and Loan Association v. F.H.L.B.B., 651 F.2d 259, 264 (5th Cir. 1981).
2. Violated an applicable law, rule, regulation, order, condition imposed by the agency in connection with an application, or written agreement with the agency. See also, III.A.1.b., infra.

3. Unsafe or unsound condition. Under 12 C.F.R. § 325.4, a bank with a ratio of primary capital to adjusted total assets of less than three percent is deemed to be in an unsafe or unsound condition.

B. Procedure.

1. Notice of findings and order of correction.
 - a. To the primary regulator(s).
 - i. National banks - OCC
 - ii. Federal savings banks - Bank Board
 - iii. State banks - State authority
 - iv. State member banks - Federal Reserve
 - b. To the bank.
2. Statutory corrective period.
 - a. General rule - 120 days.
 - b. Short correction period 20-120 days.
 - i. Fixed by the FDIC where it determines that the insurance risk of the FDIC is unduly jeopardized.
 - ii. Fixed by a regulator notified that the FDIC intends to terminate insurance.
3. Determination of compliance with corrective order.
 - a. Examination.
 - i. Full or partial.
 - ii. FDIC's or other agency's.
 - b. Reports filed under section 7(a) of the FDI Act.
4. Notice of intention to terminate insurance.
 - a. Specification of uncorrected violations or practices.
 - b. Time and place of hearing.

5. Hearing.
6. Final order.
7. Judicial review.

III. Cease-and-Desist Orders.

A. Permanent orders under section 8(b) of the FDI Act. See also 12 U.S.C. §§ 1464(d)(2), 1730(e), 1786(e), and 2261.

1. Grounds. Permanent orders may be issued to stop unsafe or unsound practices, to stop violations of law, rule, regulation, or conditions imposed in connection with applications, or to stop violations of written agreements.

a. Engaged or engaging in an unsafe or unsound practice.

i. Definition of "unsafe or unsound practice." See II.A.1., supra.

ii. Confusion between grounds for permanent and temporary cease-and-desist orders. A permanent order may be issued where a violation or practice has been established in a hearing.

(a) To initiate proceedings for a permanent cease-and-desist order, a notice of charges must be issued under section 8(b)(1). The notice provisions apply to both types of orders. A temporary cease-and-desist order may only be issued in connection with a notice of charges. Grounds for the orders, however, are different. In the early banking agency cases, all of the notices of charges initiating proceedings for permanent orders were accompanied by temporary cease-and-desist orders. First National Bank of Eden v. Department of the Treasury, 568 F.2d 610, 611 (8th Cir. 1978); Groos National Bank v. Comptroller of the Currency, 573 F.2d 889, 893 (5th Cir. 1978); Mid America Bancorporation

v. Board of Governors, 523 F. Supp. 568, 572-73 (D. Minn. 1980). Mid America clearly recognized that there is a difference between the grounds for issuing a notice of charges and those for entering a permanent cease-and-desist order. Id. at 576. Grounds for a temporary order are found at III.B.1., infra.

(b) In contrast, the first two savings and loan cases, Gulf Federal SAVings and Loan Association v. F.H.L.B.B., 651 F.2d 259 (5th Cir. 1981), cert. denied, 458 U.S. 1121 (1982), and Otero Savings and Loan Association v. F.H.L.B.B., 665 F.2d 279 (10th Cir. 1981), and the fourth banking case, del Junco v. Conover, 682 F.2d 1338 (9th Cir. 1982), did not involve temporary orders.

(c) In First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 681 (5th Cir. 1983), a court for the first time used the "about to" language of section 8(b)(1) with reference to a final cease-and-desist order. Under the statute, only a temporary order can be issued where a bank is "about to" engage in an improper act.

iii. Confusion between practice and condition. "Practices" should normally be defined in terms of conduct (see II.A.1.a. supra), but there has been confusion between what is a practice and what is a condition.

(a) Either unsafe or unsound practices or an unsafe or unsound condition is grounds for termination of insurance. Therefore, the difference is not particularly important.

(b) A cease-and-desist order is appropriate only with respect to unsafe or unsound practices. Conditions,

whether or not unsafe or unsound, are remediable only to the extent they result from unsafe or unsound practices or violations. At least in terms of the statute, a financial institution could be in an unsafe or unsound condition that the agency could not deal with under cease-and-desist authority.

- (c) Ratios might normally be thought of as describing the condition of a bank or as describing conditions within the bank, but in First National Bank of Eden v. Department of the Treasury, 568 F.2d 610 (8th Cir. 1978), a ratio of problem loans to capital was pleaded as a practice.
 - (d) First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674 (5th Cir. 1983), assumed that the OCC could regulate a national bank's capital ratio under 12 U.S.C. § 1818(b) irrespective of whether that ratio was the result of an unsafe or unsound practice or violation, but set aside a final cease-and-desist order because the OCC's finding was not supported by substantial evidence.
 - (e) Section 908 of the International Lending Supervision Act, 12 U.S.C. § 3907, authorizes the banking agencies to "deem" the failure to maintain capital above a prescribed minimum to constitute an unsafe or unsound practice.
- b. Violated or violating a law, rule, regulation, or condition imposed by the agency in connection with the granting of an application or other request.
- i. Definition of "violates." Section 8(i)(2) defines "violates" as "includ[ing] without any limitation any action (alone or with another or others) for or toward causing, bringing about,

participating in, counseling, or aiding or abetting a violation." This definition seems to be limited to action rather than omission or failure to act.

- ii. Some courts may require that the violation itself involve an unsafe or unsound practice. Gulf Federal Savings and Loan Association v. F.H.L.B.B., 651 F.2d 259, 265 n.5 (5th Cir. 1981), cert. denied, 458 U.S. 1121 (1982):

"We pretermitted deciding whether violation of such laws would give rise to the Board's cease and desist power. The 'violation of law' provision of section 1464(d)(2)(A) may be subject to the same limits as the 'unsafe or unsound practice' provision. . . . If so, the cease and desist power would arise only when an association violates a law which protects the association's financial integrity."

Logically, such a position would extend to any use of the cease-and-desist power, meaning that an agency would have to establish an unsafe or unsound practice in every case. In Larimore v. Comptroller of the Currency, 789 F.2d 1244 (7th Cir. 1986) (en banc), it was held that the cease-and-desist power "may be properly invoked [by the Comptroller of the Currency] . . . in order that he might protect the consumers, the investors in the bank and the institution itself from further deterioration." Note that some courts may allow a mere cease-and-desist order, but deny affirmative relief for certain violations. See III.A.4.b., *infra*.

- iii. Specific enforcement authority need not be provided; the cease-and-desist power is enough. Otero Savings and Loan Association v. F.H.L.B.B., 665 F.2d 279 (10th Cir. 1981), held that the general delegation of authority to the Attorney General contained in 28 U.S.C. § 516 did not of itself preclude Bank Board enforcement of 12 U.S.C. § 1832. The court also held that no specific

delegation to the Bank Board, such as that found, for example, in the Truth in Lending Act, was required.

- c. Violated or violating a written agreement with the agency. Groos National Bank v. Comptroller of the Currency, 573 F.2d 889 (5th Cir. 1978).

2. Defenses.

- a. Amendment to statute. First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 683 and n.11 (5th Cir. 1983), held that where a violation of law had been corrected by amendment to the statute, a cease-and-desist order is appropriate, but no affirmative action should be awarded. Citizens State Bank of Marshfield, Missouri v. F.D.I.C., 751 F.2d 209, 216 (8th Cir. 1984) ("Marshfield II"), held that where a violation of law has been corrected by an amendment to the statute, a cease-and-desist order is arbitrary and capricious.
- b. Discontinuance. Marshfield II did not adopt the FDIC's position that cessation of violations is not a defense in cease-and-desist proceedings. The court vacated as an abuse of discretion a portion of the order relating to a violation caused by a disclosure form no longer in use. Id. at 215 n.9. Marshfield II requires some analysis of the circumstances surrounding the cessation. First State Bank of Wayne County v. F.D.I.C., 770 F.2d 81 (6th Cir. 1985), upheld a cease-and-desist order as warranted by the facts, noting that the cessation of violations or practices was not a bar to such an order.
- c. Stale violations. Marshfield II allowed the FDIC to base an order on certain old violations, finding no abuse of discretion. 751 F.2d at 214.

3. The problem of specificity in pleadings. Consistent with the confusion between practices and conditions, as well as a normal desire to minimize burdens of proof, the agencies have tended to plead conditions as if they were practices or to plead conditions and argue that they must inherently be the result of unsafe or

unsound practices. Violations and practices have been pleaded in a general manner, without noting time, place, and manner.

a. First National Bank of Eden v. Department of the Treasury, 568 F.2d 610 (8th Cir. 1978), supra, at II.A.1.b.ii.

b. Citizens State Bank of Marshfield, Missouri v. F.D.I.C., 751 F.2d 209, 214 n.5 (8th Cir. 1984) ("Marshfield II"):

"Although we need not reach the counter-argument actually asserted by the FDIC because we find a full and fair hearing on the facts, we emphatically reject its attempt to distinguish the cases we rely on here as involving violations not alleged in complaints rather than mere evidence omitted therefrom. The FDIC cannot seriously argue that it is adequate to just list regulation subsections violated without noting time, place and manner any more than it would be adequate for an indictment to charge "X robbed a bank" or a civil plaintiff to plead "Y was negligent." Whether material omitted from a complaint is characterized as "a violation" or merely "evidence" is irrelevant; the concern is either the material is necessary for the opposing party to adequately prepare a defense so that the matter may be fully litigated."

c. Lack of adequate notice must be raised at trial and objection must be made to evidence not within the scope of the pleadings. See also, Bank of Dixie v. F.D.I.C., 766 F.2d 175 (5th Cir. 1985).

4. Limitations of agency authority.

a. Parties or nonparties.

i. First National Bank of Eden v. Department of the Treasury, 568 F.2d 610 (8th Cir. 1978) (per curiam), upheld an order requiring reimbursement by persons who were not parties to the litigation.

ii. Groos National Bank v. Comptroller of the Currency, 573 F.2d 889 (5th Cir.

1978). The bank was prohibited from extending credit to Clinton Manges. Because Manges was in control of the bank, the Fifth Circuit dismissed the argument that he was unfairly treated because he was not a direct participant in the regulatory proceedings. Manges was a party in his individual capacity to the written agreement that was being enforced.

iii. The lack of clear statutory jurisdiction over individuals was resolved in favor of such jurisdiction over certain individuals in the Financial Institutions Regulatory and Interest Rate Control Act of 1978 ("FIRIRCA"), Pub. L. No. 95-630, 92 Stat. 3641. Directors, officers, employees, agents, or other persons participating in the bank's affairs are now specifically subject to section 8(b) and (c) orders. The legislative history of this provision of FIRIRCA is discussed in Larimore v. Comptroller of the Currency, 789 F.2d 1244 (7th Cir. 1985) (en banc).

iv. First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 684 (5th Cir. 1983), held that it is not necessary to name as parties the borrowers whose loans are alleged to be illegal.

v. Unresolved issues.

(a) Are individuals connected with bank holding companies and foreign banks subject to agency jurisdiction the same way bank officials are? Subsections 8(b)(3) and 8(b)(4) are unclear.

(b) Can jurisdiction attach to former officials? See V.C., infra.

b. Affirmative action. Assuming that any enforcement of the statute can be obtained (see III.A.1.b., supra), will affirmative action requirements be upheld?

- i. First National Bank of Eden v. Department of the Treasury, 568 F.2d 610 (8th Cir. 1978) (per curiam), upheld an order requiring reimbursement of excessive compensation.
- ii. Groos National Bank v. Comptroller of the Currency, 573 F.2d 889, 897 (5th Cir. 1978) held that the Comptroller could "within his allowable discretion, fashion relief in such a form as to prevent future abuses." Because the order essentially only enforced a written agreement, this statement was probably dictum. See the discussion of this point in Larimore v. Comptroller of the Currency, 789 F.2d 1244 (7th Cir. 1986) (en banc).
- iii. "Penalty box" rejected. Otero Savings and Loan Association v. F.H.L.B.B., 665 F.2d 279 (10th Cir. 1981), limited affirmative action to practices with a reasonably direct effect on a bank's financial stability. Id., at 291 (McKay, J., concurring).
- iv. Indemnification. In del Junco v. Conover, 682 F.2d 1338, 1340 (9th Cir, 1982), the Ninth Circuit phrased the test to be applied on review as "whether the affirmative action taken [sic] by the Comptroller was appropriate to correct the condition resulting from the Directors' violation of the banking laws." Relying chiefly upon Groos National Bank, the court upheld as within the OCC's broad discretion an order requiring directors of a national bank to indemnify it for losses incurred on illegal loans. In contrast, Larimore v. Conover, 789 F.2d 1244 (7th Cir. 1986) (en banc), found no authority for indemnification orders.
- v. The Fifth Circuit will require a safety and soundness purpose for any violation for which affirmative action is required. First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674 (5th Cir. 1983), upheld affirmative action provisions for

violations of 12 U.S.C. § 84, the single borrower lending limit, 12 U.S.C. § 29, involving the bank's holding unauthorized real estate, 12 U.S.C. § 375a, involving an illegal extension of credit to an officer, and 12 U.S.C. § 30, which requires OCC approval for relocation of a national bank's head office. The basis for upholding such affirmative action requirements, was the court's finding a safety and soundness purpose in 12 U.S.C. § 29 and 12 U.S.C. § 375a. Because the violation of 12 U.S.C. § 375a had been corrected by an amendment to the statute, the majority upheld only the portion of the order dealing with policies and procedures and not the requirement that the violation be corrected. The court made no such safety and soundness analysis of 12 U.S.C. § 30, perhaps because the violation occurred as a result of the bank's relocating without meeting the OCC's capital requirement. Nor was there any analysis of 12 U.S.C. § 84.

vi. Consumer protection. "Agency ordered reimbursement [in Truth in Lending Act cases] serves no function beyond that served by the civil remedy, and to allow the FDIC such power absent the restriction incorporated by the 1980 amendment would be to sanction administrative prescription of the statutory enforcement scheme designed by Congress." Citizen State Bank of Marshfield, Missouri v. F.D.I.C., 751 F.2d 209, 217 (8th Cir. 1984) (Marshfield II"). The Eighth Circuit "assume[d] that the FDIC has the power to order affirmative action following a violation . . . which does not constitute an unsafe or unsound practice," but observed that "[t]here is as of yet no clear answer" to the question. 751 F.2d at 209, 216 n.10.

vii. Unresolved issues.

(a) When does the restriction of authority of bank officials so impinge upon their functions as to

be in effect a removal? The administrative law judge in First State Bank of Wayne County v. F.D.I.C., 770 F.2d 81 (6th Cir. 1985), held that removal of lending authority would exceed the FDIC's statutory authority and be arbitrary and capricious.

- (b) Does some relief exceed the authority of anything other than an Article III court? Orders requiring what would amount to the payment of civil damages may be unconstitutional. This issue was left open in Citizens State Bank of Marshfield, Missouri v. F.D.I.C., 751 F.2d 209, 219 (8th Cir. 1984), and the subsequent case, Larimore v. Conover, 775 F.2d 890 (8th Cir. 1985) rev'd en banc, 789 F.2d 1244 (7th Cir. 1986).

B. Temporary orders under section 8(c) of the FDI Act.
See also 12 U.S.C. §§ 1464(d)(3), 1730(f), 1786(f), and 2262.

1. Grounds. The statute appears to authorize the use of a temporary cease-and-desist order to prevent actions whose occurrence would constitute grounds for a final order.
 - a. Any of the grounds (or threat thereof) for a permanent order; plus
 - b. The violation or threatened violation or practice or practices or the continuation thereof is likely prior to the completion of the proceedings to cause
 - i. Insolvency;
 - ii. Substantial dissipation of assets;
 - iii. Serious weakening the condition of the bank;
 - iv. Serious prejudice to the interest of depositors.
2. Affirmative action may be required as part of a temporary cease-and-desist order "to prevent such

insolvency, dissipation, condition, or prejudice pending completion of such proceedings."

3. At one time the FDIC took the position that it could impose civil penalties for violations of temporary cease-and-desist orders. See 12 C.F.R. § 308.74(a)(1). See also VIII, infra.

IV. Capital Directives.

A. Background.

1. First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674 (5th Cir. 1983), set aside as not supported by substantial evidence a portion of an OCC cease-and-desist order requiring additional capital.
2. Legislative history. Section 908 of the International Lending Supervision Act requires the OCC, Federal Reserve, and FDIC to establish minimum levels of capital for banks and provides for "directives" enforceable in district court in the manner that cease-and-desist orders are enforced.

B. Procedure. Under regulations (12 C.F.R. §§ 3.12 and .16-.19 (OCC); 268.32 (Fed); and 325.6 (FDIC), the appropriate agency will notify the bank of the agency's intent to issue a directive. The notice will include the amount or ratio to be required as well as the proposed deadline. The bank will have an opportunity to respond in writing if it does not consent to the proposed directive. Following consideration of the bank's response, if any, the agency may issue a directive or require the bank to submit an acceptable plan of its own.

C. Unresolved issues. The agencies may assert that capital directives are unreviewable or that they may impose civil penalties for failure to comply. See VII and VIII.B.2.c.i., infra.

V. Suspension or Removal Under Section 8(e). See also 12 U.S.C. §§1464(d)(4), 1730(g), 1786(g), and 2264.

A. Permanent removal orders.

1. Background.

- a. Financial Institutions Supervisory Act of 1966, Pub. L. No. 89-695, 80 Stat. 1028.

b. Expanded authority under FIRIRCA.

2. Grounds.

a. Conduct with respect to bank from which the person is being removed (Section 8(e)(1)). Authority to remove a bank officer under this provision extends only to misconduct related to his tenure at the particular bank. By itself, section 8(e)(1) can have no consequences upon the individual's ability to serve as an official of another bank. [Anonymous] v. F.D.I.C., 619 F. Supp. 866 (D.D.C. 1985). Under section 8(j), however, a final order under section 8(e)(1) also prohibits voting for a director or serving or acting as a director, officer, or employee of any bank without the prior written approval of the appropriate federal banking agency. Grounds under section 8(e)(1):

i. An officer or director of an insured bank ("subject person") has:

(a) Committed a violation of law, rule or regulation, or

(b) Committed a violation of a final cease and desist order, or

(c) Engaged or participated in an unsafe or unsound practice, or

(d) Committed or engaged in an act, omission, or practice constituting breach of a fiduciary duty imposed on the subject person in his capacity as officer or director, or

and

ii. As a result of the violation, practice, or breach of fiduciary duty:

(a) The bank has suffered substantial loss or other damage, or

(b) The bank will probably suffer substantial loss or other damage, or

(c) The interests of the bank's

depositors could be seriously prejudiced, or

- (d) The subject person has received financial gain

and

iii. The violation, practice, or breach of fiduciary duty:

- (a) Involved personal dishonesty, or

- (b) Demonstrated willful or continuing disregard for the bank's safety or soundness. "Willful or continuing disregard" constitutes two separate grounds for removal. The "disregard" standard may require some showing of knowledge. Brickner v. F.D.I.C., 747 F.2d 1198 (8th Cir. 1984).

- b. Conduct with respect to another insured bank or business institution (Section 8(e)(2)). This provision authorizes the removal of a bank official based upon misconduct related to his tenure at another insured bank or business institution. The removal must be based upon a bank-by-bank analysis of the individual's misconduct and the relationship of that misconduct to the individual's fitness to serve in the bank or banks from which he is being removed. [Anonymous] v. F.D.I.C., 619 F. Supp. 866 (D.D.C. 1985). This provision also authorizes the agency to prohibit participation in the affairs of the insured bank. Under section 8(j), moreover, a final order under section 8(e)(2) also prohibits voting for a director or serving or acting as a director, officer, or employee of any bank without the prior written approval of the appropriate federal banking agency. Grounds under section 8(e)(2):

i. Conduct or practice resulting in

- (a) Substantial financial loss, or

- (b) Other damage

and

ii. The conduct or practice

(a) Involved personal dishonesty, or

(b) Willful or continuing disregard for its safety and soundness.

and

iii. Evidenced unfitness to participate in the conduct of the affairs of the bank.

c. Violation of Depository Institution Management Interlocks Act (Section 8(e)(3)).

B. Temporary orders under section 8(e)(4). See also 12 U.S.C. §§ 1464(d)(4)(C), 1730(g)(3), 1786(g)(4), and 2264(c).

1. Grounds. The suspension must be necessary for the protection of the bank or the interests of its depositors.

2. Effect. Unlike final orders under section 8(e)(1), (2) or (3), a temporary suspension does not have the effect of prohibiting participation in the affairs of all insured banks, because that result comes under section 8(j), which only applies to final orders. [Anonymous] v. F.D.I.C., 619 F. Supp. 866 (D.D.C. 1985).

C. Removal following resignation. The FDIC has on occasion attempted to remove individuals following their resignation rather than using section 8(e)(2) when they attempt to return to the industry. In Boyd v. F.D.I.C., No. 3-84-896 (E.D. Tenn. May 3, 1985) (magistrate's report and recommendation, Murrian, Mag.), a U.S. magistrate recommended that the district court rule that the FDIC lacked such authority. The case was settled without a district court determination of the issue. See also, Somerfield v. F.D.I.C., 609 F. Supp. 128 (E.D. Tenn. 1985), where the court did not reach the issue of the FDIC's authority in this regard.

VI. Suspension in Criminal Cases Under Section 8(g). Note that suspension under subsection (g) is broader than under subsection (e)(4) because subsection (g) prohibits participation.

A. Background.

1. Feinberg v. F.D.I.C., 420 F. Supp. 109 (D.D.C. 1976), held the original version of section 8(g) unconstitutional on due process grounds.
2. FIRIRCA amendment. The amendment in FIRIRCA established notice and hearing rights, but no appeal rights.
3. Amended section 8(g) was held constitutional in United States v. Mallen, 108 S.Ct. 1780 (1988).

B. Grounds.

1. Initiation of criminal proceedings. An individual charged in an information, indictment, or complaint authorized by a U.S. Attorney with a felony involving dishonesty or breach of trust may be suspended if continued service or participation might pose a threat to the interest of the bank's depositors or threaten to impair public confidence in the bank. The grounds must arise during the individual's tenure, not before. Manges v. Camp, 474 F.2d 97 (5th Cir. 1973) (prior version of section 8(g)).
2. Post-conviction suspension. After conviction, the agency may suspend an individual if his continued service or participation would pose a threat to the bank's depositors or might threaten to impair public confidence in the bank.

VII. Civil Penalties.

A. Civil penalty authority is provided as follows:

<u>Authority</u> <u>12 U.S.C. §</u>	<u>Agency</u>	<u>Grounds (violation of)</u>
93(b)	OCC	12 U.S.C. § 92a and regs.
504	Fed, OCC	12 U.S.C. §§ 371c, 375, 375a, 376, 503
505	Fed	12 U.S.C. § 505
1464(5)(d)(8)	FHLBB	final cease-and-desist orders
1730a(j)	FSLIC	12 U.S.C. § 1730a
1730(k)	FSLIC	final cease-and-desist orders
1730(q)(16)	FSLIC	(willful) CS&LCA violations
1786(j)	FCUA	final cease-and-desist orders
1817(j)(15)	Banking Agencies	(willful) CBCA violations
1818(i)	Banking Agencies	final cease-and-desist orders
1828(j)	FDIC	12 U.S.C. §§ 371c, 375b
1847(b)	Fed	BHCA
1972	Banking Agencies	12 U.S.C. § 1972
2268	FCA	temporary or final cease-and-desist orders
3909	Banking Agencies	ILSA**

B. In Security National Bank v. Clarke, Nos. 86-637 and 86-876 (D.D.C. filed July 18, 1986), the court seemed to assume that civil penalty authority also existed for failure to comply with capital directives.

C. Fitzpatrick v. F.D.I.C., 765 F.2d 569 (6th Cir. 1985), upheld a penalty for violations of sections 22(h) and 23A of the Federal Reserve Act and Regulation O.

**At one time the FDIC took the position that it could impose civil penalties for "violations" of capital directives issued under ILSA. Current FDIC regulations do not claim such authority. See 12 C.F.R. § 308.74.

D. In Abercrombie v. Office of the Comptroller of the Currency, 833 F.2d 672 (7th Cir. 1987), the denial of a motion to enjoin a civil penalty proceeding was affirmed.

E. Other, seldom used, FDIC civil penalty authority:

<u>Authority</u> <u>(FDI Act §)</u>	<u>Grounds</u>
7(a)	Failure to file reports of condition
18(a)	Failure to advertise deposit insurance
18(g)	Illegal payment of interest
18(h)	Failure to pay insurance assessment
19	Employment of person convicted of a crime involving dishonesty

VIII. Judicial Review of Enforcement Orders.

A. The Administrative Procedure Act (5 U.S.C. § 703):

The form of proceeding for judicial review is the special statutory review proceeding relevant to the subject matter in a court specified by statute or, in the absence or inadequacy thereof, any applicable form of legal action, including actions for declaratory judgments or writs of prohibitory or mandatory injunction or habeas corpus, in a court of competent jurisdiction. If no special statutory review proceeding is applicable, the action for judicial review may be brought against the United States, the agency by its official title, or the appropriate officer. Except to the extent that prior, adequate, and exclusive opportunity for judicial review is provided by law, agency action is subject to judicial review in civil or criminal proceedings for judicial enforcement.

B. The Federal Deposit Insurance Act.

1. Statutory review.

a. Final orders under subsections (a), (b), and (e) may be appealed to the court of appeals for the circuit in which the home office of the bank is located or in the District of Columbia Circuit. Section 8(h)(2).

- b. Temporary cease-and-desist orders may be joined by the district court in which the home office of the bank is located or by the District Court for the District of Columbia. Section 8(c)(2). The only reported case reviewing a temporary cease-and-desist order is Mid America Bancorporation v. Board of Governors, 523 F. Supp. 568 (D. Minn. 1980).
- c. Temporary suspensions or prohibitions may be stayed by the district court in which the home office of the bank is located or by the District Court for the District of Columbia. Section 8(f). The only reported case arising under section 8(f) is [Anonymous] v. F.D.I.C., 619 F. Supp. 866 (D.D.C. 1985).
- d. Civil penalties imposed under the change in Bank Control Act are subject to a trial de novo in district court. Section 7(j)(15).
- e. Most other civil penalties are reviewable in the courts of appeals. Sections 8(i)(2)(iv) and 18(j)(3)(D). E.g., Abercrombie v. Office of the Comptroller of the Currency, 833 F.2d 672 (7th Cir. 1987).

2. The withdrawal statute and nonstatutory review.

- a. Section 8(i)(1) provides, in part, as follows:

[E]xcept as otherwise provided in this section no court shall have jurisdiction to affect by injunction or otherwise the issuance or enforcement of any notice or order under this section, or to review, modify, suspend, terminate or set aside any such notice or order.

For cases applying section 8(i)(1) see Groos National Bank v. Comptroller of the Currency, 573 F.2d 889 (5th Cir. 1978); First National Bank of Scotia v. United States, 530 F. Supp. 162 (D.D.C. 1982) and First National Bank of Grayson v. Conover, 715 F.2d 234 (6th Cir. 1983); Eastern National Bank v. Conover, 786 F.2d 192 (3d Cir. 1986); Abercrombie v. Office of the Comptroller of the Currency, 833 F.2d 672 (7th Cir. 1987).

- b. Circumstances in which nonstatutory review is available despite the withdrawal statute.
- i. Clear departure from statutory authority. There is a general rule that withdrawal statutes apply only where the agency is operating within the limits of its powers. Therefore, nonstatutory review may be obtained to make such a determination. Manges v. Camp, 474 F.2d 97 (5th Cir. 1973); Mid America Bancorporation v. Board of Governors, 523 F. Supp. 568, 574-7 (D. Minn. 1980); First National Bank of Scotia v. United States, 530 F. Supp. 162, 169 (D.D.C. 1982). In determining the limits of an agency's powers, no deference is to be accorded to the agency's construction. Gulf Federal Savings and Loan Association v. F.H.L.B.B., 651 F.2d 259, 263 (5th Cir. 1981); Citizens State Bank of Marshfield, Missouri v. F.D.I.C., 751 F.2d 209, 217 (8th Cir. 1984).
 - ii. Deprivation of life, liberty, or property without due process of law. Feinberg v. F.D.I.C., 522 F.2d 1335 (D.C. Cir. 1975). Mallen v. F.D.I.C., 667 F. Supp. 652 (S.D. Iowa 1986).
- c. Proceedings not covered by either statutory review or the withdrawal statute.
- i. Capital directives. Like most civil penalties, a capital directive is not issued under section 8, nor is it a notice or order. Unlike civil penalties, there is no statutory review available. Therefore, review would lie in district court. But see, Security National Bank v. Clarke, Nos. 86-637 and 86-876 (D.D.C. July 18, 1986).
 - ii. Civil penalties not added by FIRIRCA. See VII.C., supra.
- d. The exhaustion doctrine. The litigant seeking nonstatutory review will have to overcome traditional barriers to review such as the exhaustion doctrine. E.g., Mid-America Bancorporation v. Board of Governors, 523 F. Supp. 568, 576 (D. Minn. 1980); First

National Bank of Grayson v. Conover, 715 F.2d 234 (6th Cir. 1983). See also, Groos National Bank v. Comptroller of the Currency, 573 F.2d 889, 898 (5th Cir. 1978). The exhaustion doctrine is, in turn, limited by the requirement that the administrative process be "available," and that submission to that process cannot be an exercise in futility. Feinberg v. F.D.I.C., 420 F. Supp. 109, 114 (D.D.C. 1976).

IX. Agency Actions in District Court.

A. Injunctions.

1. General authority. F.D.I.C. v. Sumner Financial Corporation, 451 F.2d 898 (5th Cir. 1971) and F.D.I.C. v. D'Annunzio, 524 F. Supp. 694 (N.D. W.Va. 1981) held that the FDIC may sue for injunctive relief to vindicate statutes or regulations it administers. In F.D.I.C. v. Mallen, 661 F. Supp. 1003 (N.D. Iowa 1987), the court issued a preliminary injunction enforcing section 19 of the Federal Deposit Insurance Act, 12 U.S.C. §1829.

2. Specific authority.

- a. To compel reports of condition. Section 7(f).
- b. To restrain violations pertaining to uninsured banks. Section 18(g).
- c. To compel foreign bank to pledge assets. Section 5(c)(5).

B. Temporary orders. Temporary cease-and-desist orders may be enforced by injunction under section 8(d). A preliminary injunction enforcing a temporary order was issued in F.S.L.I.C. v. Apollo Savings, 285 F. Supp. 750 (N.D. Ill. 1968). The court held that the specific issue to be resolved was whether the temporary cease-and-desist order was violated.

C. Enforcement of final cease-and-desist orders.

1. Final cease-and-desist orders are normally enforced after a minimal evidentiary hearing establishing the existence of the order and a failure to comply. E.g., F.D.I.C. v. Sparta-Sanders State Bank, No. 82-104 (E.D. Ky. Oct. 6,

1982); see also F.H.L.B.B. v. Hooper, 656 F. Supp. 719 (W.D. Va. 1986).

2. At least one district court has been willing to listen to arguments that final cease-and-desist orders should not be enforced on laches grounds, noting that the courts are not "rubber stamps," but ultimately the court enforced the order. F.S.L.I.C. v. Glen Ellyn Savings and Loan Association, 606 F. Supp. 91 (N.D. Ill. 1984).

D. Civil penalties imposed under the Change in Bank Control Act (Section 7(j)(15)).

E. Contract actions to enforce written agreements.

1. The general rule is that parties cannot confer jurisdiction. E.G., Feinberg v. F.D.I.C., 420 F. Supp. 109, 121 n.29 (D.D.C. 1976).

2. Even assuming that there is federal question, diversity or other jurisdiction, there is a question whether Congress intended a federal cause of action for violation of written agreements.

X. Other FDIC Enforcement Tools.

A. Publication of reports of examination. Section 18(f), 12 U.S.C. § 1828(f).

B. Formal investigation. Section 10(c), 12 U.S.C. § 1820.

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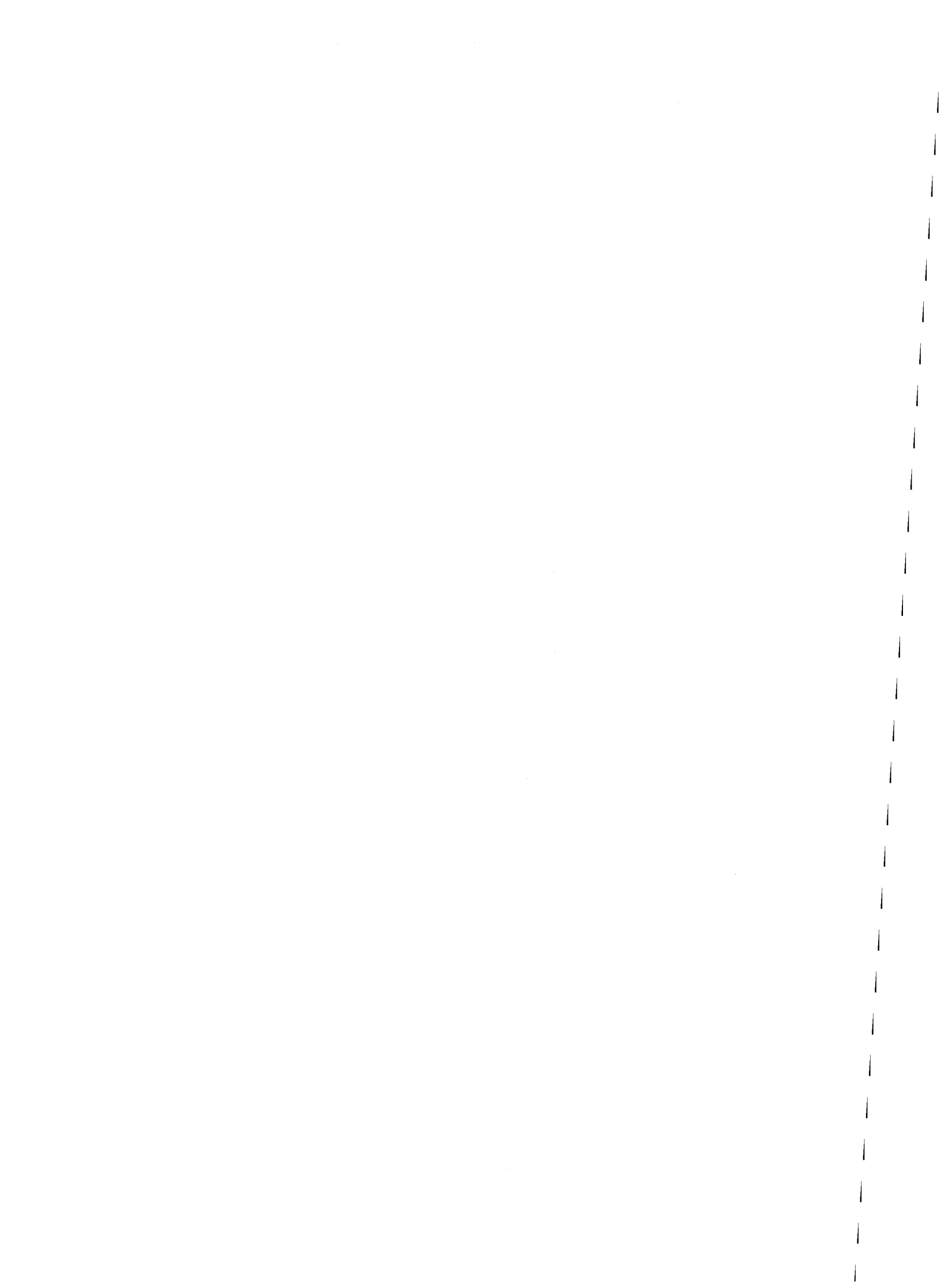
LOAN PARTICIPATION INTERESTS:

LEGAL ISSUES FOR THE PURCHASING COMMUNITY BANK

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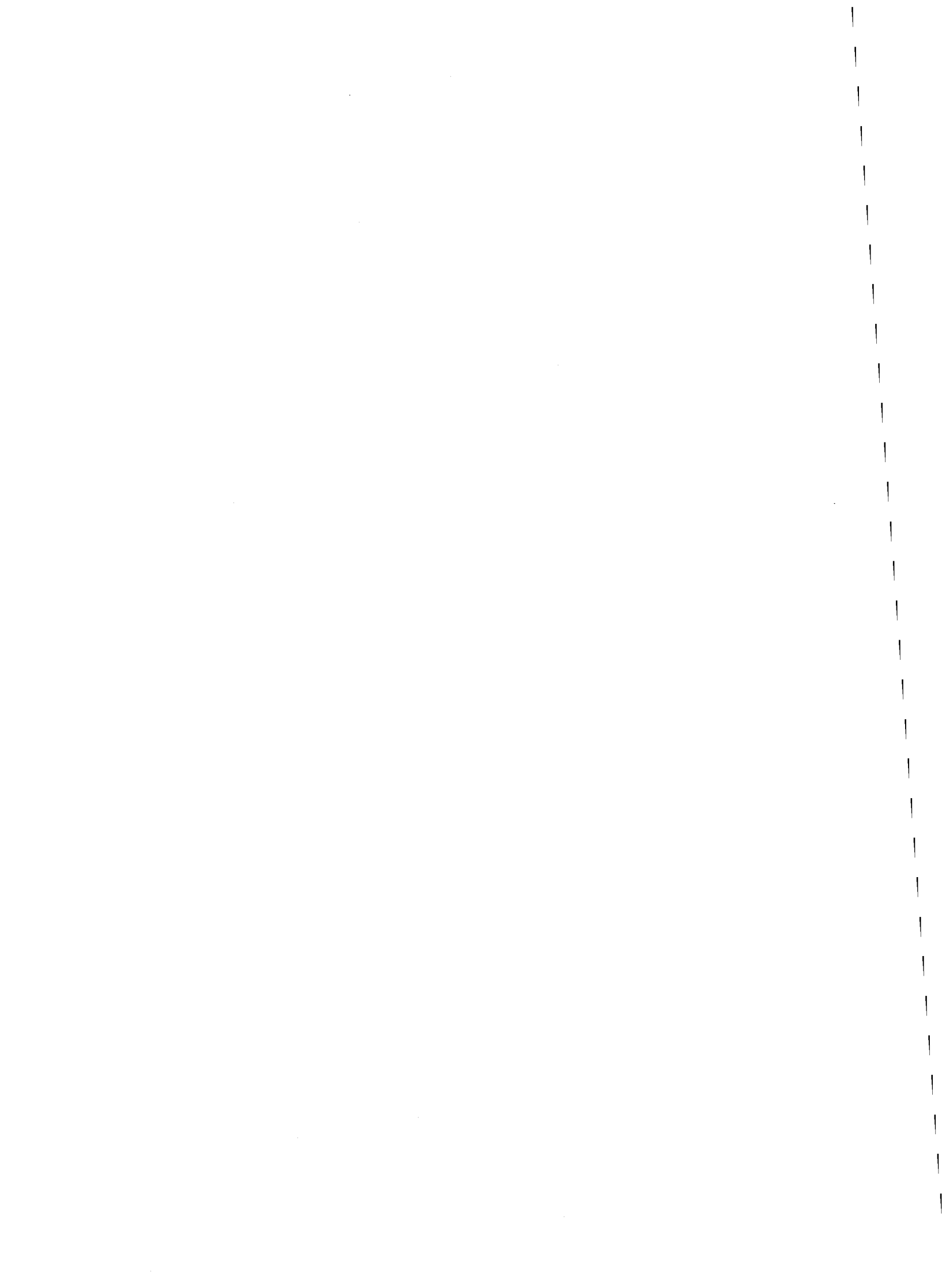
SECTION H



LOAN PARTICIAPTION INTERESTS:
LEGAL ISSUES FOR THE PURCHASING COMMUNITY BANK

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**LOAN PARTICIPATION INTERESTS: LEGAL
ISSUES FOR THE PURCHASING COMMUNITY BANK**

I. INTRODUCTION

A. General Structure of the Transaction.

1. A loan participation is generally considered the purchase by a financial institution (the "Participant") of an undivided interest in a loan originated and made by a separate financial institution (the "Lead Bank"). The participation interest is usually stated as a percentage of the loan, and it is not unique for the participation interest to equal 100% of the loan.
2. The loan in which the Participant purchases a participation interest has been made by the Lead Bank to an independent borrower (the "Borrower").
3. The Lead Bank will have prepared and negotiated the loan documents and will have undertaken to perfect all liens and security interests securing the loan, and all loan documents will be in the name of the Lead Bank and all collateral in which the Lead Bank has been granted a possessory security interest will be held by the Lead Bank.
4. The Borrower will deal directly with the Lead Bank and may not be aware of or on notice that other financial institutions own interests in the loan.
5. The sale of the participation interest is not usually accompanied by any change in possession of the loan documents or collateral or any change in the record holder of the liens and security interests securing the loan.
6. The Participant's participation interest in the loan will usually be evidenced by a participation certificate issued by the Lead Bank.

B. Objectives of the Transaction.

1. From the Lead Bank's perspective, the sale of participation interests in a loan originated by the Lead Bank may accomplish the following objectives:
 - a. The Lead Bank may avoid legal lending limitation problems.
 - i. See 12 U.S.C. Section 84 (applicable to national banks).
 - ii. See Kentucky Revised Statutes ("KRS") Section 287.280 (applicable to Kentucky chartered banks).
 - iii. Proviso: If the transaction is structured as a sale, but the Participant has rights of recourse against the Lead Bank, the transaction may nevertheless cause legal lending limitation problems for the Lead Bank.

- A. See 12 Code of Federal Regulations ("CFR") Section 32.104. (Where a bank purchases third-party paper subject to an agreement that the seller will repurchase the paper upon default or at the end of a stated period after default, the seller's obligation to repurchase is subject to 12 U.S.C. 84 and is measured by the total unpaid balance of the paper owned by the bank less any applicable dealer reserves. Where the seller's obligation to repurchase is limited, the seller's total loans or extensions of credit, for the purpose of 12 U.S.C. 84 are measured by the total amount of paper the seller may ultimately be obligated

to repurchase. Where no more than an agreed percentage of the purchase price is retained by the bank and credited to a reserve to be held as a form of collateral security, but the bank has no direct or indirect recourse to the seller, the loans or extensions of credit do not constitute loans or extensions of credit to the seller subject to the limitations of section 84.)

- B. See also 12 CFR Section 32.107(a). (When a bank sells a participation in a loan or extension of credit, including the discount of a bank's own acceptance, that portion of the loan that is sold on a nonrecourse basis will not be applied to the bank's lending limits. In order to remove a loan or extension of credit from a bank's lending limit, a participation must result in a pro rata sharing of credit risk proportionate to the respective interests of the originating and participating lenders. This is so even where the participation agreement provides that repayment must be applied first to the shares sold. In that case, the pro rata sharing may only be accomplished if the agreement also provides that, in case of a default or comparable event defined in the agreement, participants shall share in all subsequent repayments and

collections in proportion to the percentage of participation at the time of the occurrence of the event.)

- b. The Lead Bank will diversify the risk of the particular loan if the sale of the participation interest is without recourse to the Lead Bank.
 - c. The Lead Bank will increase its liquidity.
 - d. The Lead Bank may generate income from service fees received for servicing the loan.
2. From the Participant's perspective, the purchase of a participation interest in a loan originated by the Lead Bank can accomplish the following objectives:
- a. The Participant can increase its loan portfolio without incurring the costs normally associated with originating a loan.
 - b. The Participant may evade local laws relating to qualification of foreign corporations and usury.
 - c. The Participant may preserve a valued relationship by referral of a customer to the Lead Bank if the credit needs of such customer exceed the Participant's capabilities.

II. STRUCTURE OF THE TRANSACTION

- A. The transaction is usually structured as a sale of an undivided interest in the loan, as opposed to:
- 1. The sale of the entire loan, including the note evidencing the loan and all collateral securing the note; or
 - 2. A loan by the Participant to the Lead Bank.

- B. The structure of the transaction can have a profound impact on the Participant in the event of the insolvency of the Lead Bank, as discussed in Section III.B. below.
- C. The Lead Bank will usually resist constituting the transaction as a loan by the Participant to the Lead Bank in order to avoid an impairment of its credit standing and financial appearance.
- D. In determining whether the transaction is either a sale of a participation interest to the Participant or a loan by the Participant to the Lead Bank, the determination may depend upon whether the sale of the participation interest is recourse or non-recourse to the Lead Bank. If the sale of the participation interest is with recourse, the transaction may be determined to be a loan from the Participant to the Lead Bank. But see Stratford Financial Corp. v. Finex Corp., 367 F.2d 569 (2d Cir. 1966) (the existence of a guarantee from the lead bank as to repayment of a participant's advances in an accounts receivable financing does not convert the participation into a loan to the lead).

III. RISKS TO THE PARTICIPANT

- A. Insolvency of the Borrower. In a traditional loan participation, the Participant assumes the risk of insolvency of both the Borrower and the Lead Bank.
 - 1. The transaction is usually non-recourse to the Lead Bank, and if the Borrower becomes insolvent or a default otherwise occurs under the loan, the Participant shares pro rata in all losses suffered in respect of the loan (in the absence of a right of recovery against the Lead Bank for such losses).
 - 2. Although the Participant assumes the risks of the loan transaction, the Participant is not deemed to be a creditor of the Borrower solely by virtue of purchasing a participation interest in the loan. See In re Yale Express, Inc., 245 F. Supp. 790 (S.D.N.Y. 1965) (where second bank which had agreed to participate in first bank's advances to borrower which subsequently filed a petition for reorganization advanced money only to first bank, repayment of any amount advanced

was to be made by first bank and second bank's right to repayment would arise only upon receipt by first bank of payment from borrower, and all rights to amend substantial terms of credit agreement would lie solely with first bank, second bank was not a creditor entitled to set off the amount which borrower had with second bank at time of filing of petition.)

3. The Participant will, however, be deemed to have a secured interest in the collateral securing the participated loan as against creditors of the Borrower. See, e.g., In re Fried Furniture Corp., 293 F. Supp. 92 (1968), aff'd, 407 F.2d 360 (2d Cir. 1969). (Small Business Administration was properly found by bankruptcy referee to have a lien on proceeds of sale of bankrupt's chattels in situation where the Small Business Administration and bank each had an interest in loan to bankrupt, where it was not shown that creditors would in any way be prejudiced by form of bank's filing of financing statement, which indicated that the entire loan had been made by the bank); First State Bank v. Towboat Chippewa, 402 F. Supp. 27 (N.D. Ill. 1975) (where lead lender in participation agreement complied with the recording, endorsement, and declaration of citizenship requirements of the Shipping Act and the Ship Mortgage Act, participating lender, which supplied greater percentage of funds and which did not comply with the Acts, was still entitled to preferred status of mortgage executed by the borrower and the lead lender for purpose of financing purchase of towboat).

B. Insolvency of the Lead Bank. If the Lead Bank becomes insolvent, the interest of the Participant in the loan may be challenged by the trustee in bankruptcy or receiver of the Lead Bank and may be deemed to constitute an unsecured claim of the Participant against the Lead Bank.

1. The theory of the trustee in bankruptcy or receiver is that the Participant has failed to perfect its participation interest in the loan under state law and thus the Participant, rather than having a superior interest in

specific property held or controlled by the Lead Bank, has merely a general unsecured claim against the Lead Bank.

- a. If the transaction is structured as a sale of the entire loan to the Participant, as opposed to the sale of an undivided interest in the loan to the Participant, the transfer of the note to the Participant by negotiation or delivery may afford the Participant superior rights in the note if the note is negotiable and the Participant is a holder in due course of the note.
 - i. A sale of an instrument is not subject to Article 9 of the Uniform Commercial Code ("UCC"), and thus the trustee in bankruptcy may not be able to rely upon the "strong arm clause" embodied in 11 U.S.C. Section 544 to defeat the interests of the Participant in the Note. See Official Comment No. 2 to Section 9-102 of the UCC ("A sale of an instrument or general intangible is not within this Article,...").
 - ii. Continued possession of the note by the Lead Bank may enable a trustee in bankruptcy or receiver to defeat the Participant's rights in the note. See 4 Collier on Bankruptcy Chapter 541.08[5], at 541-51 (1979) ("Accordingly, regardless of the rights of the buyer, the seller's retention of possession may be fraudulent as to his creditors by the law of the state outside of the U.C.C. and if so, the trustee will defeat the claim of title or right to possession made by the buyer, using either Section 544(a) or (b)"). Further, under Section 3-603 of the UCC, payments on the note made to the Lead Bank may discharge the Borrower's liability as to those payments, and the Participant will have recourse solely against the Lead Bank for payment.

See also Section 3-301 of the UCC ("The holder of an instrument whether or not he is the owner may transfer or negotiate it and, except as otherwise provided in Section 3-603 on payment or satisfaction, discharge it or enforce payment in his own name.").

- iii. A sale of a note usually encompasses a sale of all collateral securing the note by operation of law, without requirement that the public records be amended to reflect the transferee of the note and the collateral. See Section 9-302(2) of the UCC ("If a secured party assigns a perfected security interest, no filing under this Article is required in order to continue the perfected status of the security interest against creditors of and transferees from the original debtor.").

- b. If the transaction is deemed by a court to constitute a loan by the Participant to the Lead Bank, and the Participant has failed to perfect its security interest in the collateral for such loan (which would be the loan documents and collateral pertaining to the loan made by the Lead Bank to the Borrower), the trustee in bankruptcy has the power under 11 U.S.C. Section 544 to cause the Participant's interest in the loan to be treated as an unsecured claim against the Lead Bank. 11 U.S.C. Section 544 is applicable if, on the date of bankruptcy of the Lead Bank, a hypothetical lien creditor of the Lead Bank would, under state law, have priority in the loan in which the Participant has purchased a participation interest over such interest of the Participant. Under such circumstances, Section 544 enables the trustee in bankruptcy to take title to the loan free and clear of the Participant's interest therein, and the Participant is deemed to be a general unsecured creditor of the Lead Bank.

2. A Participant has several arguments to counter the proposition that the trustee in bankruptcy or receiver for the Lead Bank has rights in the loan superior to the interest therein of the Participant.
 - a. Trust Theory. As a general rule, a trustee in bankruptcy acquires no rights in property to which the bankrupt is a fiduciary and held legal title for the benefit of the trust beneficiary. See 4 Collier on Bankruptcy Chapter 541.13, at 541-72 and 541-73 (1979) ("The rule is elementary that the estate succeeds only to the title and rights in the property that the debtor possessed although the trustee is armed, of course, with the special rights and powers conferred upon him by the Code itself"). See also Stratford Financial Corp. v. Finex Corp., 367 F.2d 569 (2d Cir. 1966) (Evidence sustained finding that trust, not debtor-creditor relationship, was created by first corporation, which was a Chapter XI debtor-in-possession, and second corporation, which had advanced \$40,000 to first corporation for interest in notes of third corporation held by first corporation, and that therefore there was no preference and second corporation was not required to return to first corporation \$25,000 received under arrangement by second corporation when first corporation endorsed to second corporation checks received from third corporation).
 - i. Contra In re Alda Commercial Corp., 327 F. Supp. 1315 (S.D.N.Y. 1971) (Even if arrangement between individual and finance company whereby individual was to participate in loans made by the finance company and secured by accounts receivable and to receive interest on the amount of his participation was in the nature of joint venture impressed with trust as between the parties, such relationship did not entitle individual, upon bankruptcy of the finance company, to

claim preferential interest in the accounts receivable securing the loans).

- ii. The assertion of the trust theory may be defeated if the Lead Bank has commingled payments on the loan with other funds of the Lead Bank. See 4 Collier on Bankruptcy Chapter 541.13 (1979).
 - iii. The assertion of the trust theory may be defeated under an estoppel theory if creditors of the Lead Bank can successfully demonstrate that such creditors extended credit to the Lead Bank in reliance upon the Lead Bank's apparent ownership of the trust property.
- b. Preferred Claim Theory. In the seminal case of Federal Deposit Insurance Corporation v. Mademoiselle of California, 379 F.2d 660 (9th Cir. 1967), the court asserted the theory that the participant in a loan has a "preferred claim" in the loan when the lead lender becomes insolvent if, but only if, the participant can clearly and certainly identify a specific fund or payment in the possession of the receiver for the lead bank cognizable in equity as its property.
3. Setoff Rights of the Federal Deposit Insurance Corporation ("FDIC").
- a. The FDIC can become the receiver for an insolvent bank upon appointment by the Comptroller of the Currency pursuant to 12 U.S.C. Section 1821(c).
 - b. The general rule is that a depositor in an insolvent bank has the right to set off any deposits in the bank against indebtedness owing to the bank. See Scott v. Armstrong, 146 U.S. 499 (1892).
 - c. Under both Mademoiselle of California and Chase Manhattan Bank, N.A. v. Federal

Deposit Insurance Corporation, 554 F. Supp. 251 (W.D. Okla. 1983), the mere set off of deposits against loan owing to insolvent bank in which participating bank has purchased a participation interest does not augment the insolvent estate and therefore does not generate funds which could become the basis for a preferred claim of the participant.

4. With respect to Kentucky chartered banks, Kentucky law provides that the rights of the Participant are superior to the rights of the receiver of the insolvent Lead Bank. KRS 287.874 provides:

The granting of a participation in a loan or other asset shall, unless otherwise expressly so stated in the participation agreement or certificate, constitute a sale and assignment of, and transfer of ownership in, a proportionate interest in the loan or other asset and in all security interests, guaranties, and other rights granted under the loan agreement, the note, and all documents of any nature related to the loan or other asset, whether such documents are contemporaneously or thereafter executed. The perfection of a security interest in personal property or the filing of a lien on real property by the selling bank shall be deemed perfection or filing on behalf of each participant, whether or not such participant shall be a participant at the time of such perfection or filing. Upon the closing of a bank under KRS 287.854, the receivership estate shall have no interest in such proportionate interests in the loan or other asset, or in any security therefor or any rights therein, therefore, sold a participant, such rights passing, to the extent such rights have not previously passed to the participant without further action on the part of the selling bank or participant. The receiver shall have no greater rights under any participation agreement than did the

closed bank immediately prior to its closing.

- a. The question to be determined is whether the preferred claim theory enunciated in Mademoiselle of California supersedes the rights afforded the Participant under this statute.
- C. The Lead Bank may attempt to sell the loan in which the Participant has a participation interest to a holder in due course or a bona fide purchaser for value, or may have pledged the loan to a creditor without knowledge of the Participant's interest therein. The sale or pledge of the note evidencing the loan, if the note is a negotiable note, to a holder in due course will defeat the Participant's participation interest in the loan under the authority of Sections 3-301 and 3-305(1) of the UCC. If the note is non-negotiable, the transfer of the note by the Lead Bank may create an estoppel in favor of the transferee, thus enabling the transferee to prevail over the Participant's rights in the loan evidenced by the note.
- D. The Lead Bank may receive payments on the participated loan without having remitted to the Participant its pro rata share thereof. Under the authority of Section 3-301 of the UCC, payments on a negotiable note made to the actual holder of the note will ordinarily discharge the obligor from liability with respect to such payments. Conversely, with respect to non-negotiable notes, Section 9-318 of the UCC suggests that the obligor on the note will be discharged from liability for payments made to the payee of the note if made without notice of the transfer of the note, even if the payee receiving such payments does not have possession of the note. The transferee of the non-negotiable note is obligated to give notice of the transfer of the note to the obligor thereon in order to preserve rights of recourse against the obligor for all payments made to the wrong person after the obligor has received such notice.
- E. The Lead Bank may release collateral for the participated loan without the consent or knowledge of the Participant, which release would be binding upon the Participant.

- F. The Lead Bank may refuse to enforce the note and the collateral for the loan, and the Participant may not have the right to enforce the note or collateral in its own name.
- G. The Lead Bank may be guilty of "lender liability" in administering the loan, with the result that the Participant suffers a pro rata loss due to any counterclaims successfully asserted by the Borrower in respect of its obligations under the loan.

IV. RIGHTS OF THE PARTICIPANT AGAINST THE LEAD BANK

- A. Rights Under the Participation Agreement.
 - 1. The Participation Agreement usually exculpates the Lead Bank from liability to the Participant for acts taken or not taken in administering the loan documents and the collateral for the loan, other than for gross negligence or willful misconduct of the Lead Bank in administering the loan documents and the collateral.
 - 2. The Participant may have a cause of action for breach of representations and warranties of the Lead Bank if the Participation Agreement includes representations and warranties of the Lead Bank and the Lead Bank breaches any one or more of them. Proviso: the typical Participation Agreement contains few, if any, representations and warranties of the Lead Bank.
- B. Rights Under Law. If the Participation Agreement is silent as to the standard of care imposed upon the Lead Bank in administering the loan documents and the collateral, or if there is no Participation Agreement, and the Participant suffers a loss with respect to its participation interest in the loan, the following causes of action may be available to the Participant depending upon the actions taken or not taken by the Lead Bank:
 - 1. Negligence. The elements of negligence under Kentucky law are:
 - a. A duty owed to the party injured;
 - b. A breach of the duty; and

- c. Injury suffered as a result of such breach.

See M & T Chemicals, Inc. v. Westrick,
Ky., 525 S.W.2d 740 (1974).

- i. The Participant, in order to succeed on a claim of negligence against the Lead Bank, must prove that the Lead Bank owed a duty of care to the Participant in the administration of the loan, the loan documents and the collateral for the loan, that the Lead Bank breached such duty of care and that the Participant suffered loss as a consequence of such breach.

- 2. Breach of Contract. The elements of breach of contract are:

- a. The existence of a contract;
- b. A breach of the contract; and
- c. Injury suffered as a result of such breach.

See Fannin v. Commercial Credit Corp.,
Ky., 249 S.W.2d 826 (1952).

- i. The Participant has the burden to prove that an enforceable contract existed between the Participant and the Lead Bank if there is no written Participation Agreement.
- ii. The Participant may have a statute of frauds problem if there is no written Participation Agreement. See KRS 371.010.

- 3. Fraud. The elements of fraud are:

- a. The defendant made a material representation to the plaintiff;
- b. The representation was false;

- c. The defendant knew the representation was false or the defendant made the representation recklessly without any knowledge of its truth, and as a positive assertion;
- d. The defendant made the representation with the intent that the plaintiff act in reliance upon it;
- e. The plaintiff acted in reliance upon the representation; and
- f. The plaintiff suffered injury as a result of acting in reliance upon the representation.

See Miles v. Proffitt, Ky., 266 S.W.2d 333 (1954).

- i. The Participant will not be able to rely on the anti-fraud provisions of the federal securities laws to assert a cause of action against the Lead Bank. Courts have consistently held that a participation interest in a loan is not a "security" within the meaning of the federal securities laws. See, e.g., Union Planters National Bank of Memphis v. Commercial Credit Business Loans, Inc., 651 F.2d 1174 (6th Cir. 1981) (loan participation agreement executed between plaintiff bank and defendant financial institution did not constitute a "security" in context of the applicable "risk capital" test and, hence, was not a basis for recovering under the Securities Exchange Act of 1934 and Rule 10b-5 promulgated pursuant thereto where the agreement was not an investment, but a routine commercial loan and, though both parties were engaged in a common venture to loan money, return expected by plaintiff was not capital appreciation, but simply the repayment of amounts advanced plus a fixed rate of interest, and efforts of the defendant were not managerial or entrepreneurial

in the sense that they generated the return expected by the parties.)

V. KEY ELEMENTS OF A PARTICIPATION AGREEMENTS

- A. The Participation Agreement should include a clear delineation of the respective rights, duties and obligations of the Lead Bank and the Participant.
- B. Duties of Participant.
 - 1. The primary duty of the Participant is to fund its pro rata share of the loan or each advance thereunder in accordance with the terms of the Participation Agreement.
 - 2. The Participant may also have a duty to indemnify the Lead Bank for costs and expenses incurred by the Lead Bank in enforcing the loan documents and the collateral securing the loan, to the extent of the Participant's pro rata share of the loan and to the extent such costs and expenses are not reimbursed by the Borrower or out of the proceeds of the collateral securing the loan.
- C. Rights of Participant.
 - 1. The Participant should have the right to receive timely its pro rata share of all payments made on the loan and all proceeds of the collateral securing the loan.
 - 2. The Participant should insist on having the right to participate in key decisions affecting the loan, such as changes in the interest rate on the loan, the amortization schedule of the principal of the loan and the due dates of principal and interest on the loan, the release of guarantors from liability for payment of the loan, the release of collateral securing the loan, the amendment of other key provisions in the loan documents, the waiving of defaults, and the acceleration of the maturity of the loan.
 - a. The Participation Agreement should include a provision whereby the Lead Bank and/or other Participants have the right to

purchase at par the participation interest of a "recalcitrant" Participant, in order to avoid tyranny by the minority.

3. The Participation Agreement should be clear that the Participant has no duty to fund the loan in excess of its pro rata share thereof, even if the Lead Bank and/or other Participants fail to fund their pro rata shares of the loan.
4. The Participant should have the right to share pro rata in all amounts realized by the Lead Bank and/or other Participants through exercise of the right of setoff against the Borrower.
5. The Participant should have the right to receive copies of all loan documents and all additional documents subsequently delivered by or on behalf of the Borrower to the Lead Bank.
6. The Participant should have the right to receive timely notice of all defaults under the loan documentation and timely notice of all other events coming to the attention of the Lead Bank which could affect the timely repayment of the loan.
7. The Participation Agreement should impose a clear duty of care on the part of the Lead Bank in administering payments received on the loan and in administering the loan documents and the collateral securing the loan.

VI. POLICY OF THE COMPTROLLER OF THE CURRENCY

- A. The Office of the Comptroller of the Currency (the "OCC") issued revised Banking Circular 181 on August 2, 1984, which sets forth policy guidelines for all national banks to observe in purchasing loans and loan participations (revised Banking Circular 181 is attached hereto as Appendix A).
- B. The major elements of revised Banking Circular 181 are as follows:
 1. Scope: The Circular describes prudent purchases of loans and loan participations.

2. Policy: The absence of satisfactory controls over risk may constitute an unsafe or unsound banking practice and thus cause for the OCC to seek appropriate corrective action through its administrative remedies. Satisfactory controls over the purchase of loans and participations in loans ordinarily include, but are not limited to, the following:
 - . written lending policies and procedures governing these transactions;
 - . an independent analysis of credit quality by the purchasing bank;
 - . agreement by the obligor to make full credit information available to the selling bank;
 - . agreement by the selling bank to provide available information on the obligor to the purchaser; and
 - . written documentation of recourse arrangements outlining the rights and obligations of each party.

3. Lending Policy and Procedures: Prudent purchases of loans, loan participations, and loan portfolios are governed by the credit principles and procedures embodied in the purchasing bank's formal lending policy. The policy ordinarily entails:
 - . complete analysis and documentation of the credit quality of obligations to be purchased;
 - . an analysis of the value and lien status of the collateral; and
 - . the maintenance of full credit information on the obligor during the term of the loan.

4. Independent Credit Analysis: To make a prudent credit decision, a purchaser conducts an independent credit analysis to satisfy itself that a loan, loan participation, or loan portfolio is a credit which it would make directly. The nature and extent of the independent analysis is a function of the type of transaction at issue and the purchaser's lending policies and procedures. Where loans are purchased in bulk, for example, a prudent

purchaser might assess the credit of the class of obligors rather than each obligor.

The acceptance by a purchaser of a favorable analysis of a loan issued by the seller, a credit rating institution, or another entity does not satisfy the need to conduct an independent credit analysis. A prudent purchaser may, however, consider such analyses obtained from the seller and other sources as factors when independently assessing a loan.

A prudent purchaser needs full credit information on an obligor before a loan or participation is purchased to make an informed and independent evaluation of the credit. After the purchase is made, the purchaser also needs timely credit information to monitor the status of the credit. Such information can often be obtained from the seller. In some situations, however, the purchaser may be unable to conduct an informed and independent analysis with information furnished by the selling or servicing bank. In such cases, other sources of information are needed to conduct an independent credit analysis.

5. Transfers of Credit Information:

- a. Prudent Transfer Agreements. The indirect relationship between the obligor and the purchaser makes it difficult for the purchaser to assess the quality of the loan without the cooperation of the selling or servicing bank. The purchaser ordinarily needs to obtain full credit information on the obligor from the selling or servicing bank at the outset and during the life of the participation to perform a continuing independent assessment of the credit. Thus, a prudent purchase or participation document would generally include an agreement by the selling or servicing bank to provide available credit information on the obligor to the purchasing bank on a continuing basis. To ensure that full credit information will be available to the seller, a loan document would ordinar-

ily include an agreement by the obligor to furnish such information to the seller on a continuing basis.

The absence of prudent transfer agreements may affect a purchaser's ability to obtain, assess, and maintain sufficient credit information. Accordingly, the purchase of a loan or participation absent such transfer obligations may be viewed as an unsafe or unsound banking practice.

b. Scope of Prudent Transfers. Prudent transfers of credit information are sufficient in scope so as to enable a purchaser to make an informed and independent credit decision. Thus, prudent transfers encompass full and timely financial and nonfinancial information bearing on the quality of a loan. Financial information ordinarily includes:

- . accrual status;
- . status of principal and interest payments;
- . financial statements, collateral values, and lien status; and
- . any factual information bearing on the continuing credit-worthiness of the obligor.

Prudent transfers also include nonfinancial information bearing on credit-worthiness. For example, any known changes in the obligor's corporate structure or management affecting the quality of a loan would generally be disclosed.

Ordinarily, full credit information is obtained on each obligor. Where loans are purchased in bulk, however, a prudent purchaser might obtain credit information on the class of obligors rather than each obligor.

Prudent transfers of full credit information do not encompass the release of information in violation of law. In particular, loan classification informa-

tion and other examiner opinions are set forth in confidential reports of examination and documents relating thereto. Such materials and information derived from them may not be disclosed absent express written approval by the Comptroller of the Currency pursuant to 12 C.F.R. §4.18(c). Unauthorized disclosures may also incur criminal penalties under 18 U.S.C. §641. In contrast, the facts underlying examiners' loan criticisms would generally be furnished; a knowing misrepresentation of credit quality may constitute a violation of 18 U.S.C. §1014.

VII. ALTERNATIVES TO PARTICIPATION INTERESTS

- A. In order to avoid certain of the risks and problems associated with the purchase of a non-recourse participation interest in a loan, the Participant may want to consider negotiating an inter-creditor agreement with each bank proposing to participate in the making of the loan.
- B. The primary characteristics of an inter-creditor agreement are:
 - 1. The Borrower issues a separate promissory note to each Participant in the amount of its pro rata share of the loan.
 - 2. Each Participant is named as a party to the loan agreement.
 - 3. Each Participant is named as a party to each collateral instrument or, alternatively, the Participants select a Participant to serve as the collateral agent for the Participants and all collateral instruments clearly reflect that the Participant is an agent of all of the Participants.
 - 4. All decisions relative to the loan, the loan documentation and the collateral for the loan are made jointly by the Participants, either unanimously or by a stipulated super-majority vote.

- C. By virtue of the inter-creditor agreement, the Participant is a direct creditor of the Borrower, which:
1. Creates a right of setoff in favor of the Participant with respect to the Borrower.
 2. Eliminates the problems and risks arising upon the insolvency of the Lead Bank.

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type **BANKING CIRCULAR**

Subject: **PURCHASES OF LOANS
IN WHOLE OR IN
PART-PARTICIPATIONS**

TO: Chief Executive Officers of all National Banks, Senior Officer of all Federal Branches and Agencies, Deputy Comptrollers, District Administrators and all Examining Personnel

SUMMARY

The purchase of loans and participations in loans may constitute an unsafe or unsound banking practice in the absence of satisfactory documentation, credit analysis, and other controls over risk.

REVISION OF CIRCULAR

The present Circular supersedes Banking Circular 181, issued on December 8, 1983.

SCOPE

This Circular describes prudent purchases of loans and loan participations. A participation, as distinguished from a multibank loan transaction (syndicated loan), ^{1/} is an arrangement in which a bank makes a loan to a borrower and then sells all or a portion of that loan to a purchasing bank.^{2/} All documentation of the loan is drafted in the name of the selling bank. Generally, the purchasing bank's share of the participated loan is evidenced by a certificate which assigns an interest in the loan and any related collateral.

^{1/} This Circular was drafted to address safety and soundness concerns arising from the purchase of loans and participations in loans. Nevertheless, the practices outlined in this Circular are illustrative of those principles of prudent banking which generally apply to any multibank lending transaction. For example, a prudent member of a loan syndication would obtain full and timely credit information to conduct an informed and independent analysis of the credit in a manner consistent with its formal lending policies and procedures.

^{2/} For the purposes of this Circular, a "loan" includes any binding agreement to advance funds on the basis of an obligation to repay the funds.



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BACKGROUND

The purchase and sale of loans and participations in loans are established banking practices. These transactions serve legitimate needs of the buying and selling banks and the public interest. However, recent abuses have highlighted the need for the Office to remind banks of prudent banking practices for these transactions.

POLICY

The absence of satisfactory controls over risk may constitute an unsafe or unsound banking practice and thus cause for the OCC to seek appropriate corrective action through its administrative remedies. Satisfactory controls over the purchase of loans and participations in loans ordinarily include, but are not limited to, the following:

- . written lending policies and procedures governing these transactions;
- . an independent analysis of credit quality by the purchasing bank;
- . agreement by the obligor to make full credit information available to the selling bank;
- . agreement by the selling bank to provide available information on the obligor to the purchaser; and
- . written documentation of recourse arrangements outlining the rights and obligations of each party.

Lending Policy and Procedures

Prudent purchases of loans, loan participations, and loan portfolios are governed by the credit principles and procedures embodied in the purchasing bank's formal lending policy. The policy ordinarily entails:

- . complete analysis and documentation of the credit quality of obligations to be purchased;
- . an analysis of the value and lien status of the collateral and
- . the maintenance of full credit information on the obligor during the term of the loan.

Comptroller of the Currency
Administrator of National Banks

Type BANKING CIRCULAR

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Independent Credit Analysis

To make a prudent credit decision, a purchaser conducts an independent credit analysis to satisfy itself that a loan, loan participation, or loan portfolio is a credit which it would make directly. The nature and extent of the independent analysis is a function of the type of transaction at issue and the purchaser's lending policies and procedures. Where loans are purchased in bulk for example, a prudent purchaser might assess the credit of the class of obligors rather than each obligor. See generally Comptroller's Handbook for National Bank Examiners at § 205 (guidelines on loan portfolio management).

The acceptance by a purchaser of a favorable analysis of a loan issued by the seller, a credit rating institution, or another entity does not satisfy the need to conduct an independent credit analysis. A prudent purchaser may, however, consider such analyses obtained from the seller and other sources as factors when independently assessing a loan.

A prudent purchaser needs full credit information on an obligor before a loan or participation is purchased to make an informed and independent evaluation of the credit. After the purchase is made, the purchaser also needs timely credit information to monitor the status of the credit. Such information can often be obtained from the seller. In some situations, however, the purchaser may be unable to conduct an informed and independent analysis with information furnished by the selling or servicing bank. In such cases, other sources of information are needed to conduct an independent credit analysis.

Transfers of Credit Information

(a) Prudent Transfer Agreements. The indirect relationship between the obligor and the purchaser makes it difficult for the purchaser to assess the quality of the loan without the cooperation of the selling or servicing bank. The purchaser ordinarily needs to obtain full credit information on the obligor from the selling or servicing bank at the outset and during the life of the participation to perform a continuing independent assessment of the credit. Thus, a prudent purchase or participation document would generally include an agreement by the selling or servicing bank to



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provide available credit information on the obligor to the purchasing bank on a continuing basis. To ensure that full credit information will be available to the seller, a loan document would ordinarily include an agreement by the obligor to furnish such information to the seller on a continuing basis.^{3/}

The absence of prudent transfer agreements may affect a purchaser's ability to obtain, assess, and maintain sufficient credit information. Accordingly, the purchase of a loan or participation absent such transfer obligations may be viewed as an unsafe or unsound banking practice.

(b) Scope of prudent transfers. Prudent transfers of credit information are sufficient in scope so as to enable a purchaser to make an informed and independent credit decision. Thus, prudent transfers encompass full and timely^{4/} financial and nonfinancial information bearing on the quality of a loan. Financial information ordinarily includes:

- . accrual status;
- . status of principal and interest payments;
- . financial statements, collateral values, and lien status; and
- . any factual information bearing on the continuing credit-worthiness of the obligor.

^{3/} The Office does not intend to suggest that existing loan and participation agreements be renegotiated where full credit information is being furnished. Nonetheless, the Office may take appropriate action in any case where less than full credit information is obtained.

^{4/} References to "full" and "timely" transfers of credit information are made herein to provide supervisory guidelines on safe and sound transfers of credit information. The guidelines describe the scope of transfers required for a purchaser to make an informed and independent credit decision. Apart from such supervisory considerations, use of the terms "full" and "timely" is not intended to suggest that the terms have particular legal significance; thus, other terms may be used. The drafting and negotiation of standards governing transfers of credit information is the responsibility of bank management and counsel.

BANKING ISSUING

Comptroller of the Currency
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Type	BANKING CIRCULAR	Subject	PURCHASES OF LOANS IN WHOLE OR IN PART-PARTICIPATIONS
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Prudent transfers also include nonfinancial information bearing on creditworthiness. For example, any known changes in the obligor's corporate structure or management affecting the quality of a loan would generally be disclosed.

Ordinarily, full credit information is obtained on each obligor. Where loans are purchased in bulk, however, a prudent purchaser might obtain credit information on the class of obligors rather than on each obligor.

Prudent transfers of full credit information do not encompass the release of information in violation of law. In particular, loan classification information and other examiner opinions are set forth in confidential reports of examination and documents relating thereto. Such materials and information derived from them may not be disclosed absent express written approval by the Comptroller of the Currency pursuant to 12 C.F.R. § 4.18(c). Unauthorized disclosures may also incur criminal penalties under 18 U.S.C. § 642. In contrast, the facts underlying examiners' loan criticisms would generally be furnished; a knowing misrepresentation of credit quality may constitute a violation of 18 U.S.C. § 1014.

Recourse Arrangements

Repurchase agreements are subject to the limitations of 12 U.S.C. § 84. Other direct or indirect recourse arrangements, written or oral, provided by the selling bank will be considered as extensions of credit to the selling bank subject to 12 U.S.C. § 84. See 12 C.F.R. §§ 32.104 and 32.107.

Prudent recourse arrangements are documented in writing and reflected on the books and records of both the buying and selling bank. The failure to properly record or document these arrangements may constitute a false entry, statement, report or representation in violation of 18 U.S.C. § 1005.

ORIGINATING OFFICE

Questions regarding this Circular may be directed to the Chief National Bank Examiner's Office, Commercial Examinations Division (202) 447-1165, and to the Legal Advisory Services Division (202) 447-1880.

H. Joe Selby
Senior Deputy Comptroller
Bank Supervision



**BANKING ISSUES COMMON TO COMMUNITY
BANKS AND THEIR BANK HOLDING COMPANIES**

A Roundtable Discussion
Among

David W. Harper, Moderator
Hirn Reed Harper & Eisinger
Louisville, Kentucky

John J. Holzknecht
Professional Bank Services, Inc.
Louisville, Kentucky

William L. Montague
Stoll, Keenon & Park
Lexington, Kentucky

R. James Straus
Brown Todd & Heyburn
Louisville, Kentucky

Presented at the 9th Annual Seminar on
"Legal Issues For Financial Institutions"
Sponsored by the University of Kentucky
College of Law in Cooperation With
the Kentucky Bankers Association

March 11, 1989

Section I

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