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8th Annual Seminar on Legal Issues for Financial Institutions

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

M. Brooke Senn
Senn, Miller & Smith

Keith G. Hanley
Brown, Todd and Heyburn

R. David Lester
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David C. Pottinger
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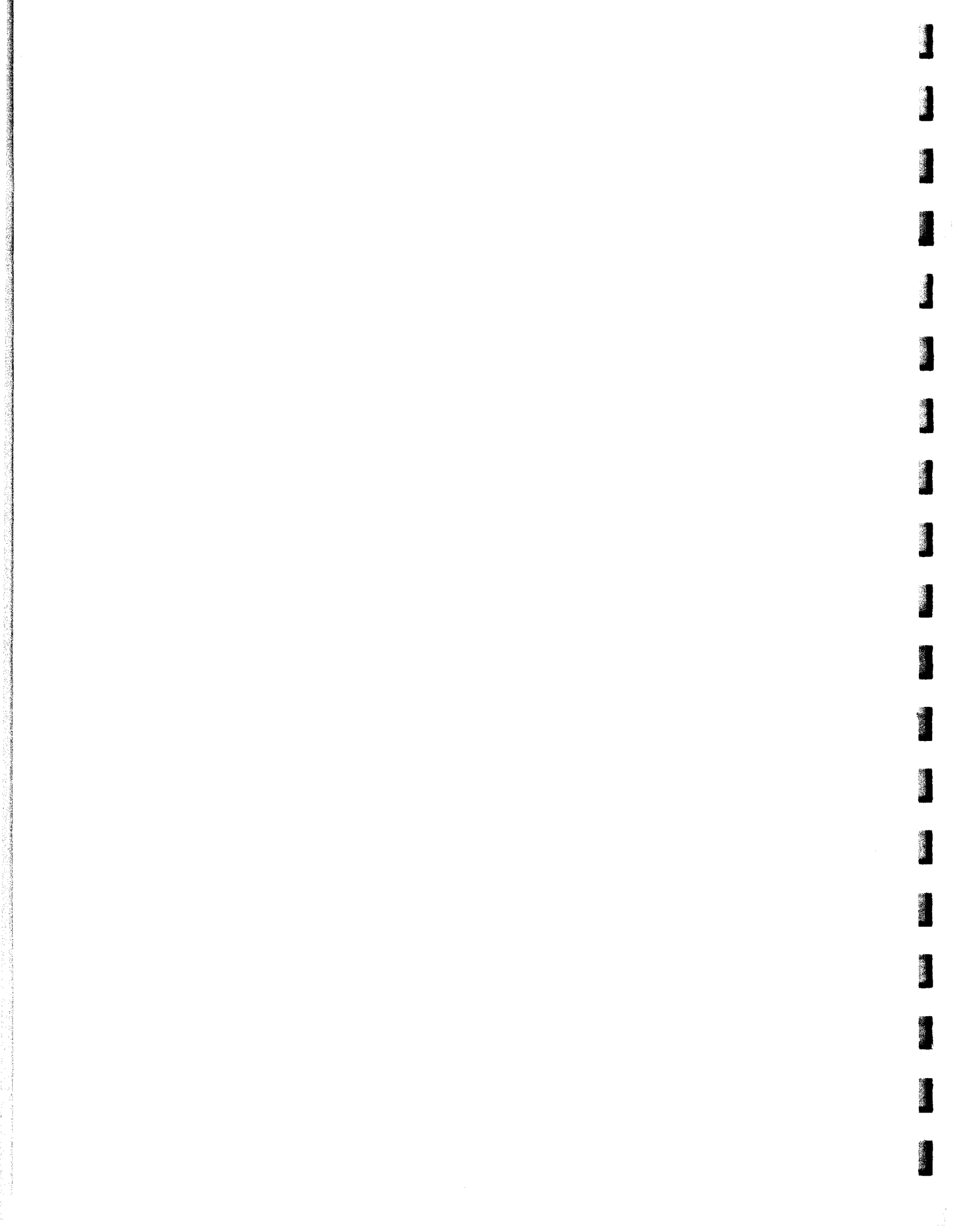
Office of Continuing Legal Education at the University of Kentucky College of Law, M. Brooke Senn, Keith G. Hanley, R. David Lester, David C. Pottinger, John T. McGarvey, Gary L. Stewart, Merrit S. Dietz, Phillip H. Schwartz, Helen Davis Chaitman, and Neal L. Wolf

**UK
CLE**

**8th ANNUAL
SEMINAR ON**

**LEGAL ISSUES FOR
FINANCIAL INSTITUTIONS**

MARCH 11-12, 1988



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

**In Cooperation with the
KENTUCKY BAR ASSOCIATION**

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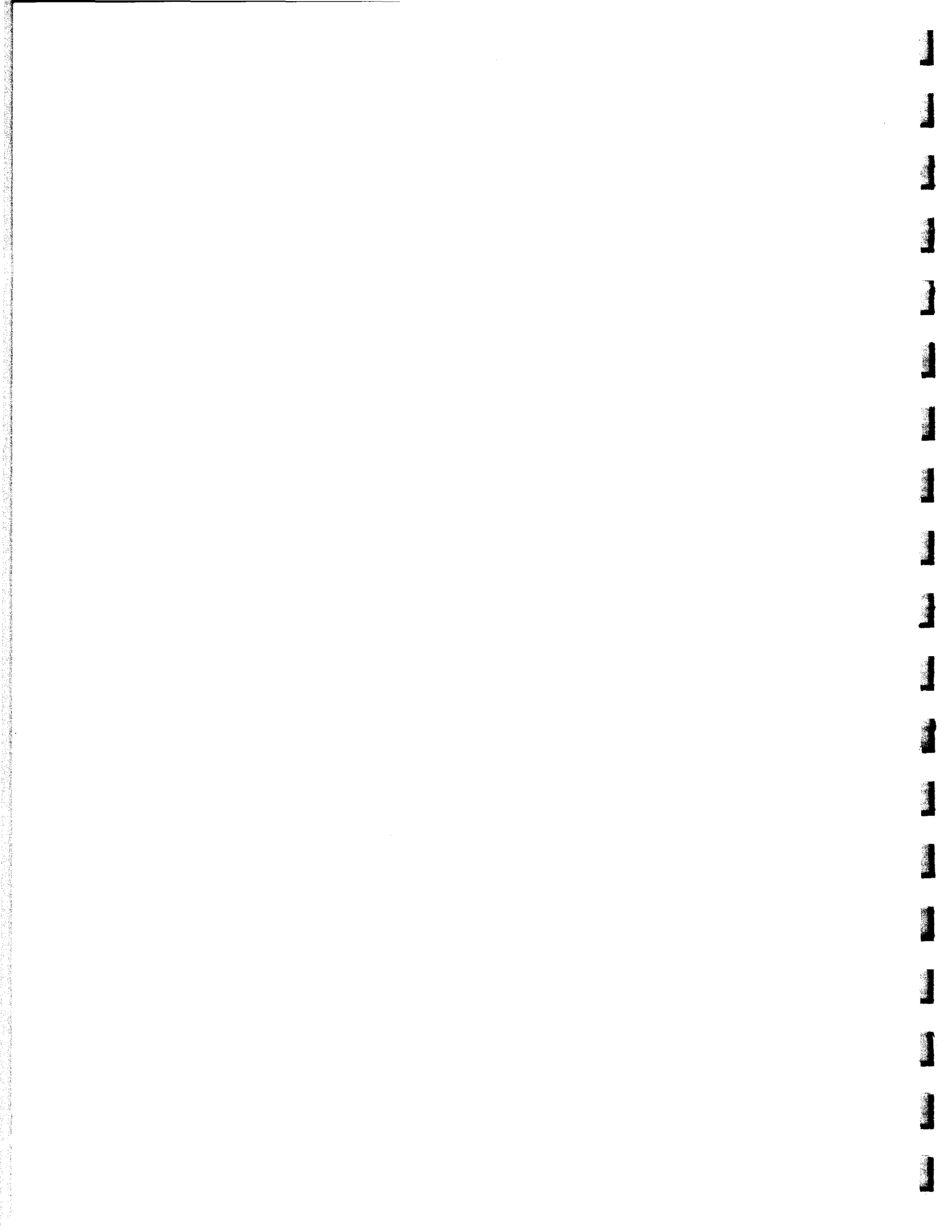


TABLE OF CONTENTS

SEMINAR SCHEDULE

OUTLINE OF SPEAKERS' PRESENTATIONS

LEGISLATIVE DEVELOPMENTS AFFECTING FINANCIAL INSTITUTIONS As of March 3, 1988

M. Brooks SennSection A

KENTUCKY BUSINESS CORPORATION ACT REVISIONS AND THEIR EFFECT UPON FINANCIAL INSTITUTIONS

Keith G. Hanley. Section B

THE "NEW" UCC AMENDMENTS AND RELATED CONCERNS: OPERATIONAL PROBLEMS IN IMPLEMENTATION

R. David LesterSection C

LEGAL ISSUES IN LIEN ENFORCEMENT

John T. McGarvey Section D

FEDERAL REGULATORY DEVELOPMENTS IN RESIDENTIAL REAL ESTATE FINANCING

David C. Pottinger.Section E

BANK REPORTING: RECENT DEVELOPMENTS

Gary L. StewartSection F

CREDITORS RIGHTS UNDER CHAPTER 12

Merritt S. Dietz Section G

CURRENT ISSUES FOR DIRECTORS AND OFFICERS OF FINANCIAL INSTITUTIONS

Phillip H. SchwartzSection H

* * * * LENDER LIABILITY * * * *

THE TEN COMMANDMENTS FOR AVOIDING LENDER LIABILITY (Annotated)

Helen Davis ChaitmanSection I

STATUTORY AND COMMON LAW THEORIES OF LENDER LIABILITY

Neal L. Wolf Section J

DEFENDING LENDER LIABILITY CASES

Neal L. Wolf. Section K

PRE-REGISTRATION LIST

CALENDAR OF UPCOMING UK/CLE PROGRAMS

PUBLICATIONS AVAILABLE FOR PURCHASE

8th ANNUAL SEMINAR ON LEGAL ISSUES FOR FINANCIAL INSTITUTIONS

Friday and Saturday, March 11 & 12, 1988

University of Kentucky College of Law
in cooperation with
The Kentucky Bankers Association
and
The Kentucky Bar Association

PROGRAM

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

FRIDAY, March 11, 1988

- 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
Opening Remarks, Leonard V. Hardin, First National Bank of Louisville, President, Kentucky Bankers Association
- 9:00 a.m. 1988 General Assembly Legislation Affecting Financial Institutions
M. Brooks Senn
Senn, Miller & Smith
Louisville, KY
- 9:50 a.m. Kentucky Business Corporation Act Revisions and Their Effect Upon Financial Institutions
Keith G. Hanley
Brown, Todd & Heyburn
Louisville, KY
- 10:40 a.m. BREAK
- 10:55 a.m. The "New" UCC Amendments: Operational Problems in Implementation
R. David Lester
Stoll, Keenon & Park
Lexington, KY
- Commentators:
Stephen B. Catron
Reynolds, Catron, Johnston & Hinton
Bowling Green, KY
and
Don Blevins
Fayette County Clerk
Lexington, KY
- 11:25 a.m. Legal Issues In Lien Enforcement
John T. McGarvey
Morgan & Pottinger
Louisville, KY

FRIDAY continued

- 11:55 a.m. **Residential Real Estate Financing**
ARMS; Home Equity Loans; Refinancings
David C. Pottinger
Morgan & Pottinger
Louisville, KY
- 12:25 p.m. **LUNCH BREAK**
- 1:55 p.m. **Bank Reporting: Recent Developments**
Bank secrecy; Backup withholding; Mortgage interest
Gary L. Stewart, C.P.A.
Eskew and Gresham PSC
Louisville, KY
- 2:45 p.m. **Financial Institutions and the New Chapter 12 Bankruptcy Proceedings**
Merritt S. Deitz
Deitz, Fridy & Freeburger
Sebree, KY
- 3:35 p.m. **BREAK**
- 3:45 p.m. **Current Issues for Directors and Officers of Financial Institutions**
FDIC Code of Conduct for Bank Directors; Bank bribery
Phillip H. Schwartz
Regional Counsel, FDIC
Memphis, TN
- 4:35 p.m. **RECESS**
- 5-6:30 p.m. **Cocktail Reception. Compliments of Brown, Todd & Heyburn, Louisville & Lexington, Ky.**

SATURDAY, March 12, 1988

- 9:00 a.m. **Lender Liability**
Helen Davis Chaitman
Ross & Hardies
Somerset, NJ
and
Neal L. Wolf
Ross & Hardies
Chicago, IL

12:00 noon **ADJOURN**

LEGISLATIVE DEVELOPMENTS
AFFECTING FINANCIAL INSTITUTIONS

As of March 3, 1988

M. Brooks Senn
Senn, Miller & Smith
Louisville, Kentucky



LEGISLATIVE DEVELOPMENTS AFFECTING FINANCIAL INSTITUTIONS
As of March 3, 1988

TABLE OF CONTENTS

	<u>Page</u>
I. Bills Passed By General Assembly	A-1
II. Bills Passed by Either Senate or House	A-3
III. Bills Pending in Either Senate or House	A-13

I. BILLS PASSED BY GENERAL ASSEMBLY

Senate Bill 47 - CAMPAIGN FINANCE REGULATION - prefiled by Senator John A. Rose, amends KRS 121.150 and 121.180 to limit campaign contributions from any person to \$4,000 per candidate per election and to prohibit candidates or campaign committees from circumventing this limitation by cooperation with or request for aid from contributors. The bill does not allow independent expenditures of any amount as long as the expenditure expressly advocates the election or defeat of a clearly defined candidate and so long as any such expenditure in excess of \$300 per calendar year is reported. Other provisions of the bill contain detailed reporting requirements, prohibit the solicitation or receipt of contributions from religious, civil and charitable organizations, limit anonymous contributions to \$100, and prohibit the solicitation or acceptance of contributions for primary or general election expenses after the date of the primary or general election. The bill has passed both the Senate and House and became law without the Governor's signature.

Senate Bill 53 - CAMPAIGN FINANCE REGULATION - prefiled by Senator Rose, amends KRS 121.150 and imposes additional limitations on campaign financing including limiting the amount of contributions to candidates by PAC's to \$4,000 and by individuals to PAC's to \$2,000. The bill has passed both Houses and has been delivered to the Governor for his signature.

Senate Bill 77 - WILLS; PERSONALTY EXEMPTION - introduced by Senator Joe L. Travis, amends KRS 391.030 to direct that the exemption of \$7,500 of personalty from distribution or sale be applicable to the surviving spouse or children not only when the decedent dies intestate but also when (1) the decedent dies testate and the surviving spouse renounces the will or (2) where the exemption exceeds the amount of probatable assets. The bill has passed both Houses and has been delivered to the Governor for his signature.

House Bill 74 - BOARD OF DIRECTORS OF A FINANCIAL INSTITUTION HOLDING SCHOOL DISTRICT FUNDS - prefiled by the Subcommittee for the Review of Education Statutes, repeals and re-enacts KRS 156.611 as a new section of KRS Chapter 164. Among other things, the bill eliminates the current prohibition on a local school district superintendant serving as a director or officer of a bank, trust company or savings and loan association in which is school district has deposits. The bill has passed both Houses and has been delivered to the Governor.

House Bill 307 - NON-PROFIT DIRECTOR, OFFICER, TRUSTEE AND VOLUNTEER LIABILITY - introduced by Representative Jon Ackerson and others, creates a new section of KRS Chapter 411 to provide that a director, officer, trustee or volunteer of a non-profit organization shall be immune from civil liability if the person acting in

good faith and within the scope of their official functions or duties. However, immunity does not exist if the damage or injury was caused by the person's willful or wanton misconduct. The bill passed both Houses and became law without the Governor's signature.

House Bill 323 - CORPORATIONS - introduced by Representatives Jim LeMaster and others, creates and repeals various sections of KRS Chapter 271A to make a complete revision of the Kentucky Corporation Act so as substantially to adopt the 1984 American Bar Association Revised Model Business Corporation Act. House Bill 323 has passed both Houses and has been delivered to the Governor. The same bill was filed in the Senate as Senate Bill 95.

House Bill 460 - CORPORATIONS - introduced by Representative E. Louis Johnson, amends KRS 271A.396 through 271A.399 relating to corporate business combinations and other transactions with shareholders of the corporation or parties closely related to such shareholders. The bill also narrows the definition of "interested shareholder" by expressly exempting beneficial ownership of stock in a option, bonus, profit sharing, pension or other similar plan. The bill would further extend the reach of the statute by amending the definition of "business combination" to include transactions in which an "associate" of any interested shareholder would have certain specified interests.

The bill changes the approval requirements for a business combination governed by the statute. As currently enacted, KRS 271A.397 requires that the business combination be both (1) recommended by the board of directors and (2) approved by the affirmative vote of both 80% of the outstanding shares of voting stock and two-thirds (2/3) of the voting stock not held by interested shareholders or parties to the business combination. The bill provides that either the above-described shareholder vote or a vote by a majority of the independent members of the board of directors would be sufficient to approve the business combination. An "independent member" of the board of directors is any director who is not an officer or full-time employee of the corporation or an affiliate or associate of an interested shareholder or any of the shareholder's affiliates. The bill further provides that no business combination with an interested shareholder is permissible for a period of five years following the date upon which the shareholder became an interested shareholder unless the business combination is approved by a majority of the independent members of the board of directors prior to the date on which the interested shareholder became an interested shareholder. The bill also specifies the factors the board of directors may consider in approving a business combination governed by this bill.

Unless otherwise prohibited by the articles of incorporation, the bill permits the board of directors to create and issue rights or options which contain provisions adjusting the option price or number of shares issuable in the event of an acquisition of shares or a reorganization, merger, consolidation or sale of assets.

The bill also amends the list of specific situations in which a shareholder or independent director vote is or is not necessary to approve a business combination. First, the bill would increase from two to five years the period in which the per share price of the transaction must equal the highest market value before the transaction would be exempted from a vote. Second, the bill amends 271A.398 to require a shareholder vote of a business combination if (1) the principal office of the corporation is located in this state or (2) more than 200 beneficial owners of the stock reside in Kentucky or (3) more than 10% of the beneficial owners of the stock reside in Kentucky or (4) more than 10% of its outstanding stock is owned by residents of Kentucky or (5) more than 100 employees of the corporation and its subsidiaries work in Kentucky or (6) the assets of the corporation in Kentucky exceed \$1 million. The bill has passed both Houses and has been delivered to the Governor for his signature.

II. BILLS PASSED BY EITHER SENATE OR HOUSE

Senate Bill 8 - PROBATE - prefiled by Senators Ed O'Daniel and Fred Bradley, creates and amends various sections of KRS Chapters 391, 394, 395, 396, 413 and 424 to effect an omnibus revision of probate and related matters. The bill passed the Senate by a vote of 36-0 on January 27, 1988. The House passed the bill with three committee amendments by a vote of 97-0 on February 16, 1988. On February 24, 1988, the Senate refused to concur in the House Committee amendments and returned the bill to the House. On February 25, 1988, the House refused to recede from the Committee amendments. A Free Conference Committee has been appointed and filed its report on March 2, 1988.

Senate Bill 29 - STATE DEPOSITORY BANKS - prefiled by the Interim Joint Committee on State Government, creates a new section of KRS Chapter 900 to provide a procedure for assigning priorities to state depository banks based upon their demonstrated effectiveness in serving the convenience and economic needs of their communities. Responsibility for making this determination would remain with the State Investment Commission. While the bill basically enacts 200 KAR 14:060, there are some differences from the existing regulation: (1) the bill deletes the requirement in the regulation which explicitly references credit services as one aspect of serving the convenience and economic needs of the community; (2) the bill, unlike the regulation, makes no provision for quarterly reports by the Office for Investment and Debt Management to the State Investment Commission; (3) The bill, unlike the regulation, contains no provision for quarterly updates of the scoring of potential depositories; and (4) the bill deletes the requirement in the regulation that scoring be kept as a moving average for each fiscal year. The bill passed the Senate 32-2-1 and is currently in the House State Government Committee.

Senate Bill 38 - KENTUCKY EDUCATIONAL SAVINGS PLAN TRUST - prefiled by Senator David K. Karem, creates new sections of KRS Chapter 164A to create a Kentucky Educational Savings Plan Trust which would provide an enhanced return on investments to be used for higher education costs at a Kentucky two-year or four-year accredited private or non-profit college or university. The trust created by the bill would administer two funds, a program fund and an endowment fund. Participants in the trust would be required to deposit funds in the program fund in a specific account, for a specific period of time, and in trust for the benefit of a specific period of time, and in trust for the benefit of a specific beneficiary who must be below the age of fifteen at the time of designation. Interest would be paid on such funds and would be exempt from the Kentucky income tax. Furthermore, during years in which the beneficiary is attending a Kentucky institution of higher learning, the interest on the funds in the program fund would be supplemented by a pro rata share of the interest earned on the funds in the endowment fund. The endowment fund would be funded by state appropriations and other private or federal contributions, with private contributions being excluded from the income of the donor for Kentucky tax purposes. The bill provides a detailed scheme for the administration of and withdrawal by participants from the trust. The bill has passed the Senate 31-4. The bill passed the House with one committee amendment which would replace the Kentucky educational savings plan trust (which was a public corporation) with the Kentucky tuition savings plan trust, an instrumentality of the Commonwealth. The bill has been received back in the Senate from concurrence in the House amendments.

Senate Bill 65 - SECURITY INTEREST IN PROPERTY WITH KENTUCKY CERTIFICATES OF TITLE - introduced by Senator David K. Karem, amends various sections of KRS Chapter 186A to clarify that the method of perfecting security interests in any property for which certificate of title is required is by notation on the certificate of title. Any security interest which was perfected by tendering a motor vehicle lien statement or filing a financing statement after July 1, 1987 but before the effective date of the bill should it be enacted is protected by a grandfather provision. A grandfathered security interest would be considered perfected as of the date of the tender or filing. Furthermore, no continuation statement would be necessary for a security interest already perfected by filing where a certificate of title has been issued. But where not certificate of title has been issued, the secured party or the debtor must apply for a certificate of title evidencing the lien prior to or upon the date that the filing of a continuation statement would be required. The bill also amends KRS 355.9-401 to provide that a security interest in mined coal is perfected by filing in the county of the debtor's residence. The bill is currently in the Senate Judiciary-Civil Committee.

Senate Bill 95 - CORPORATIONS - introduced by Senator Ed O'Daniel, creates and repeals various sections of KRS Chapter 271A to make a complete revision of the Kentucky Corporation Act so as to substan-

tially adopt the 1984 American Bar Association Revised Model Business Corporation Act. The bill is the same as House Bill 323 which has passed both Houses and been sent to the Governor.

Senate Bill 157 - CAMPAIGN FINANCE REGULATION - introduced by Senator Joe Lane Travis, creates a new section of KRS Chapter 61 to prohibit a person who contributes \$2,000 or more to a candidate, the candidate's committee, affiliated committees, PAC, or party, from subsequently obtaining employment, contracts, or other things of value from the government or from a government officer or employee. The bill also prohibits a state official or employee from offering or promising such benefits in return for a contribution. The bill further creates a private right of action to enforce the provision, criminal penalties, and personal liability on the part of any public official violating the act. The bill passed the Senate on February 23, and is in the House State Government Committee.

Senate Bill 197 - CREDIT UNIONS - introduced by Senator Dan Meyer, amends various sections of KRS Chapter 290 pertaining to credit unions. The bill makes six changes to KRS Chapter 290.

1. The bill would increase the cap on the amount of funds which a credit union may invest in stocks and bonds of corporations. Currently, KRS 290.585 limits investments in approved stocks and bonds to a maximum of 5% of the members' shares regardless of how the investments are apportioned between stocks and bonds. The bill would increase this cap by treating investments in stocks as separate from investments in bonds. The bill would allow the investment of 5% of members' shares in stocks and an additional 5% of members' shares in bonds.

2. The bill would amend KRS 290.325 to change the source of dividends from "undivided earnings" to "net earnings". The bill would also amend KRS 290.325 to require the Commissioner's prior approval before dividends may be paid in excess of net earnings, unless the excess is less than 1% of undivided earnings.

3. The bill would amend KRS 290.155 prohibit a member of the board of directors from being appointed to the supervisory committee.

4. The bill would amend KRS 290.296 to authorize the Commissioner to remove an officer or director of a credit union for violations of law, engaging in or participating in any unsafe or unsound practice, or engaging in any act, omission or practice which constitutes a breach of his fiduciary duty to the credit union. The violation, practice or breach must also either involve personal dishonesty or demonstrate a willful disregard for the safety or soundness of the credit union.

5. The bill would authorize the Commissioner to hold a hearing and issue cease and desist orders.

6. A committee amendment to the bill would require that enforcement actions be brought in the circuit court of the residence of the individual or the principal office of the credit union rather than in the Franklin Circuit Court.

The Senate passed the bill, including the committee amendment, by a vote of 38-0 on February 23, 1988. The bill has now been sent to the House where it is before the Banking and Insurance Committee.

Senate Bill 202 - KENTUCKY SAVINGS BOND AUTHORITY - introduced by Senator Ed O'Daniel, among other things, amends KRS 293.100 to require that the Kentucky Savings Bond Authority have all future bonds issued pursuant to KRS Chapters 42 and 56, and through the State Property and Buildings Commission. The bill passed the Senate by a vote of 37-0 on February 26, 1988, and has been sent to the House.

Senate Bill 220 - INSURANCE - introduced by Senators Helen Garrett and Pat McCuiston, creates and amends various sections of KRS Chapter 304 dealing with the regulation of insurers and insurance agents. Among other things, the bill would amend KRS 304.9-425 to prohibit paying compensation or advertising fees based upon the volume of insurance business produced except for remuneration paid to an association based upon endorsement of insurance programs. Furthermore, the bill would amend KRS 304.9-130 to require that a license fee be charged for each individual in a firm or corporation which acts under the firm or corporation's license. Currently, a single license fee paid by the business covers all of the business' agents. The bill passed the Senate by a vote of 32-0-1 on February 24, 1988, and has been sent to the House where it is before the Bank and Insurance Committee.

Senate Bill 312 - NUMBER OF SCHOOL BOARD DEPOSITORIES - introduced by Representative Marshall Long, amends KRS 160.570 to allow a board of education to select as many depositories as it wishes. The bill passed the House on January 29, 1988, and is in the Senate Education Committee.

House Bill 341 - GARNISHMENTS - introduced by Representatives Fribert and McElroy, amends KRS 425.506 to permit a garnishment of wages to specify succeeding pay periods during which succeeding pay periods rather than just the pay period during which the order of garnishment is served. The bill passed the House on February 8, 1988, and is in the Senate Judiciary-Civil Committee.

House Bill 497 - SAVINGS AND LOAN ASSOCIATION HOLDING COMPANIES - introduced by Representative Billy Ray Smith, this bill is modeled after Kentucky's multi-bank holding company bill and creates new sections of KRS Chapter 289 authorizing organization of multi-saving and loan association holding companies. The bill would allow any individual (but not a corporation) or a savings and loan holding company ("S&LHC") to acquire control of one or more S&L or S&LHC wherever located so long as certain limitations are not

exceeded. These limitations prohibit the acquisition by an S&LHC or individual that controls, on the effective date of the bill, an S&L or an S&LHC which was chartered after the effective date of this bill and which had been in existence less than five years at the time of the acquisition. The bill also prohibits an individual or an S&LHC from acquiring control of more than 15% of the total deposits in all S&L's in Kentucky. Furthermore, the bill limits the number of acquisitions to three (3) in any twelve (12) month period, except that an S&LHC may make one (1) acquisition of another S&LHC which controls more than three (3) S&L's so long as the total acquisitions by the S&LHC does not exceed five (5) in any five-year period.

Acquisitions by foreign S&LHC's are premitted so long as the state of the foreign S&LHC extends reciprocity on no less restrictive terms to Kentucky S&LHC's.

Finally, the bill requires that the Kentucky Commissioner of Financial Institutions approve the acquisition of a federal savings and loan association located in Kentucky by a holding company. Moreover, the bill appears to permit state wide merger and purchase of savings and loan associations, thereby providing a vehicle for state wide branching by state chartered savings and loan associations. The bill passed the House on February 17, 1988. It was recommitted to the Senate Banking and Insurance Committee on March 2, 1988, after previously having recommended for passage by that Committee.

House Bill 569 - CORPORATIONS - introduced by Representative Joe Clark, this bill eliminates the corporate organization tax on no par value shares. If enacted, no par value shares would be taxed at the current rate for par value shares. The House passed this bill by a vote of 91-0 on February 18, 1988. The bill has now been sent to the Senate where it is before the Judiciary-Civil Committee. Posted for passage on Consent Orders on March 9, 1988.

House Bill 582 - LIMITED PARTNERSHIPS - introduced by Representative Jon Ackerson and others, this bill creates and repeals various sections of KRS Chapter 362 to effect an omnibus revision of the Uniform Limited Partnership Act. The bill passed the House on March 1, 1988, and is in the Senate Judiciary-Civil Committee.

House Bill 652 - DEPARTMENT OF FINANCIAL INSTITUTIONS - introduced by Representatives Bruce and Stumbo, makes numerous revisions to KRS Chapter 287 relating to banks. A committee substitute for the bill passed the House on March 2, 1988, with one floor amendment. A section by section analysis of the major substantive provisions of the Committee Substitute for HB 652 and the floor amendment follows.

1. Issuance of Policy Statements. KRS 287.020 presently authorizes the Commissioner of Financial Institutions (the "Commissioner") to issue rules, regulations, forms and orders necessary to

interpret and carry out KRS Chapter 287 relating to banks. Section 1 of HB 652 amends KRS 287.020 and authorizes the Commissioner to also issue "policy statements." This is a practice currently employed by the federal regulators administering federal banking statutes.

2. Charter and Branch Application Records. Section 2 of the bill amends KRS 287.061 to provide for disclosure of public records relating to charter and branch applications filed with the Department to the same extent as other public records are available under the Open Records Act (KRS 61.870 to 61.884).

3. Minimum Capital Requirement. Section 3 of HB 652 amends KRS 287.070 to require that the minimum capital stock of any bank or combined bank and trust company organized after the effective date of the Act be at least \$1 million and a newly chartered trust company be at least \$500,000. The section also (a) fixes \$3,000 as the minimum capital stock of a phantom bank created solely in connection with the formation of a bank holding company or other corporate reorganization or recapitalization and (b) makes it clear that the minimum capital stock of an existing bank or trust company continues to be that required at the time it was originally organized.

Since no change is proposed to KRS 287.080 requiring that before a financial institution may commence business, it must also have surplus equal to at least 50% of the minimum capital requirement, the minimum capital stock and surplus of a bank or combined bank and trust company organized after the effective date of HB 652 will be \$1.5 million and \$750,000 for a trust company.

The amendment to KRS 287.070 has no effect upon existing banks and trust companies. Their capital requirements remain what they were at the time they were originally incorporated.

4. Approval of Change in Control of Banks. KRS 287.095 currently requires that a change in control of a bank be approved by the Commissioner and provides that a change of less than 10% of voting stock is not a change of control requiring the Commissioner's approval. Section 4 of the Department's bill amends KRS 287.095 to provide that a change of direct or indirect ownership of 25% or more of a bank's voting securities constitutes a change of control which must be approved by the Commissioner.

The amendment also makes it clear that the statute is not applicable to a change in control resulting in or by a bank holding company since acquisition of a bank by a holding company already must be approved under KRS 287.900.

5. Branching. Section 5 of the bill amends KRS 287.180, relating to the business of banking and branching, to allow a bank to open a branch anywhere in the county where its main office is located. The section specifically prohibits branching outside the county of a bank's main office.

6. Lending Limits. Section 6 of the bill amends KRS 287.280, relating to bank lending limits, by eliminating the provisions (which are already binding upon banks under the Federal Reserve Board's Regulation O) requiring that loans to directors and executive officers be on non-preferential terms and approved in advance by a majority of the board of directors with the interested party abstaining from participating directly or indirectly in the voting.

7. Exceptions to Lending Limits. KRS 287.290 presently lists a number of loans or obligations which are not subject to the lending limits of KRS 287.280. Section 7 of HB 652 expands the exceptions by providing that the lending limits are not applicable to:

(a) Loans or extensions of credit to any United States department, agency or establishment or a corporation directly or indirectly owned by the United States; and

(b) Loans or extensions of credit fully secured by (i) general obligations of Kentucky or any agency or political subdivision thereof, (ii) United States bonds, notes or other instruments fully guaranteed by the United States, (iii) segregated deposits, accounts or certificates of deposit in the lending bank, or (iv) unconditional takeout commitments or guarantees of any United States department, agency or establishment or corporation owned by the United States.

8. Loans to Department Employees. Presently neither the Commissioner, Deputy Commissioner nor any examiner may be indebted to any institution regulated by the Department. This has imposed a hardship upon certain employees of the Department. Section 8 of the bill amends KRS 287.440 to permit any employee of the Department to become indebted to a state chartered bank so long as the debt or obligation is upon the same terms and conditions which any other person may become indebted or obligated. Such debts must be reported to the Commissioner in writing and no examiner may be assigned to examine the affairs of a bank to which he or she is indebted.

9. Examination of Affiliates. Section 9 of the bill amends KRS 287.450 to authorize the Commissioner to examine or inspect the records of any affiliate of a bank which has engaged in a "covered transaction" with the bank. Section 23A of the Federal Reserve Act (12 USC 371c) defines a "covered transaction" and Section 9 of HB 652 incorporates the definition into KRS 287.450. As incorporated, the term includes:

(a) a loan or extension of credit by the bank to its affiliate;

(b) a purchase of or an investment in securities issued by the affiliate;

(c) a purchase of assets, including assets subject to an agreement to repurchase, from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Federal Reserve Board by order or regulation;

(d) the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit to any person or company; or

(e) the issuance of a guarantee, acceptance or letter of credit, including an endorsement.

10. Confidentiality of Examinations. Section 10 of the bill amends KRS 287.470 (relating to the confidentiality of examination reports) to expand the persons who may not release any information in the report to include an "employee of a state or federal regulatory authority."

11. Fee Payable to Commissioner. Section 11 of HB 652 amends KRS 287.480 to authorize the Commissioner to impose a fee for applications to change the location of a branch or principal office of a bank.

12. Bank Holding Companies. Section 12 of the bill amends KRS 287.900 (relating to bank holding companies) by:

(a) Increasing the deposit cap on holding company acquisitions in Kentucky to 20% of the total deposits in all banks in Kentucky excluding interbank deposits and deposits in foreign branches and international banking facilities.

(b) Clarifying the provisions prohibiting the acquisition of a bank chartered after July 13, 1984, if it is in existence less than five years, by making it clear that such prohibition does not apply to a bank which is the result of a merger, consolidation or conversion if any constituent institution to the merger was in existence more than five years or to a bank organized for the purpose of acquiring substantially all the assets of a bank, savings and loan association, savings bank or any office thereof so long as the acquired institution had been in existence for more than five years.

(c) Eliminating the reciprocity provisions with respect to contiguous states which expired on July 13, 1986, while retaining the nationwide reciprocity provisions with respect to acquisition of Kentucky banks by out-of-state holding companies, which provisions continue in effect.

(d) Permitting the depositor of a bank in Kentucky controlled by a holding company to make deposits to and withdrawals from the depositor's account at any other of the holding company's affiliated banks in Kentucky.

(e) Adding a new definitional subsection to KRS 287.900(1) to the effect that, for the purposes of KRS 287.900 and 287.905, the principal place of business of a bank holding company is the state where the total deposits of its bank subsidiaries are the largest and providing that such a bank holding company shall be subject to the regulatory authority of the Department.

13. Approval of Bank Holding Company Acquisitions. Under present law, the Commissioner must approve the acquisition of a Kentucky state bank or of a holding company which controls a Kentucky state bank. Section 13 of the bill amends KRS 287.905 to expand the approval authority of the Commissioner to require that the Commissioner must approve the acquisition by a Kentucky bank holding company which controls a Kentucky state bank of a bank or bank holding company located in another state.

14. Penalties. Section 14 of the bill amends KRS 287.990 (the penalty section of KRS Chapter 287) by:

(a) Adding the director of the Department's Division of Banking to the persons who are subject to a fine of up to \$2,000 for failing to report his or her knowledge of the insolvency or unsafe condition of a state bank;

(b) Imposing a fine of not less than \$2,000 nor more than \$5,000 upon bank officers and directors when the bank makes unauthorized investments in real property;

(c) Creating a new section imposing a \$1,000 per day fine for willful violations of KRS 287.095(1) requiring the Commissioner's approval of the change in control of a bank; and

(d) Creating a new section imposing a fine of not less than \$100 nor more than \$500 for violations by a bank, officer or director of any provision of the banking code (KRS Chapter 287) which does not have a specific penalty imposed for its violation.

15. Electronic Fund Transfers and Terminals. Sections 15 and 16 of HB 652 creates two new sections of KRS Chapter 287 authorizing electronic fund transfers and the ownership and use of electronic terminals. The new sections specifically address:

- * Full function electronic terminals - electronic terminals which accept paper based deposits (i.e., automated teller machines);
- * Point of sale terminals - generally, electronic terminals which effect sale transactions but do not accept paper based deposits; and

- * Cash dispensing machine - generally, electronic terminals that only dispense cash.

With respect to full function electronic terminals or cash dispensing machines, a bank may:

- (a) own such terminals in the county where the bank may establish a branch;
- (b) share or use such terminals located anywhere; and
- (c) effect any transfer from such terminals; however, if the terminals are located outside the county where the bank may establish a branch, the bank may not accept paper based deposits or transfers to another bank.

A bank may own, share or use a point of sale terminal anywhere. However, if the point of sale terminal is located outside the county where the bank may establish a branch, the bank may not transfer funds or dispense cash at such point of sale terminal except in connection with a point of sale transaction.

No later than January 31 of each year, a bank must provide the Commissioner with a written report listing any electronic terminal which the bank first used, shared, and/or operated during the preceding year.

Finally, a state bank may effect any electronic fund transfer or establish, own, operate, share or use an electronic terminal to the same extent permitted national banks.

16. Trust Department Consolidation. Section 17 of the bill creates a new section of KRS Chapter 287 to authorize consolidation of all or a part of the trust departments of a bank holding company's affiliated banks into one bank. Consolidation would have little effect upon the jurisdiction of the local probate courts. Typically, jurisdiction for appointment of a fiduciary is governed by the residence of the decedent or ward. Once the fiduciary is appointed the appointing court retains jurisdiction for filing of settlements etc. However, trust registration (which is required for testamentary trusts) is required with the court in the county where the trust is administered (the office of the trustee) and registration establishes venue for judicial proceedings. Thus, reports of testamentary trustees would be made in the county where the consolidated bank is located.

17. Liability of Investment Company Stockholders. Section 18 of HB 652 amends KRS 291.115 (relating to the liability of investment company stockholders for the contracts and liabilities of investment companies) by providing that such liability may be enforced as provided in KRS Chapter 287 rather than by KRS 287.365 which is repealed by HB 652 (see Paragraph 18 below).

18. Number of Organizers and Directors. Section 19 of HB 652 (added by the floor amendment) amends KRS 287.040 to reduce the number of required organizers and directors of a combined bank and trust company from seven to five.

19. Repeal. The bill repeals

(a) KRS 287.325 requiring that banks not fully insured by the FDIC insert a notice to that effect in any advertisement soliciting deposits; and

(b) KRS 287.360 and 287.365 relating to the double liability for certain bank stock issued prior to May 16, 1936, and the enforcement of such liability.

House Bill 654 - BOAT TITLES - introduced by Representatives Handy and Clarke, creates new section of KRS Chapter 132 relating to assessment and taxation of boats. A House Committee Amendment requires motor boats to be registered and titled in essentially the same manner as motor vehicles. The bill and amendment passed the House on February 29, 1988, and is in the Senate Appropriations and Revenue Committee.

III. BILLS PENDING IN EITHER SENATE OR HOUSE

Senate Bill 26 - INVESTMENT OF STATE FUNDS - prefiled by the Interim Joint Committee on State Government, creates a new section of KRS Chapter 900 to provide standard rules to govern the Commonwealth's investment and cash management programs. As prefiled, the bill is identical to 200 KAR 14:010 and would not have a substantive effect on current investment and cash management programs.

Two amendments to the bill have been proposed. An amendment proposed by Senator Georgia M. Powers would prohibit state investment with firms or financial institutions doing business with the Republic of South Africa. An amendment proposed by Senator Arthur L. Schmidt would amend the criteria used to distribute funds among qualifying institutions by deleting the criteria of whether the institution is meeting the economic development needs of the community. The bill is currently in the Senate State Government Committee.

Senate Bill 32 - STATE REPURCHASE AGREEMENTS - prefiled by the Interim Joint Committee on State Government creates a new section of KRS Chapter 900 to regulate the investment of state funds in repurchase agreements. The bill enacts all substantive provision of 200 KAR 14:080 with two changes concerning permissible maturity dates. If enacted, the bill would eliminate the existing minimum maturity of seven calendar days and extend the maximum maturity from 180 to 365 days. A floor amendment proposed by Senator

Georgia M. Powers would prohibit state investments with firms or financial institutions doing business with the Republic of South Africa. The bill is currently in the Senate State Government Committee.

Senate Bill 51 - CAMPAIGN FINANCE REGULATION - prefiled by Senator Larry Saunders, amends KRS 121.150 to limit campaign contributions from any person to permanent committee to \$2,000 per candidate per election and to prohibit candidates or campaign committees from circumventing this limitation by cooperation with or requests for aid from contributors. Like Senate Bill 47, this bill would allow independent expenditures subject to a reporting requirement for expenditures in excess of \$300 per calendar year, would prohibit the solicitation or receipt of contributions from religious, civil and charitable organizations, and would limit anonymous contributions to \$100. Furthermore, the bill would prohibit an elected statewide official from actively soliciting contributions to retire campaign debt or accept such contributions from any person contracting with the state. There is not prohibition on accepting unsolicited contributions. The bill contains no new reporting requirements. The bill is currently in the Senate Elections and Constitutional Amendments Committee.

Senate Bill 129 GUARANTEES - introduced by Senator Helen Garrett, amends KRS 371.065 (requiring that a separate guaranty of a debt specify the amount of the aggregate liability of the guarantor and the date on which the guaranty terminates) to provide that the guaranty may, in addition to the aggregate liability of the guarantor specified therein, guarantee payment of interest accruing on the guaranteed indebtedness, and fees, charges and costs of collecting the indebtedness (including reasonable attorney fees) without specifying the amount of such interest, fees, charges and costs. The bill was recommitted to the Senate Banking and Insurance Committee from Rules on February 4, 1988.

Senate Bill 132 - REVOLVING CREDIT MORTGAGES - introduced by Senator William L. Quinlan, the Committee Substitute for this bill creates a new section of KRS Chapter 382 relating to real estate mortgages. It specifically provides that a mortgage may secure payment of any or all sums due and payable by debtor under a line of credit or revolving credit plan if the mortgage states the maximum indebtedness which can be secured by the mortgage that the parties intend to secure the line of credit or revolving credit plan.

Under the bill, the mortgage will remain in full force and effect until released of record and will not be affected or impaired by the fact that no loan, advance or extension of credit is made at the time the mortgage is recorded or that the obligation of the debtor under the line of credit or revolving credit plan is zero at any time or times. Moreover, the mortgage is superior to any other liens or encumbrances created after recording of the mortgage even to the extent of sums advanced by the mortgage with actual or

constructive knowledge of a subsequently created lien. The mortgagee is not required to release the mortgage until the line of credit or revolving credit plan is closed or terminated and all amounts owed by the debtor thereunder is paid in full. Finally, the bill authorizes the debtor to request an amendment to the mortgage reducing the maximum indebtedness to be secured thereby.

The bill also amends KRS 382.520 relating to future advance clauses in existing mortgages by deleting some ambiguous language referring to advances made pursuant to a line of credit.

Senate Bills 153 and 156 - CORPORATIONS - respectively introduced by Senators O'Daniel and Karem, amend various sections of KRS 271A.396 through 271A.399 relating to corporate business combinations. Both bills are substantially identical to House Bill 460 which has passed both Houses and is described under Section I above.

Senate Bill 314 - CO-SIGNERS OF CREDIT CARDS - introduced by Senator Harold Haering and others, creates new sections of KRS Chapter 287, 289 and 290 to limit the liability of a co-signer for a credit card to the amount of the maximum line of credit approved in writing by the co-signer. The bill further requires that a bank, savings and loan association, or credit union must notify the co-signer in writing of any proposed increase in the maximum line of credit and would prohibit any such increase unless the co-signer approves in writing. The bill is currently before the Senate Banking and Insurance Committee.

Senate Bill 322 - RENTAL PURCHASE AGREEMENTS - introduced by Senator Gene Huff, creates new sections of KRS Chapter 367 to regulate rental-purchase agreements relating to personal, family or household purposes and executed between a natural person and a lessor who enters into such agreements in the ordinary course of business. The bill provides for detailed regulation of such agreements. The bill is currently before the Senate Business Organizations and Professions Committee.

Senate Bill 329 - TAXATION OF SAVINGS INSTITUTIONS - introduced by Senator David Karem, creates a new section of KRS Chapter 136 concerning corporate taxes relating to savings institutions. The general purpose of the bill is to update Kentucky corporate taxes relating to savings institutions so that they parallel federal statutes.

House Bill 30 - CORPORATE DIRECTOR LIABILITY - prefiled by Representative Harper, amends KRS 271A.240 and 271A.026 relating to director liability. The bill provides that a corporate director will not be liable if he performs his duty in good faith, in a manner he reasonably believes is or not opposed to the best interests of the corporation, and with the care exercised by an ordinary prudent person. The bill also establishes a presumption

that a director is not in breach of his statutory duty absent clear and convincing evidence to the contrary. The bill is in the House Judiciary-Civil Committee.

House Bill 33 - INHERITANCE TAX - prefiled by Representative Jim LeMaster, amends KRS 140.090 to increase the maximum funeral expense deduction used in calculating the value of the distributive shares from \$2,500 to \$7,500.

House Bill 61 - MECHANICS AND MATERIALMEN'S LIENS - prefiled by Representative Marshall Long, amends KRS 370.010 to increase from ten (10) to forty-five (45) days from the initial supply of materials or labor the deadline for providing notice to owner-occupied single or double family dwellings of the intent to claim a line.

House Bill 235 - FARM DEBT MEDIATION - introduced by Representatives Mike Farrow and Adrian K. Arnold. The Committee Substitute for the bill new sections to KRS Chapter 426 to create a mandatory dispute resolution procedure which must be completed before creditors holding \$10,000 or more in secured debt incurred by an individual, partnership or family corporation to finance farm operations can enforce their rights. An optional mediation procedure is also authorized.

Before a creditor governed by the bill may initiate a proceeding to enforce his rights, the creditor must either (1) obtain a mediation release by completing the mediation process prescribed by the bill, or (2) obtain a court order, after notice to the borrower and a hearing, exempting the creditor from the mediation process. Furthermore, if one creditor begins the mediation process, other creditors of the borrower must participate in the process and stop any proceedings to enforce a debt to finance farm operations.

The mandatory mediation process could last as long as a minimum of seventy-two (72) days - it will probably last longer taking into account, among other things, the time necessary to prepare a mediation release or mediation agreement. A creditor which seeks to collect a farm debt is required to file a request for mediation. Within twenty-one (21) days of receiving the request, the farm mediation service ("FMS") is required to, among other things, send a notice scheduling an initial mediation meeting between the borrower, all creditors of the borrower governed by the bill, and a mediator. Unless the FMS extends the deadline by an additional thirty (30) days, the meeting must be held within twenty-one (21) days of the issuance of the mediation meeting notice. Prior to the meeting, the borrower must attend an initial consultation with the FMS. Unless the borrower waives mediation after consulting with the FMS, the creditors must participate in at least one mediation meeting. If no agreement is reached regarding the debt at this meeting, a mediation release is issued (signed by all parties or the mediator) and the creditor may proceed with his normal remedies. If a mediation agreement is entered into, the parties

may enforce it as a legal contract. The Committee Substitute for the bill prevents the bill from going into effect until October 1, 1988, and then only after federal matching funds are available. The bill has a October 1, 1991 sunset provisions. The Committee Substitute is in the House Agricultural and Small Business Committee.

House Bill 387 - CAMPAIGN FINANCE REGULATION - introduced by Representatives John Harper and others, amends KRS 121.150 to prohibit contributions from any person under the age of eighteen (18); limit contributions from a permanent committee to \$4,000 per candidate, per election; limit to \$4,000 the amount an individual can contribute to a permanent committee in any one election.

House Bill 389 - CAMPAGIN FINANCE REGULATION - introduced by Representatives John Harper and others, creates a new section of KRS Chapter 141, to, among other things, subject receipts of a political committee in excess of \$2 million for a candidate for the office of governor and \$500,000 for candidates for other offices to state income taxes.

House Bill 393 - INVESTMENT OF STATE FUNDS - introduced by Representative Tom Riner, adds a new section to KRS Chapter 45 to, among other things, prohibit investment of state funds in any company, bank or financial institution which directly or through subsidiaries, maintains operations in or has loans with the Republic of South Africa or Angola.

House Bill 427 - STATE-LINKED DEPOSIT LOAN PROGRAM - introduced by Representatives William I. Donnermeyer, Sr. and Ronny Layman, creates new sections of KRS Chapter 41 to establish a linked investment loan program to provide low cost funds to eligible small and agricultural businesses. Financial Institutions may, but are not required to, participate in the program.

House Bill 445 - ATTORNEYS' FEES - introduced by Representative Robert A. "Bob" Jones, this bill creates a new section of KRS Chapter 454 to authorize a court in a civil action to award attorneys' fees to the prevailing party in certain cases. Attorneys' fees may be awarded if the court finds that (1) the action or defense is frivolous, unreasonable or groundless; (2) the party continue to litigate the action or defense after the claim clearly became frivolous, unreasonable or groundless; or (3) the party litigated the action in bad faith. The bill also specifically preserves the right to bring an action for abuse of process or malicious prosecution.

House Bill 525 - ATTORNEYS' FEES - introduced by Representative Billy Ray Smith and others, creates a new section of KRS Chapter 453 which provides that a court shall award damages and single or double costs, including attorneys' fees, if the court determines that a lawsuit is so totalling lacking in merit that it appears to have been instituted in bad faith.

House Bill 529 - BANK STOCK AS SECURITY FOR FIDUCIARY BONDS - introduced by Representative Jon Ackerson, amends KRS 287.220 to provide that the capital stock of a bank or trust company may not be accepted as security for a bank's or trust company's fiduciary bonds in amounts in excess of the net worth of the bank or trust company.

House Bill 551 - TORT REFORM - introduced by Representative Bill Lear and others, creates, amends and deletes various sections of the Kentucky Revised Statutes to implement the recommendations of the Kentucky Insurance and Liability Tax Force relating to civil liability. The bill is complex and deals with apportionment of liability, punitive damages, collateral sources of recovery, structured settlements, statutes of limitations, standards of care and liability of corporate directors and officers, the liability of volunteers for non-profit corporations, municipal tort claims, and the confidentiality of peer review records. The bill is currently posted in the House Banking and Insurance Committee.

House Bill 577 - CONVERSION OF AFFILIATED BANKS IN SAME MSA TO BRANCHES - introduced by Representative Joe Meyer, amends KRS 287.900 (relating to multi-bank holding companies) to authorize a bank holding company to convert an affiliated bank to a branch if the bank and the holding company are located in Kentucky in the same MSA even though the affiliated bank is located in a different county from the holding company. The bill also amends the bank shares tax (KRS 136.270) to provide for imposition of the tax when an affiliated bank is converted to a branch.

House Bill 667 - SHORT-TERM BORROWING BY GOVERNMENTAL AGENCIES - introduced by Representative Joseph Meyer, creates new sections of KRS Chapter 65 to permit, and establish procedures for, short-term borrowing by government agencies. The bill would place a cap on short-term financing by notes at 75% of the taxes or revenue from which the notes will be paid. Further, notes payable in whole or in part from taxes may mature no later than the last day of the fiscal year in which the notes were issued. Notes payable solely from revenue may mature at any time within one year from the date of the notes. The bill also provides that short-term notes are deemed to be secured by an automatically perfected security interest in the taxes or revenue which have been specified as being used to pay off the borrowing. The issuing governmental agency may sell the notes at either a public, private or invited sale. Prior notice of the notes to the state local finance officer written is required. The bill is currently posted in the House Cities Committee.

House Bill 669 - SERVICE CHARGES BY FINANCIAL INSTITUTIONS FOR INFORMATION REQUESTS ON STATE BENEFIT ACCOUNTS - introduced by Representative Paul W. Richardson, Sr., amends KRS 205.835 concerning the fees which financial institutions may charge for providing information to the Cabinet for Human Resources. The bill would eliminate the existing cap on such charges - which is actual cost -

to provide that the charge may be a "reasonable fee". Finally, the bill would provide that if funding is not available to provide a reasonable fee to the financial institution, the Secretary of the Cabinet for Human Resources shall not request information from financial institutions. The bill is currently before the House Banking and Insurance Committee.

House Bill 675 - CREDIT LIFE AND HEALTH INSURANCE - introduced by Representatives Adrian K. Arnold and others, amends KRS 304.19 to provide the following additional exemptions from the provisions of KRS Chapter 304 regulating credit life and health insurance: (1) mortgage redemption insurance; (2) classes of insurance that are age-rated; and (3) classes of insurance that are underwritten. The bill is currently posted in the House Banking and Insurance Committee.

House Bill 717 - CONSUMER CREDIT REPORTING - introduced by Representative Joe Barrows, creates new sections of KRS Chapter 287 to regulate consumer credit reporting. The bill lists those circumstances in which a consumer reporting agency may furnish a consumer credit report. Except in connection with loans or life insurance applications of \$100,000 or more or applications for jobs paying \$50,000 or more, the bill prohibits the reporting of bankruptcies, lawsuits, arrests, convictions and other items of information after specified time periods have elapsed. A private right of action against consumer reporting agencies that fail to comply with the requirements set by the bill would be created. Violations of the act are also declared to be a Class A misdemeanors. The bill is currently before the House Banking and Insurance Committee.

House Bill 718 - REAL PROPERTY TRANSFERS - introduced by Representative Joe Barrows, creates a new section of KRS Chapter 382 relating to real property transfers. The bill requires that no county clerk shall record an instrument by which the title to or an interest in real property is conveyed unless such instrument has been reviewed by the office of the Property Valuation Administrator. The bill is currently before the House Judiciary-Civil Committee.

House Bill 734 - CERTIFICATION OF REAL PROPERTY APPRAISERS - introduced by Representative Billy Ray Smith, creates new sections of KRS Chapter 324A to establish a certification board and licensing requirements for real estate appraisers. However, the bill explicitly states that certification is not required in order to prepare appraisals. Therefore, real estate appraisals prepared for banks by non-certified appraisers would not be rendered invalid by this bill. The bill is currently before the House Business Organizations and Professions Committee.

House Bill 769 - REVOLVING CREDIT PLANS BY INDUSTRIAL LOAN COMPANIES - introduced by Representatives H. Ramsey Morris, Jr. and others, creates a new section of KRS Chapter 291 to allow an industrial loan company to offer a revolving credit plan on the same terms as banks and trust companies. The bill would require

that all such revolving credit plans be secured by either a first or second mortgage on residential property. This bill is in the House Banking and Insurance Committee.

House Bill 775 - CAMPAIGN FINANCE REGULATIONS - introduced by Representative Chester "Bud" Gregory, creates a new section of KRS Chapter 121 to limit the total campaign contributions which may be accepted by certain candidates in any one election. The bill applies to candidates for governor, lieutenant governor and state-wide elected officials and places a cap of \$1.5 million, \$800,000 and \$400,000 on these candidates respectively. Contributions received in excess of the maximum must be returned to the donor or if the donor cannot be found, turned over to the state. The bill is currently before the House State Government Committee.

House Bill 797 - MECHANICS' AND MATERIALMEN'S LIENS - introduced by Representative Ernesto Scorsone, amends KRS 376.010 to provide for a lien on real property for the full rental cost of leased or rented equipment, machinery or tools used to make improvements to the property. To acquire such lien, the lessor, in addition to providing all other notices required by the current statute, must provide written notification within five (5) calendar days after he begins leasing to the owner of the property to be held liable that the lessor will be entitled to claim a lien upon the property if he is not paid. This bill is currently before the House Judiciary-Civil Committee.

House Bill 810 - STATE INVESTMENT COMMISSION - introduced by Representative Long, among other things, eliminates the requirement that two members of the Commission be appointed by the Governor from names submitted by the Kentucky Bankers Association and the Independent Bankers Association of Kentucky. The bill is in the House State Government Committee.

House Bill 811 - PERMISSABLE INVESTMENTS BY KENTUCKY AGRICULTURAL FINANCE CORPORATION - introduced by Representative Marshall Long, amends KRS 247.946 to permit the Kentucky Agricultural Finance Corporation to invest funds in (a) certificates of deposit and other evidence of deposit at state and federal chartered banks and savings and loan associations, (b) a guaranteed investment or similar contract with an insurance company or a depository financial institution, or (c) any other investment authorized for Commonwealth funds. This bill is currently before the House State Government Committee.

House Bill 837 - RELEASES AND ASSIGNMENTS OF REAL PROPERTY - introduced by Representative Jim LeMaster, amends various sections of KRS Chapter 382 and other sections, to eliminate the marginal entry record for recording the assignment or release of any deed, lien, or mortgage on real property. The bill would require that the assignment or discharge of a lien or mortgage be by a separate instrument filed with the office of the county clerk. The bill would further eliminate the use of marginal entry records to

provide the notice of legal actions, attachment or execution on real property required in KRS Section 382.440 and 382.450. The bill is currently before the House Judiciary-Civil Committee.

House Bill 842 - JUDGMENT LIENS UPON REAL PROPERTY - introduced by Representative Louis Johnson, creates a new section of KRS Chapter 426 to establish that final judgments in courts of record shall act as liens against all real property owned by the judgment debtor if notice is filed with the county clerk and served upon the judgment debtor in the form specified by the bill. This bill is currently before the House Judiciary-Civil Committee.

House Bill 849 - BANK INVESTMENT IN REAL PROPERTY - introduced by Representative Anne Northup, amends KRS 287.100 to allow a bank to invest in real property in the county in which the bank is located or in any contiguous county, rather than in the bank's generally excepted banking market. This bill is currently before the House Banking and Insurance Committee.

House Bill 881 - CAMPAIGN FINANCE REGULATION - introduced by Representative Bill Lear, amends KRS 121.150 to limit political contributions. At the time of the printing of this bulletin, a copy of this bill was unavailable and a more detailed analysis of the bill will appear in a subsequent bulletin.

House Bill 889 - LIENS ON CERTAIN ELECTRICAL APPLIANCES - introduced by Representative Louis Johnson, amends KRS 376.430 relating to liens on certain electrical appliances. At the time of the printing of this bulletin, a copy of the bill was not available, and a more detailed analysis of the bill will appear in a subsequent bulletin.

House Bill 953 - BANK INVESTMENT IN REAL PROPERTY - introduced by Representative Ark, amends KRS 287.100 to permit banks to invest in real estate within a 50 mile radius of the bank's principal office rather than in the bank's generally accepted banking market. The bill is in the House Banking and Insurance Committee.



KENTUCKY BUSINESS CORPORATION ACT REVISIONS

AND

THEIR EFFECT UPON FINANCIAL INSTITUTIONS

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SECTION B

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28
29
30
31
32
33
34
35
36
37
38
39
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67
68
69
70
71
72
73
74
75
76
77
78
79
80
81
82
83
84
85
86
87
88
89
90
91
92
93
94
95
96
97
98
99
100

KENTUCKY BUSINESS CORPORATION ACT REVISIONS
AND
THEIR EFFECT UPON FINANCIAL INSTITUTIONS

TABLE OF CONTENTS

Acknowledgment	B - 1
I. Introduction	B - 2
II. Director and Officer Liability	B - 2
III. Share Exchanges	B - 3
IV. Overhead in Concept of Capital Account	B - 3
V. Redemptions and Distributions	B - 4
VI. Miscellaneous Provisions of Interest	B - 6
VII. The Business Judgment Rule	B - 7
VIII. Director's Standard of Conduct in Kentucky -- "MISMANAGEMENT" AND THE "CONSTRUCTIVE FRAUD" STANDARD	B - 10
IX. Director's Standard of Conduct in Kentucky -- "INATTENTION" AND THE "GROSS NEGLIGENCE" STANDARD	B - 19
Appendix NEW REVISIONS TO THE KENTUCKY BUSINESS CORPORATION ACT	B - 24



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I. INTRODUCTION

- A. House Bill 323 (the "New Act") which essentially replaces the current Chapter 271A was passed without opposing vote by the 1988 General Assembly and will become law on or about July 13, 1988.
- B. Kentucky's current corporation law (contained in Chapter 271A of the KRS) was originally enacted in 1972, and was patterned after the 1969 version of the Model Business Corporation Act. The latest revised version of the MBCA was issued by the American Bar Association in 1984 following four years of study. That revised version served as the foundation for House Bill 323.
- C. The New Act will (i) be directly applicable to the corporate governance of Kentucky state banks and holding companies domiciled in Kentucky and (ii) affect certain aspects of lending by state or national banks to Kentucky corporations.

II. DIRECTOR AND OFFICER LIABILITY

- A. Suits against directors and officers are on the rise both nationally and in Kentucky. The number of failing banks has been rising which increases the number of potential suits by shareholders and regulators. Takeovers frequently accompanied by suits against directors, have continued to increase as regulatory and state law restrictions on acquisitions have fallen. The FDIC and FSLIC have commenced a number of lawsuits against directors and officers when banks fail.
- B. Due to these factors director and officer liability insurance has become (1) difficult to obtain, (2) if obtainable, extremely costly, and (3) subject to higher deductibles and more restrictive coverages.
- C. Before the MBCA was originally adopted in 1972 the Kentucky statutes contained a duty of care for directors. The current statute does not. The New Act would restore a statutory duty of care. See Appendix for Section 16 (Delaware-style provision for articles of incorporation), Section 85 (general duty of care for directors and officers) and Section 91 (duty of care for officers).

III. SHARE EXCHANGE

- A. A new type of corporate transaction allowing a corporation to acquire all of the outstanding shares of another corporation if both boards of directors and both groups of shareholders approve the exchange.
- B. The end result will be that the acquired corporation becomes a subsidiary of the acquiring corporation with the acquiring corporation being assured of owning 100 percent of the shares of the acquired corporation.
- C. The plan of exchange is similar to a plan of merger and [examine whether acquiring corporation shareholders need approve the plan of exchange.]
- D. The share exchange mechanism is essentially the same as a triangular merger. However, for bank acquisitions, in the near future it should no longer be necessary to bear the expense and time delays associated with forming an interim bank in order to complete an acquisition by triangular merger.
- E. Dissenters' rights will apply if the shareholder is entitled to vote on the plan of share exchange.

IV. OVERHAUL IN CONCEPT OF CAPITAL ACCOUNTS

- A. The New Act eliminates the necessity of the concepts of par value, stated capital and capital surplus.
- B. Two fundamental characteristics must be present in every corporation's capital structure:

There must be outstanding at all times one or more classes or shares possessing (a) unlimited voting rights and (b) the right to receive the net assets of the corporation upon dissolution.

That would be what today is "common stock."

- C. The New Act specifically authorizes the creation of "callable common stock" (i.e., shares of voting stock without preferential rights which are redeemable at the option of the corporation).

The New Act also authorizes "puttable" shares (i.e., shares which are mandatorily redeemable at the option of the shareholder).

The drafters of the MBCA concluded that a statutory limitation on the right of the corporation to issue shares of redeemable common stock or puttable common stock serves no purpose in light of contractual common stock transfer arrangements which effectively achieve the same result.

The New Act authorizes shares which are convertible into a class of shares having superior rights and preferences or into debt securities. Such upstream conversions would be prohibited under the current statutes (KRS 271A.075(2) (e)), but were permissible under Kentucky statutes before the adoption of the NBCA in 1972.

Even under prior case law, courts were reluctant to allow shareholders to stand pari passu with other creditors for claims in bankruptcy. See In re Phoenix Hotel Co., Lexington, Ky. 13 F.Supp. 229 (E.D. Ky. 1935), aff'd, 83 F.2d 724 (6th Cir. 1936) where the district court held that the statute would not give the holders of preferred stock which was convertible into mortgage bonds of the issuer priority over creditors' claims in bankruptcy.

V. REDEMPTIONS AND DISTRIBUTIONS

- A. With the elimination of the importance of capital accounts, distributions and redemptions become considerably less problematic.

Under current Kentucky statutes, redemptions are treated as distributions and can only be made to the extent of earned surplus, or, if the corporation's articles of incorporation permit, capital surplus [check this out and add citation]

These restrictions pose huge problems where one large shareholder in a successful closely held business wants to sell out to the other. Generally, banks would need the assets of the corporation to secure the loan so that the sale was frequently structured as a redemption. However, if the purchase was at a price than book value, in many

instances there was insufficient surplus to permit the "distribution" made through the redemption.

- B. The New Act gathers in one uniform section a new definition of "distribution":
 - 1. Declaration or payment of dividends.
 - 2. Purchase, redemption or other acquisition of shares.
 - 3. Distribution of indebtedness.
- C. The New Act contains two restrictions based on traditional balance sheet and insolvency tests.
- D. Distributions are permitted unless
 - 1. The distribution would render the corporation unable to pay its debts as they become due in the ordinary course of its business.
 - 2. The distribution would reduce the corporation's total assets below the sum of total liabilities and dissolution preferences.
- E. The New Act makes clear that determinations of permitted distributions may be based on financial statements prepared on the basis of reasonable accounting principles, fair valuation or other methods reasonable under the circumstances. This will permit the write-up of certain assets not fully accounted for under generally accepted accounting principles (i.e., appreciated real estate which is carried at a low value on the corporation's books).
- F. Financial statements prepared in accordance with general accounting principles are not required under the New Act in order to make these distributions. This will permit smaller corporations to use reasonable methods other than statements prepared by outside auditors.
- G. Practitioner's note: Counsel representing banks may want to draft covenants limiting distributions which can not be simply referenced into the New Act. Typical current restrictions in loan agreements regarding amendments of articles of incorporation requiring the consent of the bank should cover puttable and callable common stock and upstream conversions

if share dividends and reclassifications require the bank's consent under the loan agreement.

VI. MISCELLANEOUS PROVISIONS OF INTEREST

- A. The dissolution process for a corporation is simplified to a one-step process. It is hoped that more corporations will avail themselves of the formal process rather than letting the charter "die on the vine."
- B. Section 48 of the New Act clarifies that if indebtedness is issued as a distribution (i.e., a note given in connection with a redemption of stock) the solvency tests will be measured at the earlier of the date the debt is incurred by the corporation or the date the shareholder ceases to be a shareholder with respect to the redeemed shares. Absent a subordination agreement, the shareholder will be at parity with the corporation's other general creditors with respect to the debt.
- C. Section 57(3) makes it clear that a bank may vote shares of its own stock held in its trust department in a fiduciary capacity (consistent with Graves v. Security Trust Co., 369 S.W.2d 114 (Ky. 1963) where the Court of Appeals held that the then prevailing statutory restriction on voting shares owned directly or indirectly by a corporation of its own stock would not apply to bank trust departments holding shares of the bank in a fiduciary capacity because the stock did not "belong to the institution").
- D. The dissenters' rights provisions have been expanded and simplified.
 1. Now dissenters' rights include certain amendments to the articles of incorporation affecting the following shareholders' rights.
 - a) Alters or abolishes preferential right to distributions or in liquidation.
 - b) Creates, alters or abolishes a redemption right.
 - c) Excludes or limits voting rights other than dilutions or issuance of additional shares.

d) Cash out reverse stock split.

- E. The corporation will be required in the notice of the meeting to state that shareholders are or may be entitled to dissenters' rights (consistent with current federal law requirements for public companies).
- F. More information must be given to the shareholders explaining how to exercise their dissenters' rights, including providing them a copy of the statute.

VII. THE BUSINESS JUDGMENT RULE

- A. The Business Judgment Rule is a long-standing, common law rule of corporate governance. See A. Arsht, "The Business Judgment Rule Revisited," Hofstra L. Rev. 93 (1979). The Business Judgment Rule is rooted in the notion that courts will refrain from substituting their own judgment for that of directors acting in good faith. The Rule is generally invoked to protect directors from liability. A related concept, the Business Judgment Doctrine, is frequently invoked in the anti-takeover context to sustain defensive measures taken by a target's board of directors. Courts frequently use the two terms interchangeably.
- B. The generally cited elements of the Rule are:
 - 1. Absence of personal interest or self dealing.
 - 2. An informed decision.
 - 3. Reasonable belief that the action taken serves the corporation's best interest.
 - 4. Good faith (which has, in some cases, found to be lacking where there is a knowing violation of a statute, authorization of ultra vires acts by the corporation, or a knowing violation of a statute).
- C. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
Van Gorkom involves a class action brought by shareholders of Trans Union Corporation to enjoin a cash-out merger, and later seeking ultimate relief of damages against Trans Union's directors.

The rather complicated set of facts involves the solicitation by management of an acquisition offer from J. A. Pritzker without the Board's knowledge.

A Board meeting was called by Van Gorkom, Chief Executive Officer, on 24-hours notice to sign the merger agreement at \$55 per share. The Board was not informed of the purpose of the meeting. Of the ten directors at the Board meeting, the inside members of the Board were outnumbered by the outsiders 5 to 4 (4 of the outside directors were corporate CEO's; the 5th was the former Dean of University of Chicago Business School).

Van Gorkom began the special meeting with a 20-minute oral presentation. Copies of the merger agreement were delivered too late for the board to review them before voting on the merger. The Board meeting lasted 2 hours.

Based upon (1) Van Gorkom's oral presentation, (2) the Chief Financial Officer's oral statement, (3) legal advice that the Board might be sued if they failed to accept the offer and that a fairness opinion was not required as a matter of law, and (4) the Board's knowledge of the market history for the common stock (a premium of from 39 to 62% over various historical market prices), the Board approved the merger.

The merger agreement was signed at a social affair without any of the directors reading it.

The merger agreement contained a standstill provision. The standstill provision was subsequently amended at another hastily called meeting where the Board members did not see the amendment and Solomon Brothers was hired to solicit other offers during a proposed "market test".

While two other offers were produced by the "market test," neither came to fruition. General Electric would not make a formal offer unless the merger agreement was rescinded and Kohlberg, Kravis withdrew its offer due to Van Gorkom's completely negative attitude.

The shareholders of Trans Union subsequently approved the merger by a vote of 69.9% in favor of the

merger; 7.25% against the merger; and 22.85% abstaining.

Holding: The Court held that (1) the Board's approval of the cash-out merger was not the product of an informed business judgment (2) the Board's subsequent efforts to amend the merger agreement and take other curative action were ineffectual, both legally and factually, and (3) the Board did not deal with complete candor with the stockholders by failing to disclose all material facts, which they knew or should have known, before securing the stockholders' approval of the merger.

The Court reaffirmed its view stated in an earlier 1984 case, Aronson v. Lewis, 473 A.2d 805 (Del. 1984): "while the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the Business Judgment Rule director liability is predicated upon concepts of gross negligence. (quoting from Aronson) We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a Board of Directors was an informed one."

The Court found that: (1) the directors must be informed before making the business decision, particularly citing the lack of any sort of inside or outside valuation of the "intrinsic value" of Trans-Union; (2) the obligation requires more than mere absence of bad faith or fraud; and (3) the directors have an affirmative duty to protect the financial interest of the stockholders.

VIII. Director's Standard of Conduct in Kentucky--"MISMANAGEMENT" AND THE "CONSTRUCTIVE FRAUD" STANDARD.

A. Security Trust Company v. Dabney, 372 S.W. 2d 401 (Ky. 1963).

1. Facts. Consolidation of Security Trust Company with First National Bank and Trust Company of Lexington. Shareholder brought derivative action demanding that the proposed consolidation be judged unlawful and that officers and directors of Security Trust personally indemnify the company for the alleged loss of value of shares of its own stock held by the company in various fiduciary capacities.

Circuit Court dismissed. Affirmed.

2. Held. Plaintiff failed to state a cause of action for which relief could be granted.

3. Points.

a. Directors' assuming seats on the board of the combined entity until the first annual meeting of shareholders did not taint the transaction with self-interest.

b. Vague allegations that it was a bad business deal for Security Trust stockholders and trust accounts were rejected. The court's entire discussion of the duty of care is as follows:

All of the allegations [that it was a bad business deal] address themselves to the matter of business judgment. Absent fraud, actual or constructive, the courts will not interfere with the management of a private corporation. (Carter and Venus Oil, both discussed infra). If, as contended, Security's trust accounts will suffer loss through wrongful imprudence, this suit does not abridge or affect any redress to which the beneficiaries of the various trusts may be entitled.

The court's statement of the law and application of authority, is largely perfunctory. Compare the gross negligence applied to financial institutions for inattention to duty under Part IX.

B. Levitan v. Stout, 97 F.Supp. 105 (W. D. Ky. 1951).

1. Facts. Stockholder derivative action naming the corporation and six directors and former directors as defendants. S, the chairman, owned 32% of the stock. D, S's son-in-law and the president, owned between 8% and 15% of the stock during the years in question. Plaintiffs allege that defendants managed the corporation incompetently and negligently with resulting damage, and they kept D in office as president despite his allegedly demonstrated incompetence because D and S exercised their control of the corporation to compel the other defendants to do so. The complaint describes a series of transactions that resulted in significant losses to the corporation and in which defendants allegedly acted with "gross culpable negligence in complete disregard of the interests of" the corporation. After these transactions, D resigned as president and director.

No stockholder made demand on the board to institute legal actions against the defendants. Plaintiffs claimed such demand would have been futile. The Court noted that had plaintiffs waited until next annual meeting of stockholders, which was scheduled to occur shortly after filing of the action, a vacancy on the board would have been filled, leaving the director defendants holding only three of the seven seats on the board.

Defendants moved: (1) to realign the corporation as a party plaintiff; (2) to dismiss for lack of diversity, failure to exhaust corporate remedies and absence of a cause of action under Kentucky corporate law; and (3) to strike certain allegations relating to acts done prior to the acquisition of stock by the plaintiffs and for failure to show a breach of duty to the corporation.

The court stated that although not necessary to resolve the case, it would pass on all the motions to give any appellate court "the benefit of this Court's views, for what they may be worth, on all the points at issue."

2. Held:

a. Corporation realigned as a party plaintiff under Kentucky law, the applicable substantive law, and because demand was not made.

b. Motion to dismiss granted for lack of complete diversity, plaintiffs' failure to exhaust their corporate remedies as demand was not futile, and failure to state a

claim of "constructive fraud" upon which the directors could be held liable to the corporation.

c. Plaintiffs allegations stricken regarding acts occurring prior to plaintiffs' ownership of stock and for failure to plea fraud with sufficiently specific facts.

3. The opinion distinguishes between the standard of care for conscious business judgments and the "somewhat stricter standard of performance" for a bank directors' lack of attention to the bank's affairs. See Part II.

b. The opinion cites six of the cases discussed infra and quotes at length from the Venus Oil case. The standard for liability as quoted by the opinion includes not only acts constituting fraud in the broad sense, but also directors' abuse of "the implied trust imposed in officers and directors in such manner or such extent to warrant the imposition of equity." 97 F.Supp. at 116.

c. After quoting from Venus Oil, including the reference to fraud in the broad sense, the opinion offers the following limited definition of "constructive fraud" without citing any authority, Kentucky or otherwise.

"'Constructive fraud,' as the term is used in the Kentucky decisions, refers to acts which may have done in good faith and with no purpose to harm the corporation, but which were done by a person who has allowed himself to be placed in a position of conflict between a fiduciary obligation and his own private interests (or, perhaps, some other fiduciary obligation). In this situation, by reason of the strict rule applicable to fiduciaries, the courts will examine carefully into the results of the act and will hold the fiduciary liable if, despite his good intentions, his act results in injury of the subject-matter of his trust.

"The allegations of the amended complaint do not make out a charge of constructive fraud. The various charges of 'culpable negligence', 'reckless disregard' of the welfare of the corporation, 'incompetence', and 'waste' do not imply that individual defendants have placed

themselves in a position of conflict."
Id. at 117.

Compare this interpretation of constructive fraud against the actual language of Venus Oil and the other Kentucky cases cited in Levitan and discussed below.

C. Venus Oil Corporation v. Gardner, 244 Ky. 176, 50 S.W.2d 537 (Ky. 1932).

1. Facts. Minority stockholders brought an action against the corporation and the three majority stockholders and directors of the company, alleging the salaries paid from 1921 to 1930 to two of the named individuals (who are also officers of the corporation) were excessive in light of the company's financial condition during that period.

The circuit court entered judgment for the plaintiffs of over \$28,000 and enjoined the directors from paying any sum in excess of \$50 a month for future services rendered by the two officers. Reversed.

2. Held. Plaintiffs failed to carry the burden of affirmatively establishing that the compensation paid to the officers was unreasonable and excessive.

3. Points.

a. The analysis begins with a statement of the applicable law containing the language quoted verbatim in Levitan, supra, and the following quotation from Poutch v. National Foundry & Machine Co., 147 Ky. 242, 143 S.W. 1003 (1912): "[T]he general rule is that the action of the directors must be a fraud on the corporation, actually or constructively, before the directors can be liable." 50 S.W.2d t 538.

b. After reviewing reports prepared by accountants for the plaintiffs and for the defendants the court concludes "[The] accounts seem to reflect a satisfactory investment of the kind in a proper management. Certainly, the result does not indicate spoilation or waste." Id., at 539. Query: Does this mean that waste resulting from acts made in good faith can rise to the level of constructive fraud?

D. Carter v. Louisville Ry. Co. 238 Ky. 42, 36 S.W.2d 836 (Ky. 1931).

1. Facts. The board of directors adopted a bylaw authorizing the payment of fees for attendance at meetings of the executive committee. Shareholders challenged the

payment of such fees to the president and general counsel of the corporation at a time when earnings were down and expenses up.

Circuit Court dismissed. Affirmed.

2. Held. As a matter of construction, the bylaw at issue did not exclude the payment of fees to salaried officers. The bylaw is valid as it was validly adopted and not contrary to law.

3. Points.

a. As the bylaw was passed by a majority of the directors without counting the votes of those directors benefitted by the bylaw, there was no conflict of interest.

b. As support for its conclusion that the bylaws involved no conflict of interest that would render the directors' adoption of the bylaw ultra vires (a connection the opinion does not make very clear), the opinion makes the following statement:

It is well established that the courts will not interfere with the discretion of a board of directors in exercising its legal powers by acting within the limits of its charter, without fraud, actual or constructive, upon the shareholders, regardless of motives. [citing Haldeman] The reasoning and citations of authority contained in that opinion need not be repeated." 36 S.W.2d at 838.

E. Haldeman v. Haldeman, 176 Ky. 635 197 S.W. 376 (Ky. 1917).

1. Facts: Two brothers and a sister inherited approximately 80% of the shares of two newspapers. Following the settlement of their father's estate, the three agreed in writing to maintain an arrangement for the management of the newspapers that provided one brother would be president and director, one brother would be a director, and the sister would vote to maintain her brothers in those offices and could name another director. Several years later the board of directors of the newspapers adopted a plan calling for a three-person executive committee to control the operations and editorial policies of both newspapers. The plaintiff brought an action for injunction against his brother and sister and

against the other directors and officers requesting enforcement of the prior agreement.

The chancellor enjoined the defendants from removing the plaintiff as president of the newspapers and otherwise implementing the planned executive committee. Reversed.

2. Held: The Kentucky corporation statute regulating the control and management of corporations prevails over a personal agreement of shareholders that conflicts with the statute.

3. Points: The court declared it against public policy to enforce a private agreement (not a voting trust) by which a shareholder bargains away her right to vote for directors according to her best judgment and in the best interest of the corporation.

4. Dicta: On its own initiative, the court "recurs" some elementary rules of law regarding corporate shareholders and officers, some of which have been selectively quoted in subsequent opinions.

a. A director is a "trustee."

b. Stockholders have no right to appeal an error or mistake of judgment if no breach of trust is involved (quoting Dudley, infra).

c. Courts will not interfere with management as to matters intra vires, if management does not act fraudulently. Any such interference would be utterly inconsistent with the common laws of property as a corporation owns its property (citing Manufacturers' Land & Improvement Co. v. Cleary, infra).

d. Citing Graham v. McAdoo, infra: "Courts will not interfere with the management of a majority unless there is actual fraud or such a wasting of the corporate property as practically amounts to fraud" (the latter seems to not strictly limited intentional acts).

e. Citing Benedict v. Columbus, 49 N.J. Eq. 36, 23 A.485: The remedy of stockholders is to elect new officers or to sell their shares if the company's management is conducted without fraud or by action not ultra vires, or not in gross abuse of trust.

f. Poutch v. National Foundry & Machine Co., 147 Ky. 242, 143 S.W. 1003 (1912).

1. Facts: Minority shareholder sues three directors who together own a majority of the shares. The defendants were the president-treasurer, general manager, and a non-employee who advised management on financial matters. The plaintiff alleged that the increase in salaries for the two officers over ten years, given the financial condition of the business, constituted fraud on the shareholders.

Dismissed by Circuit Court. Affirmed.

2. Held: No proof of fraud to overturn the judgment below.

3. Points:

a. No conflict of interest. The director-officers did not vote on board action setting their respective salaries, nor were their votes required for a quorum of the board.

b. Opinion cites the need for skilled management, an increase in the cost of living during the period in question, an agreement by the officers to take a low salary in the initial years of the company's operations and the relative success of the company.

G. Graham v. McAdoo, 135 Ky. 677, 123 S.W. 260 (1909).

1. Facts: The company's common stock was equally divided between two conflicting factions. The president was authorized to cast the deciding vote in the event of any tie, effectively enabling him to monopolize the management of the corporation. G, upon his election as president, proceeded to exclude the other faction entirely from participation in the Company's affairs. G also reduced the size of the board of directors to consolidate his faction's control of the board.

Following G's election to office, the company ceased to be profitable. Officers' salaries increased and many inconsistencies appeared in the corporation's records.

Plaintiffs brought an action to dissolve the corporation and to appoint a receiver to take charge of its property. Allegations included fraudulent acts by the president in the management of the corporation, wrongful appropriation of money to his own use, his reckless wastefulness and unbusinesslike methods, and his refusal to allow plaintiffs to participate in management or to examine the books.

Circuit court appointed a receiver. Affirmed.

2. Held: There was sufficient evidence of mismanagement, if not actual fraud, to authorize the appointment of the receiver and to order the property sold.

Points:

a. While citing the general rule that, absent actual fraud or such a wasting of the corporate property as practically amounts to fraud, the court will not interfere with the management of a majority, the opinion distinguishes its action in the instant case by noting that the two factions each held 50% of shares of the corporation.

b. Although there was no unequivocal proof of misappropriation of corporation funds for the president's personal use, neither can all of the corporate funds be accounted for.

c. The court describes the president's conduct as "recklessly unbusinesslike, if not fraudulent," citing the removal of many pages from the corporation's day-book and the payment for two loads of coal when only one was purchased.

H. Manufacturers' Land & Improvement Co. v Cleary, 121 Ky. 403, 89 S.W. 248 (1905).

1. Facts: The company was organized and had invested in real estate just before the Panic of 1893 caused land values to plunge. Plaintiffs brought an action for dissolution of the corporation and appointment of receiver, alleging the corporation was doing nothing, had never made any money, its purpose was impossible of execution, and it was insolvent.

Circuit court ordered the appointment of a receiver. Reversed.

2. Held: The evidence did not show bad faith on the part of officers or a majority of shareholders or the fraudulent abuse of implied trust to warrant the appointment of the receiver.

3. Points:

a. So long as it acts within the scope of its corporate powers, a corporation has the same right to manage its property according to its own judgment which is evidenced by the judgment of its directorate, as any individual has his own property.

b. Only in the event of the fraudulent abuse of the implied trust to stockholders that the corporate assets will be honestly employed in the corporate enterprise, is a court of equity warranted in interfering with the corporate management.

c. No citations whatsoever. Lots of strong dicta.

I. Hoffaker v. Krieger's Assignee, 107 Ky. 200 53 S.W. 288 (1899).

1. Facts: The company was organized to build a bridge over the Ohio River, but did not have sufficient capital to complete the construction. A committee was appointed to negotiate with railroads for completion of the bridge with the understanding that if successful, committee members would be compensated for their services with company stock. The committee failed in its efforts, but the directors continued to negotiate with railroad companies and eventually were able to contract for the completion and sale of the bridge. To complete the deal, the directors pledged their personal credit to borrow the funds necessary to settle the claims by the company's creditors. The final sale price permitted the payment of the directors' expenses and a 33% dividend to shareholders. The directors did not enter into a formal agreement to be compensated for their services in the negotiations as they were not permitted to contract with the corporation. A resolution authorizing for the payment of bonds to the directors for their services was adopted at a subsequent meeting of shareholders.

Plaintiff, the sole shareholder not voting for the resolution, brought an action to enjoin the payment of compensation, alleging that directors could have no legal claim against the corporation for services rendered by them in fulfillment of their duties to the corporation.

The circuit court sustained a demurrer barring payment to the directors. Reversed.

2. Held. Because the directors rendered services to the corporation beyond the scope of and not required of them by their duties as director, they may recover compensation for their services upon an implied contract. By adopting the resolution, the shareholders acquiesced in the action of the directors, and the voidable contract arising by implication from the actions of the directors became binding upon the corporation.

3. Points.

a. The court made the statement that it would not, in the absence of fraud or clear mistake, substitute its judgment for the judgment of shareholders. 53 S.W. at 290.

b. Query: If a "fraud or clear mistake" standard should apply to actions by shareholders, should actions by directors be entitled to more protection from judicial intervention?

c. Huffaker is cited by Venus Oil and Levitan as authority for the "fraud in the broad sense or abuse of implied trust" standard, although it also includes "clear mistake" as grounds for judicial intervention. Under what circumstances would a conscious business judgment be clearly mistaken?

J. Dudley v. Kentucky High-school, 72 Ky. [9 Bush] 576 (1873).

1. Facts. Shareholder brought action to enjoin corporation from purchasing a house and lands, alleging it would bankrupt the corporation.

Circuit Court granted the injunction. Reversed.

2. Held: Court of equity has no power, on basis of suit by shareholder, to enjoin a corporation from executing a contract it has the lawful right to make.

3. Points: Frequently cited language: "In cases involving no breach of trust, but only an error or mistake of judgment on the part of directors who represent the company, individual stockholders have no right to appeal to the courts to dictate the line of policy pursued by the corporation."

IX. Director's Standard of Conduct in Kentucky--"INATTENTION" AND THE "GROSS NEGLIGENCE" STANDARD.

A. Cunningham v. Shellman, 164 Ky. 584, 175 S.W. 1045 (1915).

1. Facts. Depositors of insolvent bank brought action against directors to recover dividends unlawfully declared, the full amount of the deposits, and other amounts lost to the bank. Only following insolvency was it discovered that the cashier had borrowed large amounts of money from the bank on his own notes, and had invested bank funds without

security in enterprises he had promoted or with which he had been connected, all of which had failed. All of the actions by the cashier were properly entered on the bank's records. The directors admitted they had relied exclusively on statements made by the cashier and had never made an independent investigation of any information provided to them or into the unsecured investments. In addition, dividends were declared solely on the basis of the cashier's representations to the directors.

Circuit Court held directors who authorized payment of dividends liable for the amount of each dividend declared. Affirmed in part and reversed in part.

2. Held. The directors were grossly negligent, manifesting a reckless disregard of the rights of the depositors, and were liable for all the debts of the bank and the improper dividends.

3. Points. Directors of a bank must take such care of its affairs as men of ordinary prudence would exercise under similar circumstances and conditions to see that the business of the bank is conducted in a prudent manner.

b. Gross negligence constitutes the reckless disregard of the rights of depositors.

B. Savings Bank of Louisville's Assignee v. Caperton, 87 Ky. 306, 8 S.W. 885 (1888). Action by depositors against president and directors of the insolvent bank for negligence in failing to supervise the cashier, who embezzled \$118,000 and rendered the bank insolvent. The cashier was a former president of the bank and a well-respected member in the community. He doctored the books to cover up his actions such that it would have taken an accountant to discover the fraudulent entries.

Chancery Court held for defendants. Affirmed.

2. Held. Directors were not personally liable for frauds of cashier concealed by a system of false entries requiring the skill of an expert accountant to ascertain when no breach of duty on the part of the cashier had been brought to the attention of the directors.

3. Points:

a. Directors are not liable to stockholders for the default of the cashier unless occasioned by their fraud or gross neglect.

b. Directors are under no personal liability to the creditors of a bank by reason of a neglect of duty.

c. The law did not require the directors to examine the books of the bank in the absence of any reason for suspecting the honesty of the cashier. To hold directors responsible for failing to discharge such a duty would impose a responsibility that no businessman would assume, without compensation commensurate with what the labor required.

d. While it may be prudent to have more than one employee in charge of the books, in this case the directors decision to permit the cashier to discharge the double duty of bookkeeper and cashier does not evidence a want of ordinary diligence on their part.

X. Directors - Statutory Standard of Care and Liability
(herein the legacy of Smith v. Van Gorkum)

A. Background

1. Case law - Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985); see discussion supra.
2. Insurance problems
3. Other state's legislative actions
 - a. Delaware - shareholder can opt-out of directors' liability for breach of duty of care
 - b. Indiana - liability only for willful misconduct or recklessness
 - c. Ohio - liability requires deliberate intent to injure the corporation or reckless disregard for its interests
 - d. Pennsylvania - shareholder amendment can limit individual liability to self dealing, willful misconduct or recklessness
 - e. Since the Delaware statute was adopted in the summer of 1986, 24 states have acted to adopt a director exculpatory provision (through January 1, 1988)
4. Business judgment rule; duty of care; duty of loyalty

B. The New Act

1. Codifies the business judgment rule and business judgment doctrine
2. 3-part test
 - a. good faith
 - b. on an informed basis
 - c. honest belief acting in the best interest of the corporation
3. Duties are discharged on an informed basis if director, acting with the care an ordinarily prudent person in a like position would exercise under similar circumstances, makes inquiry
4. Permits reliance on reports, etc. from:
 - a. officers and employees
 - b. professionals (lawyers, accountants, etc.)
 - c. board committees
5. Reliance must be accompanied by honest belief as to competence of persons upon which reliance is made.
6. Also, no escape for ostrich - not acting in good faith if director has knowledge which makes reliance unwarranted
7. Injunctive relief - director fails 3-part test
8. Money damages -
 - a. fails 3-part test (described in "2" above)
 - b. failure constitutes willful misconduct, or wanton or reckless disregard for best interest of corporation and shareholders
9. Burden of proof on plaintiff to prove by clear and convincing evidence the breach and that breach was the legal cause of damages
10. Opt-out (similar to Delaware) - shareholders can amend articles of incorporation to limit or eliminate directors liability; except that liability may not be limited or eliminated for transactions involving:
 - a. conflict between director's personal financial interest and the financial

interests of the corporation or its shareholders

- b. acts not in good faith, which involve intentional misconduct or are known by director to be a violation of law
- c. unlawful distributions
- d. improper personal benefit received by director

NEW REVISIONS TO THE
KENTUCKY BUSINESS
CORPORATION ACT

SECTION 16. A NEW SECTION OF KRS CHAPTER 271A IS
CREATED TO READ AS FOLLOWS:

13 (d) A provision eliminating or limiting the personal
14 liability of a director to the corporation or its
15 shareholders for monetary damages for breach of his duties
16 as a director, provided that such provision shall not
17 eliminate or limit the liability of a director:

18 1. For any transaction in which the director's
19 personal financial interest is in conflict with the
20 financial interests of the corporation or its shareholders;

21 2. For acts or omissions not in good faith or which
22 involve intentional misconduct or are known to the
23 director to be a violation of law;

24 3. Under Section 88 of this Act; or

25 4. For any transaction from which the director
26 derived an improper personal benefit.

1 No such provision shall eliminate or limit the
2 liability of any director for any act or omission
3 occurring prior to the date when such provision becomes
4 effective. In no case shall this subsection or any such
5 provision be construed to expand the liability of any
6 director as determined pursuant to Section 85 of this Act.

15 SECTION 85. A NEW SECTION OF KRS CHAPTER 271A IS
16 CREATED TO READ AS FOLLOWS:

17 (1) A director shall discharge his duties as a
18 director, including his duties as a member of a committee:

19 (a) In good faith;

20 (b) On an informed basis; and

21 (c) In a manner he honestly believes to be in the
22 best interests of the corporation.

23 (2) A director shall be considered to discharge his
24 duties on an informed basis if he makes, with the care an
25 ordinarily prudent person in a like position would
26 exercise under similar circumstances, inquiry into the

1 business and affairs of the corporation, or into a
2 particular action to be taken or decision to be made.

3 (3) In discharging his duties a director shall be
4 entitled to rely on information, opinions, reports, or
5 statements, including financial statements and other
6 financial data, if prepared or presented by:

7 (a) One (1) or more officers or employes of the
8 corporation whom the director honestly believes to be
9 reliable and competent in the matters presented;

10 (b) Legal counsel, public accountants, or other
11 persons as to matters the director honestly believes are
12 within the person's professional or expert competence; or

13 (c) A committee of the board of directors of which
14 he is not a member if the director honestly believes the
15 committee merits confidence.

16 (4) A director shall not be considered to be acting
17 in good faith if he has knowledge concerning the matter in
18 question that makes reliance otherwise permitted by
19 subsection (3) of this section unwarranted.

20 (5) In addition to any other limitation on a
21 director's liability for monetary damages contained in any
22 provision of the corporation's articles of incorporation
23 adopted in accordance with subsection (2)(d) of Section 16
24 of this Act, any action taken as a director, or any
25 failure to take any action as a director, shall not be the
26 basis for monetary damages or injunctive relief unless:

1 (a) The officer has breached or failed to perform
2 his duties in compliance with this section; and

3 (b) In the case of an action for monetary damages,
4 the breach or failure to perform constitutes willful
5 misconduct or wanton or reckless disregard for the best
6 interests of the corporation or its shareholders.

7 (6) A person bringing an action or monetary damages
8 under this section shall have the burden of proving by
9 clear and convincing evidence the provisions of subsection
10 (5)(a) and (b) of this section, and the burden of proving
11 that the breach or failure to perform was the legal cause
12 of damages suffered by the corporation.

13 (7) Nothing in this section shall eliminate or limit
14 the liability of any officer for any act or omission
15 occurring prior to the date when his section becomes
16 effective.

22 SECTION 91. A NEW SECTION OF KRS CHAPTER 271A IS
23 CREATED TO READ AS FOLLOWS:

24 (1) An officer with discretionary authority shall
25 discharge his duties under that authority:

26 (a) In good faith;

1 (b) On an informed basis; and

2 (c) In a manner he honestly believes to be in the
3 best interests of the corporation.

4 (2) An officer shall be considered to discharge his
5 duties on an informed basis if he makes, with the care an
6 ordinarily prudent person in a like position would
7 exercise under similar circumstances, inquiry into the
8 business and affairs of the corporation, or into a
9 particular action to be taken or decision to be made.

10 (3) In discharging his duties an officer shall be
11 entitled to rely on information, opinions, reports, or
12 statements, including financial statements and other
13 financial data, if prepared or presented by:

14 (a) One (1) or more officers or employes of the
15 corporation whom the officer honestly believes to be
16 reliable and competent in the matters presented; or

17 (b) Legal counsel, public accountants, or other
18 persons as to matters the officer honestly believes are
19 within the person's professional or expert competence.

20 (4) An officer shall not be considered to be acting
21 in good faith if he has knowledge concerning the matter in
22 question that makes reliance otherwise permitted by
23 subsection (3) of this section unwarranted.

24 (5) Any action taken as an officer, or any failure
25 to take any action as an officer, shall not be the basis
26 for monetary damages or injunctive relief unless:

1 (a) The director has breached or failed to perform
2 the duties of the director's office in compliance with
3 this section; and

4 (b) In the case of an action for monetary damages,
5 the breach or failure to perform constitutes willful
6 misconduct or wanton or reckless disregard for the best
7 interests of the corporation and its shareholders.

8 (6) A person bringing an action for monetary damages
9 under this section shall have the burden of proving by
10 clear and convincing evidence the provisions of subsection
11 (5)(a) and (b) of this section, and the burden of proving
12 that the breach or failure to perform was the legal cause
13 of damages suffered by the corporation.

14 (7) Nothing in this section shall eliminate or limit
15 the liability of any director for any act or omission
16 occurring prior to the date when this section becomes
17 effective.

THE "NEW" UCC AMENDMENTS AND RELATED CONCERNS:
OPERATIONAL PROBLEMS IN IMPLEMENTATION

By

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THE "NEW" UCC AMENDMENTS AND RELATED CONCERNS:
OPERATIONAL PROBLEMS IN IMPLEMENTATION

TABLE OF CONTENTS

I. Introduction - Senate Bill 65	C- 1
A. Amendments to the Automated Motor Vehicle Registration System	C- 1
B. Amendments to the UCC Regarding Fixture Filings	C- 3
II. The Food Security Act of 1985	C- 5
A. In General	C- 5
B. History of the Act	C- 5
C. Effects of the Act	C- 6
D. Conclusion	C- 9
EXHIBIT 1 - SENATE BILL No. 65 - Kentucky General Assembly 1988 Regular Session	C-11
EXHIBIT 2 - Kentucky Attorney General's Opinion RE: Financial Statements and Motor Vehicle Lien Statements; OAG 87-52, 8/19/87	C-36
EXHIBIT 3 - Kentucky Attorney General's Opinion RE: Filing of Financing Statements Covering Fixtures to Real Estate; OAG 86-83, 12/17/86	C-40
EXHIBIT 4 - 7 USCA§1631, "Protection for purchasers of farm products," section of the Food Security Act of 1985.	C-45

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THE "NEW" UCC AMENDMENTS AND RELATED CONCERNS:

OPERATIONAL PROBLEMS IN IMPLEMENTATION

I) INTRODUCTION - SENATE BILL 65

A bill is currently before the Kentucky General Assembly which seeks to remedy many of the "operational problems" that have been discovered in the implementation of Kentucky's recently amended Uniform Commercial Code. (See attached "Exhibit 1").

Some of the existing operational problems may have been created by Attorney General Opinions which interpreted statutory language differently than may have been intended. Senate Bill 65 seeks to alleviate some of these problems through providing more concise definitions and guidelines.

A) Amendments to the Automated Motor Vehicle Registration System

1) A problem was created with the perfection of liens on mobile homes and trailers when Attorney General Opinion 87-61 defined the term "motor vehicle", as used in KRS Section 186A.070 of the Automated Motor Vehicle Registration System very narrowly, including only those vehicles that are motor operated. This definition excluded such vehicles as "fifth wheels" and trailers. OAG 87-51 stated that the proper method for perfecting a security interest in non-motorized vehicles was through the filing of a financing statement pursuant to the UCC. This meant that for those vehicles not included in the AG's definition there would be no notation of the lien on the certificate of title.

2) Senate Bill 65 seeks to remedy this problem by amending KRS 186A.070 so that it applies to all vehicles as

defined by KRS 186.010(8)(a), mobile homes, as defined by KRS 186.650, and trailers. This broadening and clarification will cause any vehicle for which a Kentucky certificate of title has been issued to fall under the provisions of Section 186A.

3) After passage of Senate Bill 65, liens will be noted on the certificate of title of most vehicles, both motorized and non-motorized. (It should be noted that OAG 87-61 has been withdrawn in light of this proposed legislation.)

4) To aid in the transition period, and to alleviate existing confusion as to when a continuation statement needs to be filed under the new laws, Senate Bill 65 adds the following provisions to KRS 186A:

a) Any lien notated on a Kentucky certificate of title which evidences security interest perfected after July 1, 1987, but before the effective date of this Act shall be valid whether the security interest was perfected by filing a motor vehicle lien statement under this chapter or by filing a financing statement under Article 9 of KRS Chapter 355. Such security interests shall be considered perfected as of the date of the tender of the motor vehicle lien statement or financing statement as the case may be. A security interest evidenced by a lien notated on a Kentucky certificate of title, which was perfected by filing a financing statement under Article 9 KRS Chapter 355, remains perfected without the requirement of filing a continuation statement under KRS 355.9-403.

(b)(1) If a Kentucky certificate of title is outstanding as of the effective date of this Act without the notation of a valid lien representing a security interest perfected under this chapter, the transportation cabinet upon application of either the secured party or the debtor shall cancel the current certificate of title and issue a new certificate of title with the lien notated thereon. The security interest represented by the lien shall be considered perfected as of the original date of filing of the title lien statement or financing statement.

(2) Notwithstanding the provisions of KRS 355.9-403, no continuation statement shall be filed under KRS 355.9-403 for security interests in property eligible to be titled through issuance of a Kentucky certificate of title, but for which no Kentucky certificate of title has been issued. The secured party or debtor shall apply for the issuance of a Kentucky certificate of title on such property, with the valid lien representing the security interest notated thereon, prior to or upon the date that the filing of a continuation statement would be required under KRS 355.9-403. The security interest then represented by the lien so notated shall be considered perfected as of the original date of the filing the financing statement.

5) Thus, the problem of when continuation statements need be filed, partially answered by OAG 87-52 (see attached "Exhibit 2"), is further clarified by these transition provisions.

B) Amendments to the Uniform Commercial Code Regarding
Fixture Filings

1) Another difficulty has been the determination of the proper place to file a financing statement for fixtures, or goods that are to become futures. The problem arises because Kentucky still uses a local filing system, while the UCC contemplates a centralized filing system,

2) Debtors attempting to perfect a security interest are told that they should file "in the office where a mortgage on the real estate would be filed." KRS 355.9-103. This creates confusion when the same local office is used to file both mortgages and UCC financing statements, because it is unclear whether the debtor should file in the mortgage book, the UCC book or both.

3) OAG 86-83 attempted to partially resolve this dilemma by stating that a financing statement that did not

meet the criteria for serving as a mortgage could still be filed in the real estate books to put creditors on notice. (see attached "Exhibit 3").

4) Senate Bill 65 goes one step further, and proposes to amend KRS 355.9-401, concerning the proper place to file in order to perfect a security interest by requiring that "when the financing statement is filed as a fixture filing (KRS 355.9-313) and the collateral is goods which are or are to become fixtures, then [the statement should be filed] in the office where a mortgage on the real estate would be filed or recorded, and where they shall be indexed separately from mortgage instruments."

5) This amendment will therefore alleviate the confusion by requiring that the financing statement be filed in the office with mortgages and indexed separately.

6) Senate Bill 65 also amends KRS 355.9-401 and KRS 355.9-403 to exclude coal operators and the sale of mined coal from complying with the "fixture" filing requirements under Article 9 of the UCC. This amendment was prompted by the nature of the coal industry in general. Since coal is typically mined under a leasing arrangement, with the operators obtaining the financing, and since the operators typically move from location to location frequently, requiring that they file financing statements, is impractical and inefficient.

II) THE FOOD SECURITY ACT OF 1985

A) In General

1) The Food Security Act of 1985, enacted as Public Law 99-198, includes a section concerning "Protection For Purchasers of Farm Products," ("Farm Products Section") (copy attached as Exhibit 4). This section is codified at 7 U.S.C.A. §1631(d).

2) The Food Security Act of 1985 applies to horses. If a lender fails to comply (which in some cases may be impossible), The Food Security Act of 1985 provides that "a buyer who, in the ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller, even though the security interest is perfected; and the buyer knows of the existence of such interest." 7 U.S.C.A. §1631(d).

B) History of The Act

1) Currently, §9-307 of the Uniform Commercial Code covers "buyers of goods in the ordinary course of business". Under the Code a buyer takes goods free and clear of any security interest, even if the buyer knows of an existing lien. The lone exception to this provision is the sale and purchase of agricultural products.

2) This "farm product exception" permits a lender to obtain payment or return of goods from a purchaser of agricultural products for any valid unpaid security interest

in the goods - even if the buyer was unaware of the existence of the lien.

3) Section 9-307 was originally adopted by 49 of the 50 states, however, because of the "undue" financial burden on agricultural markets, and individual farmers, 20 states have "opted out" of the farm products exception and have established their own central filing or notice system. Under such conditions, §9-307 of the UCC is no longer "uniform". Congress has determined application of the current set of state laws has created a substantial burden on interstate commerce in agricultural products.

4) The Farm Products Section was enacted to provide a single Federal rule protecting purchasers of agricultural commodities. As such, §1631 preempts the farm products exception of UCC §9-307, as well as any existing state law relating to the enforcement of security interests against the purchasers of farm products.

C) Effects of The Act

1) The Farm Products Section of the Food Security Act of 1985 essentially extends the protection granted to most purchasers under UCC §9-307 to purchasers of agricultural products. Pertinent exceptions to such protections, specifically included in the Farm Products Section, are as follows:

(e) A buyer of farm products takes subject to a security interest created by the seller if:

(1)(A) Within 1 year before the sale of the farm products, the buyer has

received from the secured party or the seller written notice of the security interest organized according to farm products that

(i) is an original or reproduced copy thereof;

(ii) contains,

(I) the name and address of the secured party;

(II) the name and address of the person indebted to the secured party;

(III) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;

(IV) a description of the farm products subject to the security interest created by the debtor, including the amount of such products where applicable, crop year, county or parish, and a reasonable description of the property; and

(iii) must be amended in writing, within 3 months, similarly signed and transmitted, to reflect material changes;

(iv) will lapse on either the expiration period of the statement or the transmission of a notice signed by the secured party that the statement has lapsed, whichever occurs first; and

(v) any payment obligations imposed on the buyer by the secured party as conditions for waiver or release of the security interest; and

(B) the buyer has failed to perform the payment obligations, or

(2) in the case of a farm product produced in a State that has established a central filing system

(A) the buyer has failed to register with the Secretary of State of such State prior to the purchase of farm products; and

(B) the secured party has filed an effective financing statement or notice that covers the farm products being sold; or

(3) in the case of a farm product produced in a State that has established a central filing system, the buyer

(A) receives from the Secretary of State of such State written notice as provided in subparagraph (c) (2) (E) or (c) (2) (F) that specifies both the seller and the farm product being sold by such seller as being subject to an effective financing statement or notice; and

(B) does not secure a waiver or release of the security interest specified in such effective financing statement or notice from the secured party by performing any payment obligation or otherwise; and

(f) What constitutes receipt, as used in this section, shall be determined by the law of the State in which the buyer resides.

(note: these exceptions also apply to commission merchants and selling agents.)

2) The effect of the federal legislation in Kentucky is not as dire as it will be in some other states because, Kentucky has already amended §9-307 to include additional protection for certain industries, including warehouses, stockyards, and horse auctions. Because there is no centralized filing system in Kentucky, Kentucky creditors must comply with

the pre-notification provisions of the federal act if they want to preserve their perfected security interests.

3) It is clear that the Farm Product Section applies to the sale of horses. The definition of "farm product" is defined as "an agricultural commodity such as wheat, corn, soy beans, or species of livestock such a cattle, hogs, sheep, horses, or poultry used or produced in farming operations, or a product of such crop or livestock in its unmanufactured state (such as ginned cotton, wool-clip, maple syrup, milk and eggs), that is in the possession of a person engaged in farming operations." (emphasis added). 7 U.S.C.A. §1631(c)(5). While some courts have held that horses may not be "farm products" in certain limited circumstances, as that term is utilized in the Uniform Commercial Code, little comfort is provided since the Uniform Commercial Code would then otherwise protect a buyer in the ordinary course.

4) The Secretary of Agricultural has issued regulations concerning the procedures that must be followed by a state to obtain certification for a centralized filing system. 51 Fed.Reg. 10, 796 (1986). These regulations also explain the effect of filing an Effective Financing Statement in one state on transactions occurring between buyers and sellers from different states.

--- D) Conclusion

1) There is discussion of legislation to establish a centralized filing system in Kentucky, however, until such system is established, it will be necessary for creditors to

comply with the pre-notification provisions set forth in the Federal Act. Horses are among the farm products included under the Federal Act, so such pre-notification provisions apply to the sale of horses.

2) Until a centralized filing system is adopted, lenders should obviously use their influence to encourage the adoption of such a system. Also, until the adoption of such a system, equine lenders will need to take special care to include appropriate information in their notifications to sales companies and also consider notifying other potential purchasers on an annual basis.

3) In addition, the Jockey Club is currently working on proposed legislation which would exempt horses from The Food Security Act of 1985.

IN SENATE

REGULAR SESSION 1988

COMMITTEE SUBSTITUTE FOR
SENATE BILL NO. 65

WEDNESDAY, FEBRUARY 10, 1988

Committee on Judiciary-Civil reported the following bill which was ordered to be printed.

"EXHIBIT 1"

C-11

AN ACT relating to security interests and declaring an emergency.

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

1 Section 1. KRS 186A.070 is amended to read as
2 follows:

3 Except as otherwise provided, the state resident
4 owner of a ~~[motor]~~ vehicle as defined in KRS
5 186.010(8)(a), mobile home as defined in KRS 186.650, or
6 trailer which will not be operated upon the highways of
7 this state must within fifteen (15) days apply for and
8 obtain a certificate of title in his name. He shall not,
9 however, be required to obtain a certificate of
10 registration until such time as the ~~[motor]~~ vehicle,
11 mobile home or trailer is to be operated upon the highways
12 of this state.

13 Section 2. KRS 186A.190 is amended to read as
14 follows:

15 (1) The perfection and discharge of a security
16 interest in any property for which has been issued a
17 Kentucky certificate of title [a motor vehicle/ required
18 to be registered or titled in accordance with this
19 chapter/] shall be by notation on the certificate of
20 title. The notation of the security interest on the

1 certificate of title shall be in accordance with this
2 chapter and remain effective until discharged under this
3 chapter and KRS Chapter 186. The perfection of an
4 assignment of a security interest which has been noted on
5 the certificate of title shall be in accordance with the
6 provisions of KRS 186.045(1).

7 (2) The notation of security interests relating to
8 property [~~vehicle~~s] required to be titled in Kentucky
9 through the county clerk shall be done in the office of
10 the county clerk of the county in which the debtor resides
11 or, if the debtor is a nonresident, in the office of the
12 county clerk in which the property [~~vehicle~~] is
13 principally situated or operated. Notwithstanding the
14 existence of any filed financing statement under the
15 provisions of KRS Chapter 355 relating to any property
16 [~~vehicle~~] registered or titled in Kentucky, the sole
17 means of perfecting and discharging a security interest in
18 property [~~a vehicle~~] for which a certificate of title is
19 required by this chapter is by notation on such property's
20 [~~vehicle/s~~] certificate of title. In other respects the
21 security interest is governed by the provisions of KRS
22 Chapter 355.

23 (3) Before ownership of property [~~a vehicle~~]
24 subject to a lien evidenced by notation on the certificate
25 of title may be transferred, the transferor shall obtain
26 the release of the prior liens in his name against the

1 property [~~vehicle~~] being transferred. Once a security
2 interest has been noted on the owner's title, no
3 subsequent title may be issued by any county clerk free of
4 such notation unless the owner's title is presented to the
5 clerk and it has been noted thereon, that the security
6 interest has been discharged. If this requirement is met,
7 information relating to any security interest shown on the
8 title as having been discharged may be omitted from the
9 title to be issued by the clerk.

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

12 (5) In noting a security interest upon a certificate
13 of title, the county clerk shall ensure that the
14 certificate of title bears the lienholder's name, mailing
15 address and zip code, the date the lien was noted, the
16 notation number and the county in which the security
17 interest was noted. The clerk shall obtain the information
18 required by this subsection for notation upon the
19 certificate of title from the title [~~motor vehicle~~] lien
20 statement described in KRS 186A.195 to be provided to the
21 county clerk by the secured party.

22 (6) In lieu of any and all fees prescribed by
23 statute and for all the costs incurred in the notation and
24 discharge of a security interest [~~on a motor vehicle~~] on
25 the certificate of title, the county clerk shall receive
26 ten dollars and fifty cents (\$10.50) of which seven

1 dollars and fifty cents (\$7.50) shall be retained by the
2 clerk and three dollars (\$3.00) transmitted to the state
3 treasurer. The fee prescribed by this subsection shall be
4 paid at the time of submittal of the title [~~motor~~
5 ~~vehicle~~] lien statement described in KRS 186A.195.

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

9 Section 3. KRS 186A.193 is amended to read as
10 follows:

11 The title [~~motor vehicle~~] lien statement, provided
12 for in KRS 186A.195, shall be developed by January 1, 1987
13 by the transportation cabinet, in cooperation with county
14 clerks, financial institutions and auto dealers. The
15 transportation cabinet shall ensure that the title [~~motor~~
16 ~~vehicle~~] lien statement is in a similar form and contains
17 the same information as that provided for in KRS 355.9-402
18 and where applicable [~~in addition~~] include the year,
19 make, motor number and identification number of a a [~~the~~]
20 motor vehicle.

21 Section 4. KRS 186A.195 is amended to read as
22 follows:

23 (1) As used in this chapter a title [~~motor~~
24 ~~vehicle~~] lien statement is a document to be submitted by
25 the secured party to the county clerk. Upon submission of
26 the title [~~motor vehicle~~] lien statement the county

1 clerk shall use the information contained therein to note
2 the security interest on the certificate of title. The
3 county clerk may make title [motor vehicle] lien
4 statements available to the general public. However,
5 public availability of such statements is not necessary or
6 effective to perfect a security interest in property
7 [motor vehicles] required to be registered or titled in
8 accordance with this chapter.

9 (2) If a title [motor vehicle] lien statement and
10 the required fees accompany the application for first
11 title of any property [a vehicle] in the name of an
12 owner, the county clerk shall enter the information
13 required by KRS 186A.190(5) into the automated system so
14 as to produce a certificate of title in Frankfort bearing
15 in addition to any other required information, the
16 information designated by KRS 186A.190(5). The clerk shall
17 thereby produce, in accordance with design of the
18 automated system, a certificate of registration, if
19 required.

20 (3) If a title [motor vehicle] lien statement and
21 the required fees are not received at the time of
22 application for first title of any property [a vehicle]
23 in the name of the owner due to owner's residency in
24 another county or if the form prescribed by KRS 186A.060
25 indicates a pending lien but the title [motor vehicle]
26 lien statement does not accompany the application for

1 title, the county clerk shall enter into the automated
2 vehicle informational system (AVIS) the name and address
3 of the lienholder and the county where the lien is to be
4 noted or that a lien is pending. The clerk shall indicate
5 a title is not to be issued until the lien has been noted
6 and fees, according to KRS 186A.190, paid in the county of
7 the owner's residence or in thirty (30) days. The county
8 clerk shall then issue the registration. The county clerk
9 in the county of the owner's residence shall, after
10 receiving the title [~~motor vehicle~~] lien statement and
11 fees, contained in KRS 186A.190 enter into the automated
12 vehicle information system (AVIS) the date of lien
13 notation and the notation number, thus enabling the system
14 to produce the title in Frankfort.

15 (4) Should a certificate of title be issued after
16 the thirty (30) day period has expired without the
17 notation of a security interest thereon or should there be
18 no provision made for a lien to be noted in the county of
19 residence of the debtor within thirty (30) days and the
20 title issued within that time, the secured party shall
21 request from the debtor, and the debtor shall submit to
22 the secured party, the certificate of title. The secured
23 party shall submit the certificate of title along with the
24 title [~~motor vehicle~~] lien statement to the county clerk
25 of the county of the debtor's residence. The county clerk
26 shall then enter the information required by KRS

1 186A.190(5) into the automated vehicle information system
 2 (AVIS) and note on the certificate of title in the
 3 appropriate section the information described in that
 4 section. Following the notation of the appropriate
 5 information on the certificate of title, the county clerk
 6 shall return the title to the debtor.

7 (5) The security interest noted on the certificate
 8 of title shall be deemed perfected at the time the
 9 security interest attaches (KRS 355.9-203) if the secured
 10 party tenders the required fees and submits a properly
 11 completed title [motor vehicle] lien statement and
 12 application for first title or, in the case of property
 13 [a vehicle] previously titled in the name of its debtor,
 14 the certificate of title to the appropriate county clerk
 15 within ten (10) days of attachment. Otherwise the security
 16 interest shall be deemed perfected at the time that such
 17 fees are tendered and such documents are submitted to the
 18 appropriate county clerk.

19 SECTION 5. A NEW SECTION OF KRS CHAPTER 186A IS
 20 CREATED TO READ AS FOLLOWS:

21 Any lien notated on a Kentucky certificate of title
 22 which evidences a security interest perfected after July
 23 1, 1987, but before the effective date of this Act shall
 24 be valid whether the security interest was perfected by
 25 filing a motor vehicle lien statement under this chapter
 26 or by filing a financing statement under article 9 of KRS

1 Chapter 355. Such security interests shall be considered
2 perfected as of the date of tender of the motor vehicle
3 lien statement or financing statement as the case may be.
4 A security interest evidenced by a lien notated on a
5 Kentucky certificate of title, which was perfected by
6 filing a financing statement under article 9 KRS Chapter
7 355, remains perfected without the requirement of filing a
8 continuation statement under KRS 355.9-403.

9 SECTION 6. A NEW SECTION OF KRS CHAPTER 186A IS
10 CREATED TO READ AS FOLLOWS:

11 (1) If a Kentucky certificate of title is
12 outstanding as of the effective date of this Act without
13 the notation of a valid lien representing a security
14 interest perfected under this chapter, the transportation
15 cabinet upon application of either the secured party or
16 the debtor shall cancel the current certificate of title
17 and issue a new certificate of title with the lien notated
18 thereon. The security interest represented by the lien
19 shall be considered perfected as of the original date of
20 filing of the title lien statement or financing statement.

21 (2) Notwithstanding the provisions of KRS 355.9-403,
22 no continuation statement shall be filed under KRS
23 355.9-403 for security interests in property eligible to
24 be titled through issuance of a Kentucky certificate of
25 title, but for which no Kentucky certificate of title has
26 been issued. The secured party or debtor shall apply for

1 the issuance of a Kentucky certificate of title on such
2 property, with the valid lien representing the security
3 interest notated thereon, prior to or upon the date that
4 the filing of a continuation statement would be required
5 under KRS 355.9-403. The security interest then
6 represented by the lien so notated shall be considered
7 perfected as of the original date of filing the financing
8 statement.

9 Section 7. KRS 355.9-401 is amended to read as
10 follows:

11 (1) The proper place to file in order to perfect a
12 security interest is as follows:

13 (a) When the collateral is equipment used in farming
14 operations, or farm products, or accounts[,] or general
15 intangibles arising from or relating to the sale of farm
16 products by a farmer, or consumer goods, then in the
17 office of the county clerk in the county of the debtor's
18 residence or if the debtor is not a resident of this state
19 then in the office of the county clerk in the county where
20 the goods are kept, and in addition when the collateral is
21 crops growing or to be grown in the office of the county
22 clerk in the county where the land is located;

23 (b) When the collateral is timber to be cut or is
24 minerals or the like (including oil and gas), other than
25 coal, or accounts subject to subsection (5) of KRS
26 355.9-103, other than accounts arising out of the sale of

1 coal, or when the financing statement is filed as a
2 fixture filing (KRS 355.9-313) and the collateral is goods
3 which are or are to become fixtures, then in the office
4 where a mortgage on the real estate would be filed or
5 recorded, and where they shall be indexed separately from
6 mortgage instruments; and

7 (c) In all other cases, if the debtor is a resident
8 of this state in the office of the county clerk in the
9 county of the debtor's residence or, if the debtor is a
10 nonresident of this state, then in the office of the
11 secretary of state of the Commonwealth of Kentucky. The
12 secretary of state may collect a fee of eight dollars (\$8)
13 for each filing in his office under this section.

14 (2) A filing which is made in good faith in an
15 improper place or not in all of the places required by
16 this section is nevertheless effective with regard to any
17 collateral as to which the filing complied with the
18 requirements of this Article and is also effective with
19 regard to collateral covered by the financing statement
20 against any person who has knowledge of the contents of
21 such financing statement.

22 (3) A filing which is made in the proper place in
23 this state continues effective even though the debtor's
24 residence or place of business or the location of the
25 collateral or its use, whichever controlled the original
26 filing, is thereafter changed.

1 (4) The rules stated in KRS 355.9-103 determine
2 whether filing is necessary in this state.

3 (5) For the purposes of this section:

4 (a) An individual debtor for whom filing is
5 controlled by KRS 355.9-401(1)(c) shall be deemed a
6 resident of the county in which the debtor's principal
7 place of business in this state is located. If the debtor
8 does not have a place of business in this state, then the
9 debtor shall be deemed a nonresident for purposes of
10 filing in this state;

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

16 (c) A limited partnership organized under KRS
17 Chapter 362 shall be deemed a resident of the county in
18 which its principal place of business is located, as set
19 forth in its certificate of limited partnership or most
20 recent amendment thereto filed pursuant to KRS Chapter 362;

21 (d) A limited partnership not organized under the
22 laws of this state and authorized to do business in this
23 state under KRS Chapter 362 shall be deemed a resident of
24 the county in which the office of its process agent is
25 located, as set forth in the designation or most recent
26 amendment thereto filed with the secretary of state of the

1 Commonwealth of Kentucky;

2 (e) A corporation organized under KRS Chapter 271A,
3 273 or 274 shall be deemed a resident of the county in
4 which its registered office is located, as set forth in
5 its most recent corporate filing with the secretary of
6 state which officially designates its current registered
7 office;

8 (f) A corporation not organized under the laws of
9 this state and authorized to transact or do business in
10 this state under KRS Chapter 271A, 273 or 274 shall be
11 deemed a resident of the county in which its registered
12 office is located, as set forth in its most recent
13 corporate filing with the secretary of state which
14 officially designates its current registered office;

15 (g) A cooperative corporation or association
16 organized under KRS Chapter 272 shall be deemed a resident
17 of the county in which its principal business is
18 transacted, as set forth in its articles of incorporation
19 or most recent amendment thereto filed with the secretary
20 of state of the Commonwealth of Kentucky;

21 (h) A cooperative corporation organized under KRS
22 Chapter 279 shall be deemed a resident of the county in
23 - which its principal office is located, as set forth in its
24 articles of incorporation or most recent amendment thereto
25 filed with the secretary of state of the Commonwealth of
26 Kentucky;

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

6 (j) A credit union organized under KRS Chapter 290
7 shall be deemed a resident of the county in which its
8 principal place of business is located, as set forth in
9 its articles of incorporation or most recent amendment
10 thereto filed with the secretary of state of the
11 Commonwealth of Kentucky; and

12 (k) Any other organization (defined in KRS
13 355.1-201) shall be deemed a resident of the county in
14 which its principal place of business in this state is
15 located. If the organization does not have a place of
16 business in this state, then it shall be deemed a
17 nonresident for purposes of filing in this state.

18 Section 8. KRS 355.9-402 is amended to read as
19 follows:

20 (1) A financing statement is sufficient if it gives
21 the names of the debtor and the secured party, is signed
22 by the debtor, gives an address of the secured party from
23 which information concerning the security interest may be
24 obtained, gives a mailing address of the debtor and
25 contains a statement indicating the types, or describing
26 the items, of collateral. A financing statement may be

1 filed before a security agreement is made or a security
2 interest otherwise attaches. When the financing statement
3 covers crops growing or to be grown, the statement must
4 also contain a description of the real estate concerned
5 and must describe the production season. If the production
6 season is not described, the financing statement shall be
7 deemed to describe the crops produced in the production
8 season which ends within twelve (12) months after the
9 filing date of the financing statement. A financing
10 statement shall not describe more than one (1) production
11 season. When the financing statement covers timber to be
12 cut or covers minerals or the like (including oil and
13 gas), other than coal, or accounts subject to subsection
14 (5) of KRS 355.9-103, other than accounts arising out of
15 the sale of coal, or when the financing statement is
16 filed as a fixture filing (KRS 355.9-313) and the
17 collateral is goods which are or are to become fixtures,
18 the statement must also comply with subsection (5). A copy
19 of the security agreement is sufficient as a financing
20 statement if it contains the above information and is
21 signed by the debtor. A carbon, photographic or other
22 reproduction of a security agreement or a financing
23 statement is sufficient as a financing statement if the
24 security agreement so provides or if the original has been
25 filed in this state or in any other state.

26 (2) A financing statement which otherwise complies

1 with subsection (1) of this section is sufficient when it
2 is signed by the secured party instead of the debtor if it
3 is filed to perfect a security interest in:

4 (a) Collateral already subject to a security
5 interest in another jurisdiction when it is brought into
6 this state, or when the debtor's location is changed to
7 this state. Such a financing statement must state that the
8 collateral was brought into this state, or that the
9 debtor's location was changed to this state under such
10 circumstances; or

11 (b) Proceeds under KRS 355.9-306 if the security
12 interest in the original collateral was perfected. Such a
13 financing statement must describe the original collateral;
14 or

15 (c) Collateral as to which the filing has lapsed; or

16 (d) Collateral acquired after a change of name,
17 identity or corporate structure of the debtor (subsection
18 (7) of this section).

19 (3) A form substantially as follows is sufficient to
20 comply with subsection (1) of this section:

21 Name of debtor (or assignor).....
22 Address.....
23 Name of secured party (or assignee)
24 Address

25 (a) This financing statement covers the following
26 types (or items) of property:

1 (Describe)

2 (b) (If collateral is crops) The above described
3 crops are growing or are to be grown on:

4 (Describe Real Estate)

5 (c) (If applicable) The above goods are to become
6 fixtures on (or) The above timber is standing on (or) The
7 above minerals or the like (including oil and gas) or
8 accounts will be financed at the wellhead or minehead of
9 the well or mine located on:

10 (Describe Real Estate).....

11 and this financing statement is to be filed in the same
12 office as the real estate records. (If the debtor does not
13 have an interest of record) The name of a record owner
14 is.....

15 (d) (If products of collateral are claimed)Products
16 of the collateral are also covered.

17 Signature of Debtor (or Assignor)

18 Signature of Secured Party (or Assignee)

19 (4) A financing statement may be amended by filing a
20 writing signed by both the debtor and the secured party.
21 An amendment does not extend the period of effectiveness
22 of a financing statement. If any amendment adds
23 collateral, it is effective as to the added collateral
24 only from the filing date of the amendment. In this
25 Article, unless the context otherwise requires, the term
26 "financing statement" means the original financing

1 statement and any amendments.

2 (5) A financing statement covering timber to be cut
3 or covering minerals or the like (including oil and gas),
4 other than coal, or accounts subject to subsection (5) of
5 KRS 355.9-103, other than accounts arising out of the sale
6 of coal, or a financing statement filed as a fixture
7 filing (KRS 355.9-313), must show that it covers this type
8 of collateral, must recite that it is to be filed in the
9 same office as the real estate records, and the financing
10 statement must contain a description of the real estate.
11 If the debtor does not have an interest of record in the
12 real estate, the financing statement must show the name of
13 a record owner.

14 (6) A mortgage is effective as a financing statement
15 filed as a fixture filing from the date of its recording
16 if:

17 (a) The goods are described in the mortgage by item
18 or type;

19 (b) The goods are or are to become fixtures related
20 to the real estate described in the mortgage;

21 (c) The mortgage complies with the requirements for
22 a financing statement in this section other than a recital
23 that it is to be filed in the real estate records; and

24 (d) The mortgage is duly recorded.

25 No fee with reference to the financing statement is
26 required other than the regular recording and satisfaction

1 fees with respect to the mortgage.

2 (7) A financing statement sufficiently shows the
3 name of the debtor if it gives the individual, partnership
4 or corporate name of the debtor, whether or not it adds
5 other trade names or the names of partners. Where the
6 debtor so changes his name or in the case of an
7 organization its name, identity or corporate structure
8 that a filed financing statement becomes seriously
9 misleading, the filing is not effective to perfect a
10 security interest in collateral acquired by the debtor
11 more than four (4) months after the debtor notifies the
12 secured party in writing of the change, unless a new
13 appropriate financing statement is filed before the
14 expiration of that time. A filed financing statement
15 remains effective with respect to collateral transferred
16 by the debtor even though the secured party knows of or
17 consents to the transfer.

18 (8) A financing statement substantially complying
19 with the requirements of this section is effective even
20 though it contains minor errors which are not seriously
21 misleading.

22 Section 9. KRS 355.9-403 is amended to read as
23 follows:

24 (1) Presentation for filing of a financing statement
25 and tender of the filing fee or acceptance of the
26 statement by the filing officer constitutes filing under

1 this Article.

2 (2) Except as provided in subsection (6) of this
3 section a filed financing statement is effective for a
4 period of five (5) years from the date of filing. The
5 effectiveness of a filed financing statement lapses on the
6 expiration of the five (5) year period unless a
7 continuation statement is filed prior to the lapse. If a
8 security interest perfected by filing exists at the time
9 insolvency proceedings are commenced by or against the
10 debtor, the security interest remains perfected until
11 termination of the insolvency proceedings and thereafter
12 for a period of sixty (60) days or until expiration of the
13 five (5) year period, whichever occurs later. Upon lapse
14 the security interest becomes unperfected, unless it is
15 perfected without filing. If the security interest
16 becomes unperfected upon lapse, it is deemed to have been
17 unperfected as against a person who became a purchaser or
18 lien creditor before lapse.

19 (3) A continuation statement may be filed by the
20 secured party within six (6) months prior to the
21 expiration of the five (5) year period specified in
22 subsection (2) of this section. Any such continuation
23 statement must be signed by the secured party, identify
24 the original statement by file number and date filed and
25 state that the original statement is still effective. A
26 continuation statement signed by a person other than the

1 secured party of [~~of~~] record must be accompanied by a
2 separate written statement of assignment signed by the
3 secured party of record and complying with subsection (2)
4 of KRS 355.9-405, including payment of the required fee.
5 Upon timely filing of the continuation statement, the
6 effectiveness of the original statement is continued for
7 five (5) years after the last date to which the filing was
8 effective whereupon it lapses in the same manner as
9 provided in subsection (2) of this section unless another
10 continuation statement is filed prior to such lapse.
11 Succeeding continuation statements may be filed in the
12 same manner to continue the effectiveness of the original
13 statement. Unless a statute on disposition of public
14 records provides otherwise, the filing officer may remove
15 a lapsed statement from the files and destroy it
16 immediately if he has retained a microfilm or other
17 photographic record, or in other cases after one (1) year
18 after the lapse. The filing officer shall so arrange
19 matters by physical annexation of financing statements to
20 continuation statements or other relating filings, or by
21 other means, that if he physically destroys the financing
22 statements of a period more than five (5) years past,
23 those which have been continued by a continuation
24 statement or which are still effective under subsection
25 (6) of this section shall be retained.

26 (4) Except as provided in subsection (7) of this

1 section a filing officer shall mark each statement with a
2 file number and with the date and hour of filing and shall
3 hold the statement or a microfilm or other photographic
4 copy thereof for public inspection. In addition the filing
5 officer shall index the statements according to the name
6 of the debtor and shall note in the index the file number
7 and the address of the debtor given in the statement.

8 (5) The uniform fee for filing and indexing an
9 original or a continuation statement shall be as provided
10 for in KRS 64.012. This fee includes the fee for filing
11 and indexing a termination statement and for sending or
12 delivering the terminated instrument and financing
13 statement.

14 (6) A real estate mortgage which is effective as a
15 fixture filing under subsection (6) of KRS 355.9-402
16 remains effective as a fixture filing until the mortgage
17 is released or satisfied of record or its effectiveness
18 otherwise terminates as to the real estate.

19 (7) When a financing statement covers timber to be
20 cut or covers minerals or the like (including oil and
21 gas), other than coal, or accounts subject to subsection
22 (5) of KRS 355.9-103, other than accounts arising out of
23 the sale of coal, or is filed as a fixture filing, the
24 filing officer shall index it under the names of the
25 debtor and any owner of record shown on the financing
26 statement in the same fashion as if they were the

1 mortgagors in a mortgage of the real estate described,
2 and, to the extent that the law of this state provides for
3 indexing of mortgages under the name of the mortgagee,
4 under the name of the secured party as if he were the
5 mortgagee thereunder, or where indexing is by description
6 in the same fashion as if the financing statement were a
7 mortgage of the real estate described.

8 Section 10. KRS 355.9-405 is amended to read as
9 follows:

10 (1) A financing statement may disclose an assignment
11 of a security interest in the collateral described in the
12 financing statement by indication in the financing
13 statement of the name and address of the assignee or by an
14 assignment itself or a copy thereof on the face or back of
15 the statement. On presentation to the filing officer of
16 such a financing statement the filing officer shall mark
17 the same as provided in KRS 355.9-403 (4). The uniform fee
18 for filing and indexing a financing statement so
19 indicating an assignment shall be as provided in KRS
20 64.012.

21 (2) A secured party may assign of record all or a
22 part of his rights under a financing statement by the
23 filing in the place where the original financing statement
24 was filed of a separate written statement of assignment
25 signed by the secured party of record and setting forth
26 the name of the secured party of record and the debtor,

1 the file number and the date of filing of the financing
2 statement and the name and address of the assignee and
3 containing a description of the collateral assigned. A
4 copy of the assignment is sufficient as a separate
5 statement if it complies with the preceding sentence. On
6 presentation to the filing officer of such a separate
7 statement, the filing officer shall mark such separate
8 statement with the date and hour of filing. He shall note
9 the assignment on the index of the financing statement, or
10 in the case of a fixture filing, or a filing covering
11 timber to be cut, or covering minerals or the like
12 (including oil and gas), other than coal, or accounts
13 subject to subsection (5) of KRS 355.9-103, other than
14 accounts arising out of the sale of coal, he shall index
15 the assignment under the name of the assignor as grantor
16 and, to the extent that the law of this state provides for
17 indexing the assignment of a mortgage under the name of
18 the assignee, he shall index the assignment of the
19 financing statement under the name of the assignee. The
20 uniform fee for filing and indexing such a separate
21 statement of assignment shall be as provided in KRS
22 64.012. Notwithstanding the provisions of this subsection,
23 an assignment of record of a security interest in a
24 fixture contained in a mortgage effective as a fixture
25 filing (subsection (6) of KRS 355.9-402) may be made only
26 by an assignment of the mortgage in the manner provided by

1 the law of this state other than this chapter.

2 (3) After the disclosure or filing of an assignment
3 under this section, the assignee is the secured party of
4 record.

5 Section 11. Whereas, existing statutes are ambiguous
6 concerning the method of perfecting security interests in
7 certain property eligible for issuance of Kentucky
8 certificates of title thereby encouraging multiple or
9 incorrect filings of financing and lien statements, an
10 emergency is declared to exist, and this Act shall become
11 effective upon its passage and approval by the Governor.

KENTUCKY ATTORNEY GENERAL'S OPINION

**RE: Financial Statements and Motor Vehicle Lien Statements
OAG 87-52 8/19/87**

OAG 87-52

**To: Donald W. Blevins, Fayette County Clerk, Lexington, Kentucky
By: Patricia Todd Thomas, Assistant Attorney General, August 19, 1987**

MOTOR VEHICLE LIEN STATEMENT—Expiration of financing statement filed prior to 7-1-87

MOTOR VEHICLE LIEN STATEMENTS—Fee for partial termination

MISCELLANEOUS TAX—Tax due for continuation statement filing

SECURED TRANSACTIONS—Proper order & place of filing fixture filing

SECURED TRANSACTIONS—Fee for filing secured interest containing assignment

MOTOR VEHICLE LIEN STATEMENT—Circumstances for amendment

SYLLABUS: Recent changes in statutes governing the filing, amending, continuation and assigning of financial statements and motor vehicle lien statements cause the following results:

- (1) A valid lien on a motor vehicle on 7-1-87 continues pursuant to transition rules KRS 355.11-103.
- (2) Before 7-1-87 a \$1.00 fee is charged for partial termination. After 7-1-87 there is no need for a partial termination on a motor vehicle lien statement.
- (3) There is no 142.010 tax on continuation statements.
- (4) A fixture filing is to be filed in a fixture filing book or in a mortgage book if document complies with mortgage requirements under Chapter 382.
- (5) A \$10.50 fee is charged for a MVLS with an assignment. Others are charged pursuant to KRS 64.012.

KRS 355.11-103, 186A.190, 142.010, 355.9-401(1)(b), 355.9-313(1)(b), 64.012

You have requested a formal opinion from the Office of the Attorney General regarding recent changes in statutes governing security agreements and secured transactions embodied in SB-28 passed by the 1986 General Assembly. In your letter of July 13, 1987, you presented the following questions:

1. Security agreements filed on motor vehicles prior to July 1, 1987 were effective for five years and sixty days unless a written continuation statement was filed. The statute, 186A under the new law, makes no mention of continuation statements. When does a perfected lien on a motor vehicle which was filed prior to July 1, 1987 expire?

If motor vehicle liens which were filed before July 1, 1987 will expire in five years and sixty days the only procedure for preserving that lien perfection is by filing a Motor Vehicle Lien Statement. Since it is a new filing it will be assigned a new file number and filing date by the clerk. In the instance where there are two liens on one title, does the secured party who holds first priority lose that priority because of this new filing?

In response to your first question, KRS 355.11-103 provides transition procedures for those transactions validly entered into after July 1, 1960 and before July 1, 1987. According to that statute,

. . . the rights, duties and interests flowing from such transactions remain valid after the latter date and may be terminated, completed, consummated or enforced as required or permitted by new UCC.

This section applies to valid security interests in collateral and, thus, applies to valid liens held on motor vehicles. A valid lien is one which has not been held for a period of time longer than five years. Any valid lien held on a motor vehicle on July 1, 1987, would not expire until terminated according to new law. No new filing is necessary so there is no confusion in the priorities.

2. Prior to July 1, 1987, the fee for filing an original security agreement included a \$1.00 fee for termination of the financing statement. Partial releases of collateral were \$1.00.

September 1987

The filing fee per motor vehicle included a \$1.00 fee for termination on motor vehicle lien statements. What is the fee for partial termination for security agreements with motor vehicles included for filings prior to July 1, 1987? What is the fee, if any, for partial terminations on Motor Vehicle Liens statements filed after July 1, 1987?

The answer to your second question is that there is a \$1.00 fee for a partial release on an original security agreement filed prior to July 1, 1987. After July 1, 1987, the revised KRS 186A.190 establishes the fee for the single notation of a security interest on the certificate of title for one motor vehicle. Therefore, after that date a partial termination would not be necessary since there is not a situation in which part of a security interest in a motor vehicle would end. Instead, a new motor vehicle lien notation should be made.

3. Does the state tax imposed by KRS 142.010 apply to continuation statements?

In response to your third question regarding the state tax imposed by Chapter 142 of the Revised Statutes, I call your attention to an opinion of the Attorney General found at 74-465. The opinion states this particular tax applies only to the filing of the original statement and not to the filing of a continuation statement. The appropriate section of the Kentucky Revised Statutes, which is now codified as 142.010(1)(c), is substantially similar to the statute upon which the above-referenced opinion is founded. Therefore, the tax is to be charged in the same manner.

4. Does a fixture filing which the secured party requests to be filed in the mortgage records have to be first filed as a financing statement before or simultaneous with its filing in the mortgage index and records?

Your fourth question is partially addressed by OAG 86-83 which refers to KRS 355.9-401(1)(b) and 355.9-313(1)(b). These sections of the Uniform Commercial Code direct fixture filings to be filed in the office where a mortgage on real estate would be filed or recorded. However, neither these sections of the Uniform Commercial Code nor OAG 86-83 require fixture filings actually be recorded with mortgages in a mortgage book. If a separate fixture filing book has been established, then the appropriate place for filing would be made in the book created for that purpose.

A duplicate filing may be made in the Mortgage Book at the request of the secured party if the fixture filing complies with Chapter 382 of the Kentucky Revised Statutes. That chapter establishes the contents which are necessary to permit proper recordation of a mortgage. Should a fixture filing contain all of the requirements of a mortgage, then it, at the request of the secured party, may be filed in the appropriate mortgage book. As to the chronological order of filing, there is no statutory direction; however, a uniform system of treatment would seem appropriate.

5. What fee should a clerk collect on a security agreement at its original filing

which assigns the secured interest within the document to a third party?

The fifth question presented concerns the fee to be collected for the filing of an original security agreement containing an assignment. The answer is dependent upon whether the security interest is to be noted upon a motor vehicle lien statement. KRS 186A.190 establishes the fee for the notation of the secured interest on the certificate of title for a motor vehicle as \$10.50. Since only one actual notation is made on the certificate, that of the assignee, the fee is \$10.50. On the other hand, if the secured interest is being filed upon property other than a motor vehicle, the fee, pursuant to KRS 64.012, would be \$6.00 for filing, \$6.00 for an assignment and \$1.00 for termination, plus any miscellaneous fees established by other applicable statutes.

6. Under what circumstances would an amendment be required to be filed to a filed Motor Vehicle Lien Statement?

With regard to your final question, it is very difficult to predict the circumstances under which a Motor Vehicle Lien Statement would be amended. The only possible amendments would be the address of the debtor or the secured party or if the secured party has changed its name. Amendments of this nature are not necessary and are at the option of the parties.



COMMONWEALTH OF KENTUCKY

OPINION OF THE ATTORNEY GENERAL

DAVID L. ARMSTRONG
Attorney General

OAG 86-83

THE CAPITOL
Frankfort 40601

December 17, 1986

Mr. Thomas V. Kennedy
Ogden & Robertson
1200 One Riverfront Plaza
Louisville, Kentucky 40202-2938

Dear Mr. Kennedy:

In your letter to the Attorney General you state that your client, AgriStor Credit Corporation, has unsuccessfully attempted to have a financing statement covering fixtures filed in several counties in the mortgage records. The financing statement is filed in the chattel records. However, the county clerks in these counties will not file the financing statement in the mortgage records since it does not comply with all the requirements of a mortgage pursuant to KRS Chapter 382. You ask for our opinion on this and several related questions (whether a full description of the real estate is required or merely a reference to the deed book and page number; whether one or two filing fees are required).

KRS 355.9-401(1)(b) states: "The proper place to file in order to perfect a security interest is as follows... (b) When the collateral is goods which at the time the security interest attaches are or are to become fixtures, then in the office where a mortgage on the real estate concerned would be filed or recorded...." This statute is effective until July 1, 1987, at which time the statute will read: "The proper place to file in order to perfect a security interest is as follows... (b) ... when the financing statement is filed as a fixture filing (KRS 355.9-313) and the collateral is goods which are or are to become fixtures, then in the office where a mortgage on the real estate would be filed or recorded..." KRS 355.9-313(1)(b) (effective July 1, 1987) states: "In this section and in the provisions of Part 4 of this Article referring to fixture filing, unless the context otherwise requires ... (b) A 'fixture filing' is the filing in the

Mr. Thomas V. Kennedy
Page Two, OAG 86-83

office where a mortgage on the real estate would be filed or recorded of a financing statement covering goods which are or are to become fixtures and conforming to the requirements of subsection (5) of KRS 355.9-402 ..."

In The Uniform Commercial Code of Kentucky (Charlottesville, Va.: Michie Co., 1983), Professors Leibson and Nowka state:

"Where the collateral is classified as a fixture at the time of attachment, or a good to become a fixture, section 9-401(1)(b) requires filing in the office where a mortgage on the real estate concerned would be filed. This filing is made with the real estate records. Simply because the office where UCC financing statements are filed happens to be the same office where real estate mortgages are recorded does not mean the attorney or secured party can just hand the financing statement to the clerk and ask him to file it. We advise attorneys to inform the clerk that the financing statement perfects a security interest in fixtures when financing statements and real estate mortgages are filed in the same office. If a fixture security interest is filed in the UCC records, it should not be considered a proper filing. The purpose behind filing is to give notice of a possible security interest to other interested persons. In the fixture situation, the interested person almost always is a subsequent mortgagee or purchaser who wants to know what liens encumber the real estate. He searches the real property records without ever thinking of searching the UCC records and has every right to expect that security interests in fixtures would be filed in the real estate records." § 8.3(C), p. 732

Mr. Thomas V. Kennedy
Page Three, OAG 86-83

This position is supported by Attorney General Opinions and case law from other states. In Florida OAG 66-52 (3 UCC Rep. Ser. 546) it was stated that a financing statement relating to a security interest in a fixture must be recorded in the same record book as mortgages. In Minnesota OAG No. 3736-17d (3 UCC Rep. Ser. 665) it was opined that a financing statement that did not meet the statutory requirements of a mortgage must still be recorded in the real estate records. In Iowa OAG S/67/1/1 (4 UCC Rep. Ser. 125) it was stated that it would be proper to note the filing of a financing statement in the real estate mortgage index. In In re Plummer, 6 UCC Rep. Ser. 555 (U.S. Dist. Ct., ED Mich., 1969), the court held that failure to file a financing statement with the real estate records caused the security interest to be unperfected.

In In re Shepherd, 14 UCC Rep. Ser. 249, 252 (U.S. Dist. Ct., WD Va., 1974) the court stated:

"The reason why a sufficient description is required on a financing statement is because property which is to become a fixture upon real estate places a burden upon lending institutions and their attorneys, as well as purchasers of said real estate, who examine the title to determine what liens and security devices may be asserted against the title and become a prior encumbrance to such a loan as may be contemplated. A title examiner is entitled in this jurisdiction, according to the cases heretofore decided prior to the Uniform Commercial Code, to rely upon the record available in the Clerk's Office to determine what encumbrances, if any, exist against the real estate."

See, also, In re Trestle Valley Recreation Area, Inc., 40 UCC Rep. Ser. 291 (U.S. Dist. Ct., North Dakota, 1984); Oklahoma OAG 70-278 (8 UCC Rep. Ser. 1150); Corning Bank v. Bank of Rectör, 265 Ark. 68, 576 S.W.2d 949 (1979).

Mr. Thomas V. Kennedy
Page Four, OAG 86-83

In our opinion, a financing statement that complies with KRS 355.9-402 and covers fixtures should be filed, at the instance of the requesting party, with the real estate records. This is not contrary to our previous opinions (OAG 81-144 and 68-407). In those opinions we stated that a financing statement could not, in and of itself, serve as a real estate mortgage unless it complied with KRS Chapter 382. In this opinion, we are stating that a financing statement that does not comply with KRS Chapter 382 may still be filed with the real estate records, not as a mortgage, but rather, to put subsequent creditors on notice. Riley v. Miller, Ky. App., 549 S.W.2d 314, 315 (1977).

You also ask what type of description is needed. KRS 355.9-402(1) states, in applicable part: "When the financing statement covers ... goods which are or are to become fixtures, the statement must also contain a description of the real estate concerned." (See, also, KRS 355.9-402(5), effective July 1, 1987.) You ask whether the description must be by metes and bounds or merely by reference to deed book and page number. In Bank of Danville v. Farmers National Bank, Ky., 602 S.W.2d 160, 162 (1980) the court held: "The description contemplated by the statutes is not required to be by metes and bounds. It does not have to be meticulous. It is only required to be in such words and terms that it can be readily located." In our opinion, a description by reference to deed book and page number is sufficient.

Finally, you ask whether, if the financing statement is filed as a fixture filing in the real estate records and as a security interest in personal property in the chattel records, two filing fees should be paid or only one. In our opinion, two separate filings are being made. Therefore, two fees should be paid.

Sincerely,



DAVID L. ARMSTRONG
ATTORNEY GENERAL



NATHAN GOLDMAN
ASSISTANT ATTORNEY GENERAL

DLA:NG:as

COMMERCIAL CODE - FINANCING STATEMENT - FORM UCC-1

CHICAGO, ILL. 60627

Financing statement is presented to a filing officer for filing pursuant to the Uniform Commercial Code: 3. Maturity date (if any):

1. Debtor (Last Name First) and address(es) Eagle, Paul, Dorothy 1424 Cedarwood Dr Louisville, KY 40272	2. Secured Party (Last Name First) and address(es) MANUFACTURERS HANOVER CONSUMER SERVICES OF AMERICA Inc. FKA FINANCE ONE 107 N. Hurstbourne Ln Louisville, KY 40222	3. Maturity date (if any): For Filing Officer (Date, Time, Number, and Filing Office):
--	---	---

Financing statement covers the following type(s) of property:
 BE FILED IN THE REAL ESTATE SECTION AS A MORTGAGE
THIS REQUEST MUST APPEAR ON ORIGINAL
 Enclosure of Back Porch
 property being improved is above address filed in
 deed book 4566 Page 50 in the Clerks office, Jefferson
 county, Kentucky

4. Description of Collateral (Date, Time, Number, and Filing Office):
 5. Assignments of Secured Party and Address(es)

Financing statement is filed without the debtor's signature to perfect a security interest in collateral. (check if so)
 already subject to a security interest in another jurisdiction when it was brought into this state.
 which is proceeds of the original collateral described above in which a security interest was perfected:

if covered: Proceeds of Collateral are also covered. Products of Collateral are also covered. No. of additional Sheets presented.

and with:
 Paul F. Eagle
 Dorothy P. Eagle
 Signature(s) of Debtor(s)
 James G. Seward
 Signature(s) of Secured Party(ies)

(1) Filing Officer Copy - Alphabetical STANDARD FORM, FORM UCC-1.

7 USCA Section 1631;

SECTION OF THE FOOD SECURITY ACT OF 1985

§ 1631. Protection for purchasers of farm products

(a) Congressional findings

Congress finds that—

(1) certain State laws permit a secured lender to enforce liens against a purchaser of farm products even if the purchaser does not know that the sale of the products violates the lender's security interest in the products, lacks any practical method for discovering the existence of the security interest, and has no reasonable means to ensure that the seller uses the sales proceeds to repay the lender;

(2) these laws subject the purchaser of farm products to double payment for the products, once at the time of purchase, and again when the seller fails to repay the lender;

(3) the exposure of purchasers of farm products to double payment inhibits free competition in the market for farm products; and

(4) this exposure constitutes a burden on and an obstruction to interstate commerce in farm products.

(b) Declaration of purpose

The purpose of this section is to remove such burden on and obstruction to interstate commerce in farm products.

(c) Definitions

For the purposes of this section—

(1) The term "buyer in the ordinary course of business" means a person who, in the ordinary course of business, buys farm products from a person engaged in farming operations who is in the business of selling farm products.

(2) the term "central filing system" means a system for filing effective financing statements or notice of such financing statements on a statewide basis and which has been certified by the Secretary of the United States Department of Agriculture; the Secretary shall certify such system if the system complies with the requirements of this section; specifically under such system—

(A) effective financing statements or notice of such financing statements are filed with the office of the Secretary of State of a State.

(B) the Secretary of State records the date and hour of the filing of such statements;

(C) the Secretary of State compiles all such statements into a master list—

(i) organized according to farm products;

(ii) arranged within each such product—

(I) in alphabetical order according to the last name of the individual debtors, or, in the case of debtors doing business other than as individuals, the first word in the name of such debtors; and

(II) in numerical order according to the social security number of the individual debtors or, in the case of debtors doing business other than as individuals, the Internal Revenue Service taxpayer identification number of such debtors; and

(III) geographically by county or parish; and

(IV) by crop year;

(iii) containing the information referred to paragraph (4)(D);

(D) the Secretary of State maintains a list of all buyers of farm products, commission merchants, and selling agents who register with the Secretary of State, on a form indicating—

(i) the name and address of each buyer, commission merchant and selling agent;

(ii) the interest of each buyer, commission merchant, and selling agent in receiving the lists described in subparagraph (E); and

(iii) the farm products in which each buyer, commission merchant, and selling agent has an interest;

(E) the Secretary of State distributes regularly as prescribed by the State to each buyer, commission merchant, and selling agent on the list described in subparagraph (D) a copy in written or printed form of those portions of the master list described in paragraph (C) that cover the farm products in which such buyer, commission merchant, or selling agent has registered an interest;

(F) the Secretary of State furnishes to those who are not registered pursuant to (2)(D) of this section² oral confirmation within 24 hours of any effective financing statement on request followed by written confirmation to any buyer of farm products buying from a debtor, or commission merchant or selling agent selling for a seller covered by such statement.

(3) The term "commission merchant" means any person engaged in the business of receiving any farm product for sale, on commission, or for or on behalf of another person.

(4) The term "effective financing statement" means a statement that—

- (A) is an original or reproduced copy thereof;
- (B) is signed and filed with the Secretary of State of a State by the secured party;
- (C) is signed by the debtor;
- (D) contains,
 - (i) the name and address of the secured party;
 - (ii) the name and address of the person indebted to the secured party;
 - (iii) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;
 - (iv) a description of the farm products subject to the security interest created by the debtor, including the amount of such products where applicable; and a reasonable description of the property, including³ county or parish in which the property is located;
- (E) must be amended in writing, within 3 months, similarly signed and filed, to reflect material changes;
- (F) remains effective for a period of 5 years from the date of filing, subject to extensions for additional periods of 5 years each by refiling or filing a continuation statement within 6 months before the expiration of the initial 5 year period;
- (G) lapses on either the expiration of the effective period of the statement or the filing of a notice signed by the secured party that the statement has lapsed, whichever occurs first;
- (H) is accompanied by the requisite filing fee set by the Secretary of State; and
- (I) substantially complies with the requirements of this subparagraph² even though it contains minor errors that are not seriously misleading.

(5) The term "farm product" means an agricultural commodity such as wheat, corn, soybeans, or a species of livestock such as cattle, hogs, sheep, horses, or poultry used or produced in farming operations, or a product of such crop or livestock in its unmanufactured state (such as ginned cotton, wool-clip, maple syrup, milk, and eggs), that is in the possession of a person engaged in farming operations.

(6) The term "knows" or "knowledge" means actual knowledge.

(7) The term "security interest" means an interest in farm products that secures payment or performance of an obligation.

(8) The term "selling agent" means any person, other than a commission merchant, who is engaged in the business of negotiating the sale and purchase of any farm product on behalf of a person engaged in farming operations.

(9) The term "State" means each of the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the Virgin Islands of the United States, American Samoa, the Commonwealth of the Northern Mariana Islands, or the Trust Territory of the Pacific Islands.

(10) The term "person" means any individual, partnership, corporation, trust, or any other business entity.

(11) The term "Secretary of State" means the Secretary of State or the designee of the State.

(d) Purchases free of security interest

Except as provided in subsection (e) of this section and notwithstanding any other provision of Federal, State, or local law, a buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller, even though the security interest is perfected; and the buyer knows of the existence of such interest.

(e) Purchases subject to security interest

A buyer of farm products takes subject to a security interest created by the seller if—

(1)(A) within 1 year before the sale of the farm products, the buyer has received from the secured party or the seller written notice of the security interest organized according to farm products that—

(i) is an original or reproduced copy thereof;

(ii) contains,

(I) the name and address of the secured party;

(II) the name and address of the person indebted to the secured party;

(III) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue Service taxpayer identification number of such debtor;

(IV) a description of the farm products subject to the security interest created by the debtor, including the amount of such products where applicable, crop year, county or parish, and a reasonable description of the property and

(iii) must be amended in writing, within 3 months, similarly signed and transmitted, to reflect material changes;

(iv) will lapse on either the expiration period of the statement or the transmission of a notice signed by the secured party that the statement has lapsed, whichever occurs first; and

(v) any payment obligations imposed on the buyer by the secured party as conditions for waiver or release of the security interest; and

(B) the buyer has failed to perform the payment obligations, or

(2) in the case of a farm product produced in a State that has established a central filing system—

(A) the buyer has failed to register with the Secretary of State of such State prior to the purchase of farm products; and

(B) the secured party has filed an effective financing statement or notice that covers the farm products being sold; or

(3) in the case of a farm product produced in a State that has established a central filing system, the buyer—

(A) receives from the Secretary of State of such State written notice as provided in subparagraph⁵ (c)(2)(E) or (c)(2)(F) that specifies both the seller and the farm product being sold by such seller as being subject to an effective financing statement or notice; and

(B) does not secure a waiver or release of the security interest specified in such effective financing statement or notice from the secured party by performing any payment obligation or otherwise; and⁶

(f) Law governing "receipt"

What constitutes receipt, as used in this section, shall be determined by the law of the State in which the buyer resides.

(g) Commission merchants or selling agents: sales free of or subject to security interest; law governing "receipt"

(1) Except as provided in paragraph (2) and notwithstanding any other provision of Federal, State, or local law, a commission merchant or selling agent who sells, in the ordinary course of business, a farm product for others, shall not be subject to a security interest created by the seller in such farm product even though the security interest is perfected and even though the commission merchant or selling agent knows of the existence of such interest.

(2) A commission merchant or selling agent who sells a farm product for others shall be subject to a security interest created by the seller in such farm product if—

(A) within 1 year before the sale of such farm product the commission merchant or selling agent has received from the secured party or the seller written notice of the security interest; organized according to farm products, that—

(i) is an original or reproduced copy thereof;

(ii) contains,

(I) the name and address of the secured party;

(II) the name and address of the person indebted to the secured party;

(III) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Internal Revenue service taxpayer identification number of such debtor;

(IV) a description of the farm products subject to the security interest created by the debtor, including the amount of such products, where applicable, crop year, county or parish, and a reasonable description of the property, etc.; and

(iii) must be amended in writing, within 3 months, similarly signed and transmitted, to reflect material changes;

(iv) will lapse on either the expiration period of the statement or the transmission of a notice signed by the secured party that the statement has lapsed, whichever occurs first; and

(v) any payment obligations imposed on the commission merchant or selling agent by the secured party as conditions for waiver or release of the security interest; and

(B) the commission merchant or selling agent has failed to perform the payment obligations;

(C) in the case of a farm product produced in a State that has established a central filing system—

(i) the commission merchant or selling agent has failed to register with the Secretary of State of such State prior to the purchase of farm products; and

(ii) the secured party has filed an effective financing statement or notice that covers the farm products being sold; or

(D) in the case of a farm product produced in a State that has established a central filing system, the commission merchant or selling agent—

(i) receives from the Secretary of State of such State written notice as provided in subsection (c)(2)(E) or (c)(2)(F) of this section that specifies both the seller and the farm products being sold by such seller as being subject to an effective financing statement or notice; and

(ii) does not secure a waiver or release of the security interest specified in such effective financing statement or notice from the secured party by performing any payment obligation or otherwise.

(3) What constitutes receipt, as used in this section, shall be determined by the law of the State in which the buyer resides.

(h) Security agreements; identity lists; notice of identity or accounting for proceeds; violations

(1) A security agreement in which a person engaged in farming operations creates a security interest in a farm product may require the person to furnish to the secured party a list of the buyers, commission merchants, and selling agents to or through whom the person engaged in farming operations may sell such farm product.

(2) If a security agreement contains a provision described in paragraph (1) and such person engaged in farming operations sells the farm product collateral to a buyer or through a commission merchant or selling agent not included on such list, the person engaged in farming operations shall be subject to paragraph (3) unless the person—

(A) has notified the secured party in writing of the identity of the buyer, commission merchant, or selling agent at least 7 days prior to such sale; or

(B) has accounted to the secured party for the proceeds of such sale not later than 10 days after such sale.

(3) A person violating paragraph (2) shall be fined \$5,000 or 15 per centum of the value or benefit received for such farm product described in the security agreement, whichever is greater.

(i) Regulations

The Secretary of Agriculture shall prescribe regulations not later than 90 days after December 23, 1985, to aid States in the implementation and management of a central filing system.

(j) Effective date

This section shall become effective 12 months after December 23, 1985.

(Pub.L. 99-198, Title XIII, § 1324, Dec. 23, 1985, 99 Stat. 1558.)

- ¹ So in original. Probably should be "subparagraph".
- ² So in original. Probably should be "pursuant to subparagraph (D)".
- ³ So in original. Probably should be followed by "the".
- ⁴ So in original. Probably should be preceded by "contains".
- ⁵ So in original. Probably should be "subsection".
- ⁶ So in original. A period probably should appear instead of ", and".
- ⁷ So in original. Probably should be preceded by "contains".

Codification. Section was enacted as part of the Food Security Act of 1985, and not as part of the Agricultural Marketing Act of 1946, which comprises this chapter.

Legislative History. For legislative history and purpose of Pub.L. 99-198, see 1985 U.S. Code Cong. and Adm. News, p. 1103.

Library References

Secured Transactions §141.
C.J.S. Secured Transactions §§ 61 to 65.

Notes of Decisions

Farm products exception 2
Law governing 1

1. Law governing

The content of federal rule regarding alleged conversion of farm product in which security interest allegedly existed by commission merchant was determined by incorporating state law, absent federal law in effect at time of alleged conversion. *U.S. v. Progressive Farmers Marketing Agency*, C.A.8 (Iowa) 1986, 788 F.2d 1327.

2. Farm products exception

Security interest in hogs sold by debtor farmer was extinguished by sale of hogs through farmer's marketing agent; transaction did not fall within the "farm products" exception, especially in light of subsequent legislative intent as expressed through amendments to relevant state and federal laws. *U.S. v. Progressive Farmers Marketing Agency*, C.A.8 (Iowa) 1986, 788 F.2d 1327.

LEGAL ISSUES IN LIEN ENFORCEMENT

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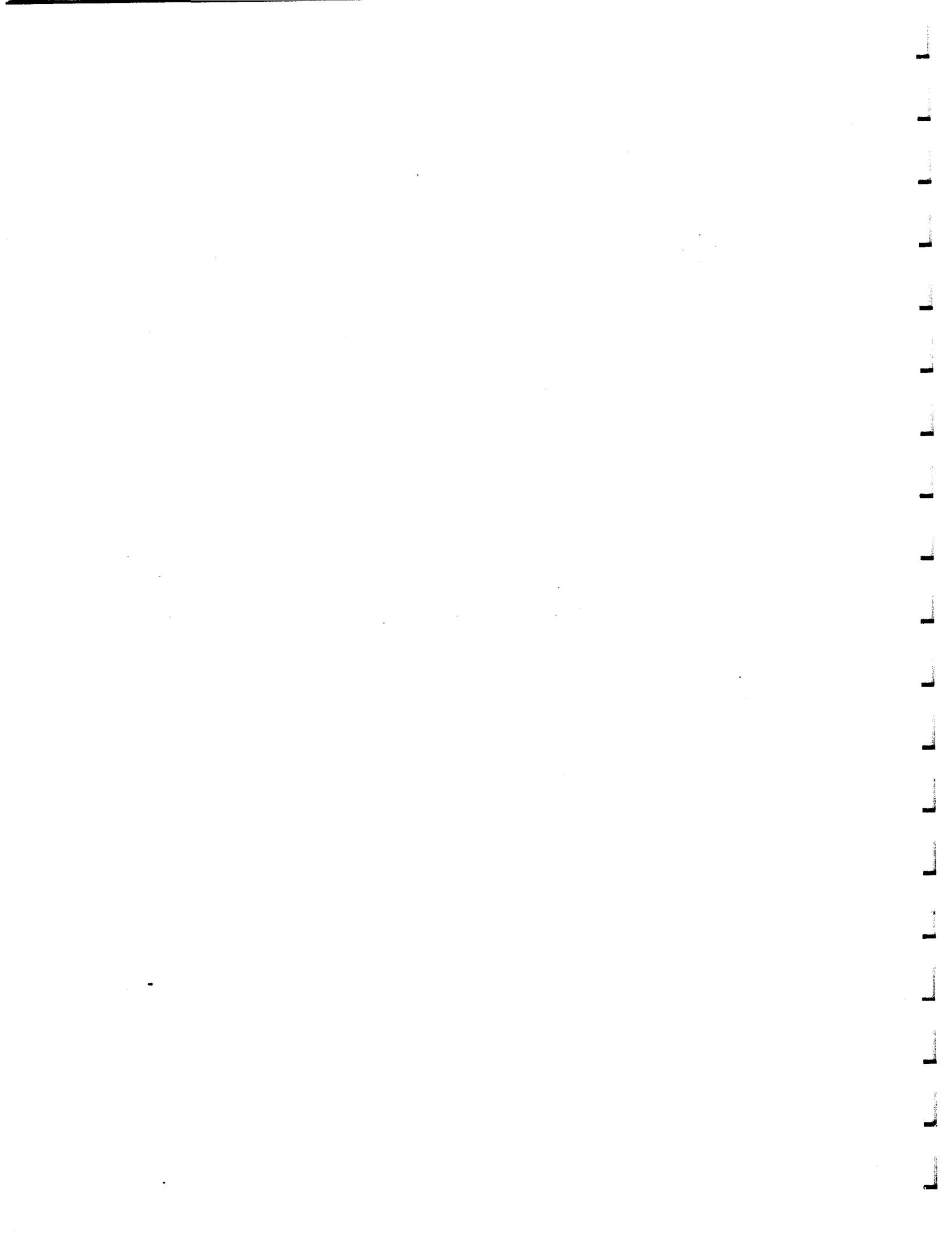
SECTION D



LEGAL ISSUES IN LIEN ENFORCEMENT

TABLE OF CONTENTS

I. Enforcing Liens and Security Interests: Remedies Available To The Secured Creditor	D - 1
A. Non-judicial foreclosure self-help repossession	D - 1
B. Writ of Possession, KRS 425.001 et seq.	D - 5
C. Judgment for possession	D - 15
II. Sale of Collateral	D - 16
A. Notice of sale	D - 17
B. The Commercially reasonable sale - An elusive term	D - 21
C. The penalty for failure to properly notify the debtor or conduct the sale in a commercially reasonable manner	D - 24
D. Strict foreclosure (Article 9, Section 505) - An alternative to sale	D - 26
III. Special Collateral - Special Considerations	D - 28
A. Perfection and enforcement of aircraft liens	D - 28
B. Receivables	D - 31
C. Ships and boats	D - 32
IV. Other Considerations in Federal Law	D - 32
EXHIBIT Form for Writ of Possession	D - 35



I. ENFORCING LIENS AND SECURITY INTERESTS: REMEDIES AVAILABLE TO THE SECURED CREDITOR.

A. Non-judicial Foreclosure - Self-Help Repossession. The Uniform Commercial Code (Article Nine, Section 503) provides a secured party with the right to repossess. (Some states have limited the right generally or in conjunction with consumer transactions. Check with local counsel on your version of this Code Section). Although the right to self-help repossession was frequently challenged on Constitutional grounds during the seventies it has been approved by all of the United States Courts of Appeals which have considered the subject and the concept of a self-help remedy under the Code has been approved by the United States Supreme Court. See Flagg Brothers v. Brooks, 98 S.Ct. 1729, 56 L.Ed.2d 185 (1978); Adams v. Southern California First National Bank, 492 F.2d 324 (9th Cir. 1973); Turner v. Impala Motor, 503 F.2d 607 (6th Cir. 1974). The right of self-help repossession is not unlimited but must be carried out with the restrictions placed upon the creditor by the Code and various Courts which have construed the Code.

1. The most important restriction on self-help repossession is that it must be accomplished without a breach of the peace. The definition of breach of the peace is so vague that some Courts have declared criminal breach of the peace statutes unconstitutional. The

definitions of "breach of the peace" reached by civil courts have ranged from a mere oral protest by the debtor to full physical confrontation.

- a. The United States Fifth Circuit Court of Appeals has probably come closest to articulating what is breach of the peace in conjunction with a repossession. The Court ruled that breach of the peace is the use of actual or constructive force, including threats and intimidation. Thompson v. Ford Motor Credit, 550 F.2d 256 (5th Cir. 1977).
- b. In contrast a North Carolina Court has ruled that a secured party must cease an attempted repossession if there is a "confrontation." Everett v. U.S. Life Credit Corp., 327 S.E.2d 269 (N.C. App. 1985).
- c. Minnesota has ruled that a debtor's actions may revoke the right of self-help repossession and force the creditor to use a judicial remedy. Bloomquist v. First National Bank of Elk River, 378 N.W.2d 81 (Minn. App., 1985). Arkansas has approved a peaceful repossession in the "dead of night" which

followed a shotgun brandishing confrontation with the debtor. Oaklawn Bank v. Baldwin, 709 S.W.2d 91 (Ark., 1986).

d. A breach of the peace which is not contemporaneous with the act of repossession by the creditor does not result in an infraction of the law. Wade v. Ford Motor Credit Company, 668 P.2d 183 (Kan. App. 1983); Jordan v. Citizens and Southern & Bank of South Carolina, 298 S.E.2d 213 (S.C. 1982).

e. The right to prevent a repossession extends to non-debtors who are merely in control of the secured party's collateral. Census Federal Credit Union v. Wann, 403 N.E.2d 348 (Ind. App. 1980).

2. Trespass on Private Property - How far and in what manner may a Secured Party enter? This is the question on which the states vary most widely in their application of the law. The 8th Circuit has ruled that the mere entry of private property at night may constitute a jury question on whether or not breach of peace has taken place. Rogers v. Allis Chalmers Credit Corporation, 679 F.2d 138 (8th Cir., 1982). Georgia has ruled that entering an open garage is permitted, Pierce

v. Leasing International, 235 S.E.2d 752 (Ga. App. 1977); however, Florida has indicated that even the entry of a carport might be questionable. Raffa v. Dania Bank, 321 So.2d 83 (Fla. 1975).

a. The majority of jurisdictions have ruled that breaking a lock or chain is improper. Laurel Coal Company v. Walter E. Heller & Company, Inc., 539 F.Supp. 1006 (W.D.Pa., 1982); General Electric Credit Corporation v. Timbrook, 291 S.E.2d 383 (W.Va., 1982). But Idaho has ruled that breaking a padlock on the property of a third party to obtain possession of collateral did not constitute breach of the peace. Massey-Ferguson Credit Corp. v. Peterson, 626 P.2d 767 (Idaho 1980).

b. The "Front of the House Rule".

3. A frequent but blatantly illegal practice is the self-help repossession of collateral by or in the presence of law enforcement officers. See Stone Machinery v. Kessler, 463 P.2d 651 (Wash. App. 1970).

4. A recent line of cases has held that self-help repossession may not be accomplished through trick or fraud. Chrysler

Credit Corp. v. McKinney, 38 U.C.C.Rep. 1409
(Ala., 1984).

5. Personal property contained in repossessed collateral is the single largest source of litigation stemming from self-help repossessions. A noted commentator on secured transactions, Barkley Clark, has dubbed this the case of the "Golden Glove Compartment." There is no fool proof manner in which a creditor may protect itself. Some creditors attempt to immediately inventory the repossessed property in the presence of a third party and return the property to the debtor as soon as possible. Other creditors rely upon contractual provisions that require a demand by the debtor for the return of personal property. See Thompson v. Ford Motor Credit, supra.

B. Writ of Possession, KRS 425.001 et seq.

1. Difference from attachment suit and grounds for action.
 - a. Remedy proper at anytime prior to judgment (KRS 425.011(1)).
 - b. Plaintiff may pursue monetary balance and repossession in the same action. See KRS 355.9-501(1). Ingersoll-Rand Financial Corporation vs. Electro Coal

Inc., 496 F.Supp. 1289 (E.D. Ky. 1980);
Avco Financial Services vs. Christiaens,
652 P.2d 220 (Mont. 1982).

2. Procedure to obtain Writ of Possession.

a. Verified motion, or motion accompanied by Affidavit, which must include certain specific averments, KRS 425.011(2)(3).

(1) Showing of basis for Plaintiff's claim, including copy of instrument.

(2) Showing that property is wrongfully detained, reason for detention, and manner in which debtor obtained possession.

(3) Particular description of the property and statement of its value. Description meeting requirements of KRS 355.9-110 is sufficient and the value may be as a whole. (1984 change)

(4) The location of collateral and if on private property, why you believe it is there.

(5) A statement that the property has not been taken for a tax assessment, or fine, pursuant to a statute; or if seized under an

execution against the property of the Plaintiff; or if so seized, that it is by statute exempt from such seizure.

b. Prior notice and demand, KRS 425.012.

(1) Writ of Possession may be issued not less than seven days nor more than sixty days after notice to the Defendant.

(a) There is no requirement of actual service, notice may be by personal service or by certified mail to the last known address. Restricted delivery is not required. C.R. 69.01.

(2) Notice must contain:

(a) Statement to the effect that debtor has seven days to petition for a hearing or pay amount claimed and that if not paid and no hearing held the Writ of Possession will issue.

1. Change time period if C.R. 6.05 applicable.

(b) Notice must identify the court, grounds for seeking the

writ, date of demand, amount claimed, and name and address of the plaintiff and its attorney.

(c) See special Fayette and Jefferson Local Rules for specific requirements of notice in these districts and circuits. Jeff. Cir. Ct. Rule 309.

c. Issuing the Writ, KRS 425.012(2), 425.046

(1) Writ shall be issued by the clerk upon Affidavit of Counsel, that requirements have been met.

(2) The Writ document must: (see attached form)

(a) Be directed to the Sheriff.

(b) Describe the property to be seized.

(c) Specify any private property to be entered.

(d) Direct the Sheriff to levy pursuant to KRS 425.091 and hold pursuant to KRS 425.101.

(e) Inform the Defendant that he has the right to post a bond

or except to the Plaintiff's sureties and to move to quash the Writ.

(f) Defendants must be informed on the Writ of Possession document that they have a right to seek an order from the Court to quash the Writ and seek a release of the property seized. (1984 change)

(3) Writ may be directed to any county of Kentucky.

d. Levy of Writ of Possession, KRS 425.091, 425.096, and 425.101.

(1) Sheriff has the right to break in.

(2) Sheriff has the authority to call upon other law enforcement agencies for assistance.

(3) Sheriff must retreat if there is a risk of death or serious bodily harm.

(4) If the property is a dwelling the Sheriff must appoint a keeper of the property for two days before removing personal property and taking possession of the dwelling.

(5) Sheriff is required to hold property for ten days and if no Defendant's bond has been posted he may deliver the property to the Plaintiff.

(a) If the Sheriff determines it is impractical or impossible to move the property to a place of safekeeping, or to store the property, the Sheriff may secure the property where the levy is made or surrender the property immediately to the Plaintiff to hold under the same restrictions as the Sheriff.

(1984 change)

1. In order for the property to be secured in the place where the levy is made, it must consist of all, or substantially all, of the property within a structure or area not used as a dwelling. The consent of any third party owner or

occupant of the structure or area must also be obtained. The Defendant is entitled to a reasonable right of access to any property not covered by the levy.

- (6) A return of the Writ of Possession must be made no more than sixty days after the date it is issued.

e. Writ of Possession Bonds.

- (1) Plaintiff's bond, KRS 425.111, must be twice the value of collateral and is not tied to the amount of the claim.
- (2) Defendant's bond, KRS 425.116, may be in the amount of the Plaintiff's bond or the value of the property.
- (3) Sureties are not required for banks and certain other financial institutions, KRS 425.001 (1982).

3. Special Procedures

a. Proceeding ex parte, KRS 425.076

- (1) Must show specific circumstances that would cause immediate and irreparable harm if issuance of the

Writ were delayed until notice and/or hearing.

- (2) Remedy should be used with great care. There has been no specific approval of an ex parte prejudgment remedy by the United States Supreme Court.

b. Temporary restraining orders.

- (1) 425.066 provides for a TRO at the time a Motion for Writ of Possession is made.
- (2) 425.086 allows a TRO to be entered in lieu of an ex parte Writ of Possession.
- (3) TRO's may prohibit the sale, pledge, or grant of security interest, disposing, encumbering, concealing, removing, or impairing the value of the collateral.
- (4) If the property sought is inventory or farm products a TRO cannot prohibit transfer but may provide for an escrow of sale proceeds.

c. Order transferring possession, KRS 425.041

- (1) This order can be very useful in situations where the property

itself cannot be located but the debtor can be found for service of such an order.

- d. Endorsement of the Writ of Possession, KRS 425.051. If the Sheriff reports that the collateral sought is not located on the property he is authorized to enter but is actually located on other private property, the Plaintiff may proceed ex parte, upon Affidavit, to obtain an endorsement to his Writ of Possession allowing the Sheriff access to private property not previously noted in the Writ document.
4. Defense of Writ of Possession Actions.
- a. Extraordinary procedure requires strict compliance with statute, Duo-Therm vs. Sheergrain, Ky., 504 S.W.2d 689 (1974).
 - b. A request for hearing.
 - c. Motion to quash, KRS 425.081.
 - (1) Limited to situations where the property has already been taken.
 - d. Exception to sureties, KRS 425.121.
 - e. Creditors must be careful even within the "law". Gunzman vs. Western State Bank, 540 F.2d 948 (8th Cir. 1976).

5. Constitutional Considerations.

a. Sniadach vs. Family Finance Corporation,
395 U.S. 337, 23 L.Ed. 2d 349, 89 S.Ct.
1820.

(1) First case to bring constitutional
due process to civil remedies,
indicated wages were a special
category of property.

b. Fuentes vs. Shevin, 407 U.S. 67, 32
L.Ed. 2d 556, 92 S. Ct. 1983.

(1) Applied due process concepts of notice
and hearing to all forms of personal
property.

c. Mitchell vs. Grant, 416 U.S. 600, 40
L.Ed 2d 406, 94 S.Ct. 1895.

(1) A slight retreat from Fuentes, no
prior hearing but inspection of
pleadings by neutral magistrate and
an immediate opportunity for
hearing.

d. North Georgia Finishing vs. Di-Chem, 419
U.S. 601, 42 L. Ed. 2d 751, 95 S.Ct.
719.

(1) Extended due process protection
from customer to commercial area.

e. Examination of Kentucky law.

(1) Writ is issued by a clerk upon affidavit of counsel without inspection by neutral magistrate.

(a) 1984 Amendment requiring notice to defendant of entitlement to immediate hearing on motion to quash should help Kentucky statute pass constitutional scrutiny.

(2) Meaningful opportunity to be heard.

6. Venue.

a. Gover vs. Wheeler, Ky., 178 S.W.2d 404 (1944).

(1) Writ coupled with demand of damages is transitory action.

b. May be filed where property is located in some instances.

c. K.R.S. 425.046(3) provides partial answer. "The Writ at any time before Judgment may be directed to any county for the delivery of the property claimed."

C. Judgment for possession, KRS 426.295.

1. If time is not of the essence, the secured party may proceed to obtain possession of its collateral through final judgment through the

form provided in KRS 426.295. Damages for wrongful detention may also be obtained.

2. A judgment for possession is enforced through KRS 426.300. A sheriff may seize the specific property or may use the judgment for taking an execution for the assessed value of the property.

a. A sheriff does not have the authority under KRS Chapter 426 to force entry in order to levy.

3. The Uniform Commercial Code specifically provides that an Article Nine security interest may be enforced under the terms of the Code or may be reduced to judgment. KRS 355.9-501(1) and (2). If a security agreement covers both real and personal property the secured party may proceed as to the personal property under the UCC or may proceed as to both the real and personal property through a standard foreclosure action. KRS 355.9-501(4) Owens v. First Commonwealth Bank, Ky. App., 706 S.W.2d 414 (1985).

II: SALE OF COLLATERAL.

The requirements of the Uniform Commercial Code are simple enough as to the sale of repossessed collateral. The Code only requires that the sale be conducted in a "commercially

reasonable manner" and that the debtor be given the right and sufficient time to redeem the collateral before sale. Within the past decade the Courts have taken the simple phrase "commercially reasonable sale" and established a substantial body of "judicial regulation" of the sale process. The creditor/secured party's responsibility can be divided into two primary elements: The notice of sale and the actual conduct of the sale.

A. Notice of Sale. The debtor and all others liable on the obligation directly or indirectly, or who hold an interest in the collateral to be sold, must be sent a notice of sale. (See definition of "debtor" at Article 9, Section 105(d)). Two cases have recently reached opposite conclusions on whether or not a pre-default waiver of notice by a guarantor is effective. Iowa said yes in F.S. Credit Corp. v. Troy Elevator, Inc., 2 U.C.C.Rep.2d 1704 (Iowa, 1986) and Georgia said no, Branan v. Equico Lessors, Inc., 342 S.E.2d 671 (Ga., 1986). A trustee in Bankruptcy may qualify as a debtor for notice of sale purposes. First National Bank and Trust Company v. Hutchins, 2 B.R. 92 (N.D.Okla., 1979).

1. Timing of the Notice. Many creditors have long used ten (10) days as the notice a debtor must be given. Few states actually specify the notice period prior to the sale of collateral. The Courts have recently begun to recognize that it is difficult to apply an objective test to the notice period

and have used a more subjective test depending on the circumstances under which the notice as given, whether or not there were intervening holidays, and the type of collateral to be sold. See Paco Corp. v. Vigliarola, 611 F.Supp. 923 (E.D.N.Y. 1985); Swanson v. May, 697 P.2d 1013 (Wash. App. 1985);

a. Some states even apply a second try-doctrine when the first notice of sale is returned to the creditor unclaimed or undelivered. See Mallicoat v. Volunteer Finance, 415 S.W.2d 347 (Tenn. App. 1966); In re Carter, 511 F.2d 1203 (9th Cir. 1983).

b. Can a notice become stale? Where collateral was not sold for a year or more following the initial notice some states have held the notice becomes stale. International Harvester Credit Corporation v. Ingram, 619 S.W.2d 134 (Tenn., 1981).

2. Public vs. Private Sale. The notice requirements vary considerably. For a private sale the Code requires only that the debtor be notified of the date after which sale may take place. A public sale requires a more

extensive notice as to the time and place of sale, terms of sale, etc. Confusion on the creditor's part can lead to liability. See First Missouri Bank and Trust Company v. Newman, 680 S.W.2d 767 (Mo. App. 1984).

a. Any auction, no matter how many bidders attend, which is not open to the public, may be a private sale requiring a private sale notice. John Deery Motors, Inc. v. Steinbronn, 383 N.W.2d 553 (Iowa, 1986).

3. Balance of Debt. If the creditor elects to provide its debtor with a specific balance necessary for redemption care must be used to provide the pay off rather than the gross balance number. Wilmington Trust v. Conner, 415 A.2d 773 (Del. 1980).

a. Understating the balance owed by the debtor may also result in a commercially unreasonable sale. Cessna Finance Corp. v. Design Engineering & Construction International, 335 S.E.2d 625 (Ga.App., 1985).

4. Husbands and Wives. A separate notice should be sent to each debtor rather than a single notice addressed to "Mr. and Mrs. _____."

Central Bank and Trust Company v. Metcalfe,
663 S.W.2d 957 (Ky. App. 1984).

5. Debtor's Right to Redeem. A debtor may redeem collateral at any time before the secured party has disposed of the collateral, or entered into a contract for its disposition, by tendering fulfillment of all obligations secured by the collateral as well as the expenses reasonably incurred by the secured party in the retaking, holding, preparing for sale, and to the extent provided in the agreement, and not otherwise prohibited by law, reasonable attorney fees and legal expenses. Article 9, Section 506.
 - a. A common mistake made by creditors is to limit the debtor's right to redeem to ten (10) days following the notice of sale. See First National Bank of Maryland v. DiDomenico, 487 A.2d 646 (Md. App. 1985).
6. Debtor's Liability for Deficiency. A Nebraska decision has held that the notice of sale must make it crystal clear to the debtor that in the event the sale fails to liquidate the total amount of the debt the debtor will remain liable for the deficiency. First

National Bank and Trust Co. of Fremont v. Hughes, 332 N.W.2d 674 (Neb. 1983).

7. A notice is not required only if the collateral "is perishable or threatens to decline speedily in value or is a type customarily sold on a recognized market." Article 9, Section 504(3).

a. The term "recognized market" has been strictly construed by the Courts. Creditors have often argued that the sale of livestock at a stockyard or cars subject to widely circulated price quotation are on a recognized market. Courts have generally held that the recognized market exception applies only to securities or commodities traded on exchanges and for which standard price quotations are available.

b. Tennessee has stretched the term "perishable" to include Christmas toys repossessed in late November. American City Bank v. Western Auto Supply, 631 S.W.2d 410 (Tenn., 1981).

B. The Commercially Reasonable Sale - An Elusive Term.
Most judicial constructions of a commercially reasonable sale have set out practices which are commercially unreasonable. One decision which sets out a course of

conduct undertaken by a creditor which constituted a commercially reasonable method of selling a large quantity of commercial collateral is School Supply Company v. First National Bank of Louisville, 685 S.W.2d 200 (Ky. App. 1984). In this case the net proceeds of obtained by the creditor at sale were only a small fraction of the alleged value of the collateral; however, due to the meticulous conduct of the sale by the creditor a deficiency judgment was entered against the debtor.

1. Public Auctions vs. Private Sales. This decision is a judgment call for the creditor. In U.S. v. Terrey, 554 F.2d 685 (5th Cir. 1977) the Court pointed out circumstances under which a private sale was commercially more reasonable than a public auction. As to repossessed cars a Kentucky Court has held that a sale at a regularly scheduled auction is per se commercially reasonable. Gregg Coats Cars v. Kasey, 576 S.W.2d 251 (Ky. App. 1978).

a. California through statutory and case law requires certain advertising for the sale of consumer collateral and generally requires a retail versus a wholesale auction disposition.

- b. If the secured party intends to bid, the auction must be truly public. Benton v. General Mobile Homes, Inc., 678 S.W.2d 774 (Ark. App., 1984).
 - c. "Dealer auctions" are private sales (secured party may not bid), which require a private sale notice, but which if properly conducted are commercially reasonable. Calcote v. Citizens & Southern National Bank, 345 S.E.2d 616 (Ga.App., 1986); John Deery Motors, Inc. v. Steinbronn, 383 N.W.2d 553 (Iowa, 1986).
2. Specialized Collateral Requires a Specialized Sale. The manner of sale and advertising for the sale must match the type of collateral and the market area in which the collateral could reasonably be sold. Liberty National Bank v. Acme Tool, 540 F.2d 1375 (10th Cir. 1976) and United States v. Conrad Publishing, 589 F.2d 949 (8th Cir. 1978).
- a. The advertising of specialized collateral must reach the particular market for the collateral no matter how large the geographic area of that market may be.
3. Duty to Clean up and fix up Collateral. If the amount of money invested by the creditor

in the collateral can reasonably be anticipated to return an equal or greater amount at sale there is almost an affirmative duty to clean up and fix up the collateral. Liberty National Bank v. Acme Tool, supra. The Eighth Circuit held to the contrary in C.I.T. Corp. v. Duncan Grading & Construction, Inc., 739 F.2d 359 (8th Cir. 1984).

4. How long to hold the collateral prior to sale is also a judgment call depending on the nature of the collateral. A case setting out too quick a resale is Hancock County Bank v. American Fletcher Bank, 276 N.E.2d 580 (Ind. App. 1971) and a case where the Court determined the creditor took too long is In Re: Myers, 20 U.C.C.Rep. 1420 (W.D.Va., 1976).

5. Some states are now substantively regulating repossession sales. Maryland's requirements include approval of the sale by the Commissioner of Consumer Credit. See C.C.H. Consumer Guide, ¶'s 6351, 6381, 6414A (1987).

C. The Penalty for Failure to Properly Notify the Debtor or Conduct the Sale in a Commercially Reasonable Manner. Article 9, Section 507. The trend in case law has been to expand rather than contract the remedies available to the debtor against the creditor.

Violation of the notice and sale requirements under 9-504 may preclude a deficiency; however, 9-507 allows a debtor to make an affirmative recovery against its creditor which may include actual losses (even lost profits and attorney's fees) and in consumer situations an automatic penalty not less than the credit service charge plus ten percent (10%) of the principal amount of the debt or the time price differential plus ten percent (10%) of the cash price. In Re: Andersen, 50 B.R. 137 (B.C.W.D.Mich., 1985); Kouba v. East Joliet Bank, 481 N.E.2d 325 (Ill. App., 1985). A case which takes a middle ground approach and contains an excellent discussion of the philosophy of 9-507 is Hall v. Owen County State Bank, 370 N.E.2d 918 (Ind. App. 1977).

1. The creditor's failure to send a notice of sale may result in an automatic loss of the deficiency or in a rebuttable presumption that the value of the collateral was equal to the debt. Examples of these differing judicial philosophies can be found in First State Bank of Morrilton, Arkansas v. Hallett, 722 S.W.2d 555 (Ark., 1987), (pro debtor) and First Galesburg National Bank and Trust Company v. Joannides, 469 N.E.2d 180 (Ill., 1984).

2. A new and extremely serious consequence of a commercially unreasonable sale of personal property collateral is voiding the creditor's opportunity to realize on real property collateral. This penalty is over and above the mere voiding of a deficiency. See Bank of Hawaii v. Davis Radio Sales & Service, 727 P.2d 419 (Hawaii App., 1986) and Garden National Bank of Garden City v. Cada, 729 P.2d 1252 (Kan., App., 1986).

D. Strict Foreclosure (Article 9, Section 505) - An Alternative to Sale.

1. A secured party may choose to retain collateral in satisfaction of the debt. If the debtor has not paid sixty percent (60%) of the loan, or if the debtor, in writing, explicitly agrees to the procedure, a creditor may accept its collateral as satisfaction in full of its debt. This avoids all the thorny problems concerning notice and sale. If a creditor is to take advantage of this procedure there are certain requirements which must be met.

a. If the collateral is consumer goods and sixty percent (60%) of the cash price of a purchase money security interest, or sixty percent (60%) of the loan in the

case of other security interests, has been paid, strict foreclosure can only be used when the debtor agrees in writing, after default, to renounce or modify his rights under 9-505.

- b. In all cases involving consumer goods, or any other collateral, a secured party in possession may, after default, propose to retain the collateral in satisfaction of the obligation. Written notice of the proposal must be sent to the debtor and except in the case of consumer goods to any other secured party who has an interest in the collateral and has duly filed a financing statement indexed in the name of the debtor, has placed the secured party on notice of the interest (1972 Code), or is known by the secured party in possession to have a security interest in the collateral. If the debtor or other person entitled to notification objects in writing within twenty-one (21) days of the date the notice is sent (30 days from the receipt of notice under the 1960 Code) the secured party must then

dispose of the collateral by commercially reasonably sale.

III. SPECIAL COLLATERAL - SPECIAL CONSIDERATIONS.

A. Perfection and Enforcement of Aircraft Liens. The Federal Aviation Act specifically pre-empts state law as it relates to filing and perfection of aircraft liens. See 49 USC Section 1403(C). Supremacy of federal law as it relates to priorities established by filing was confirmed by the United States Supreme Court in Philko Aviation, Inc., v. Shacket, 103 S.Ct. 2476, 76 L.Ed. 2d 678 (1983). State law determines priority questions between properly filed liens. Aircraft Trading & Services, Inc. v. Braniff, 3 U.C.C. Rep.2d 1297 (2nd Cir. 1987).

1. There are no formal requisites as to form and style of documents to be recorded with the FAA; however, an Aircraft Security Agreement should include the manufacturer's name, the model, the year, whether or not the aircraft is new or used, the manufacturer's serial number, and most importantly the FAA registration number sometimes referred to as the "N" Number. The "N" Number is the primary basis for lien searches in the FAA records. FAA rules for recording security interests, and the designation of various forms for the

transfer and registration of aircraft, are found at 14 C.F.R.

2. In addition to airframes (the primary body of the aircraft) separate perfection is required for engines rated at 750 shaft horse power or more and propellers capable of absorbing that power rating. Additionally, liens on parts and other sub-components of aircraft which are held by, or held for, a certified air carrier must be recorded with the FAA.
3. Sound banking practice would dictate that liens on engines of less than 750 horse power, possibly their propellers, and most certainly aircraft avionics should be perfected through state filing procedures in addition to the main aircraft lien of record with the FAA. Aircraft engines are readily demountable and most avionics, even though they cost thousands of dollars, are simply slide-in slide-out modules. The worth of an aircraft to the holder of a security interest varies substantially depending upon the engines and avionics and the ability to perfect an interest in after acquired avionics.
4. Any security interest in an aircraft should include an interest in the aircraft's log

books. A repossessed aircraft without its log books is no more than a mobile parts bin. By obtaining a security interest in the log books the creditor has the ability to force surrender of the books through judicial process and many times can invoke criminal statutes relating to fraud of a secured creditor when a recalcitrant debtor attempts to hold the log books.

5. Lien searches of the Federal Aviation Records can be accomplished with ease. The FAA is merely a national central file for aircraft liens. The file is located at the Federal Aviation Administration, P.O. Box 25504, Oklahoma City, Oklahoma 93125. Commercial services available for the search of FAA records include:

Powell Aircraft Title Company
P.O. Box 19096
Oklahoma City, Oklahoma 73114
Telephone: (405) 685-4858

Aviation Title Services, Inc.
P.O. Box 59121
Oklahoma City, Oklahoma 73159
Telephone: (800) 654-3237

Insured Aircraft Title Service
P.O. Box 19527
Oklahoma City, Oklahoma 73144
Telephone: (800) 654-4882

6. When repossessing an aircraft a secured party needs to determine if there is a current Certificate of Airworthiness, whether or not

any required inspections have been met and airworthiness directives complied with, and if a ferry permit will be necessary from the FAA.

7. Selling a repossessed aircraft in a commercially reasonable manner may require extensive advertising. Although a small aircraft might be successfully sold by advertising in a local newspaper and a specialized aircraft sales publication a large aircraft may require worldwide advertising in publications such as The Wall Street Journal and even the use of a broker.

B. Receivables.

1. A power of attorney and/or an executed change of address form from the United States Postal Service should be obtained in order for the creditor to take possession of mailed in receivables.
2. A security interest should be obtained in the physical receivables and all of the equipment necessary to read whatever medium on which the receivables are maintained.
3. In addition to the rights provided at Article 9, Section 502 a secured creditor should obtain a documentation right to notify its debtor's customers that payment should be

made directly to the lender. Manufacturers & Traders Trust Company v. ProMation, Inc., 497 N.Y.S.2d 541 (N.Y.App. Div., 1985).

4. Creditors who foreclose on receivables must collect the receivables in a commercially reasonable manner. See FDIC v. Fort Worth Aviation, 806 F.2d 575 (5th Cir., 1986).

C. Ships and Boats.

1. Is the craft subject to Federal Registry or the Ship Mortgage Act. An entire seminar could be conducted on the Ship Mortgage Act of 1920 (46 USC Section 911) but suffice it to say that a lien interest in a ship is much more akin to a real estate lien than liens under Article 9 of the Uniform Commercial Code.
2. Craft not subject to Federal Registry and the Ship Mortgage Act are often docked on bodies of water which form boundaries between jurisdictions. Are you perfected in all of the necessary jurisdictions?
3. Do you have a security interest in all of the items necessary for a sale of the boat or movement of the boat such as its trailer.

IV. OTHER CONSIDERATIONS IN FEDERAL LAW.

- A. If the collateral is a manufactured product did the borrower comply with the provisions of the Fair Labor

Standards Act? Failure to comply can result in a prohibition against the goods being shipped in interstate commerce. See Brock v. Ely Group, Inc., 788 F.2d 1200 (6th Cir., 1986), Cert. granted, 107 S.Ct. 397, and Wirtz v. Powell Knitting Mills, 360 F.2d 730 (3rd Cir., 1966).

- B. Is the borrower a defense contractor? Frequently the Department of Defense retains title to raw materials, finished products, and in some instances equipment in the hands of its contractors.
- C. Any person or business who lends money secured by property must report to the Internal Revenue Service on Form 1099-A the full or partial satisfaction of the debt by acquisition of an interest in the security or any knowledge acquired by the secured party concerning the abandonment of the security.
 - 1. The reporting requirement does not apply to credit extended to an individual secured by tangible personal property which is not used in a trade or business.
- D. Assessment by the Internal Revenue Service of past due federal taxes automatically creates a lien on all of the taxpayer's property. The tax lien is inferior to a creditor's lien until a notice of the lien is filed by the Internal Revenue Service. Notice is filed in the office designated by state law, or, if no designation is made, the office of the United States District Court

Clerk for the District in which the property subject to the lien is situated.

1. The priority of the federal lien does not apply to advances made or collateral required within forty-five (45) days after the filing of the notice and where the secured party did not have knowledge of the lien. This is particularly critical for advances being made against inventory and receivables.

NO.

PLAINTIFF

VS.

WRIT OF POSSESSION

DEFENDANT

THE COMMONWEALTH OF KENTUCKY, To the Sheriff of

Greetings:

You are hereby ordered to seize from the possession of the defendant, the following described property:

You may enter upon the following private places to take possession of the property, or any part of it:

You are directed to levy on the property pursuant to KRS 425.091 if it is found and to retain it in your custody until released or sold pursuant to KRS 425.101.

NOTICE TO DEFENDANT

You have the right to obtain re-delivery of the property being seized by filing a bond with one or more sufficient sureties as prescribed by KRS 425.116 and you have the right to except to the sureties upon the plaintiff's bond, a copy of which is attached to this writ of possession.

You further have the right to seek an order from the court, pursuant to KRS 425.081, to quash the writ of possession and seek a release of the property seized.

ISSUING OFFICER

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FEDERAL REGULATORY DEVELOPMENTS IN
RESIDENTIAL REAL ESTATE FINANCING

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SECTION E

FEDERAL REGULATORY DEVELOPMENTS IN
RESIDENTIAL REAL ESTATE FINANCING

TABLE OF CONTENTS

	<u>Page</u>
I. Background	E - 1
II. General Observations	E - 3
III. New Requirements: Closed-End Residential Real Estate Secured Loans - Which Involve A Variable Interest Rate	E - 5
IV. New Requirements: Open-End Credit Plans Secured by Consumer's Principal Dwelling	E - 15
V. New Requirements: Adjustable Rate Mortgage Interest Rate Caps	E - 21
VI. New Requirements: Uniform Appraisal Guidelines	E - 24
Appendix A. Revision of Regulation Z; New Adjustable Rate Mortgage Disclosures	E - 27
Appendix B. Proposed Revision to Regulation Z; Home Equity Lines of Credit	E - 37
Appendix C. Revision to Regulation Z; Adjustable Rate Mortgage Caps	E - 43
Appendix D. Proposed Revision of Regulation Z Commentary; Adjustable Rate Mortgage Caps	E - 44
Appendix E. Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency-- Guidelines for Real Estate Appraisal Policies and Review Procedures	E - 51

FEDERAL REGULATORY DEVELOPMENTS IN
RESIDENTIAL REAL ESTATE FINANCING

I. BACKGROUND

- A. Over the past several years, it has become fairly commonplace for financial institutions to use a variable interest rate in residential real estate transactions. Since the very early days, Truth-in-Lending and Regulation Z have required special disclosures when a variable interest rate is part of a loan package. As new products were developed and the regulation became more sophisticated, clear and distinct disclosures were required for open-end as well as closed-end type transactions.
- B. Prior to the recent amendments to Regulation Z, four different federal agencies required lenders subject to their jurisdiction to provide differing disclosures about adjustable rate mortgages. As early as August 1984, members of Congress wrote a letter to the Federal Reserve Board requesting uniform disclosures and also requested that a "worst-case" type of disclosure be required. The Federal Reserve Board asked the Federal Financial Institutions Examination Council (FFIEC) to develop recommendations for uniform requirements among the various federal agencies. The FFIEC responded and made various proposals including a "worst-case" payment example. For more than a year following the Federal Reserve Board's first proposal, the FFIEC considered

alternative plans for uniform ARM disclosures. Finally in August 1986 the FFIEC agreed on and announced a proposal. Ultimately, the Federal Reserve Board proposed and adopted final revisions to Regulation Z dealing with variable rate disclosures in closed end transactions.

- C. In the past few years, financial institutions generally have jumped at the chance to create and offer customers a line of credit secured by the equity in their residence. The desirability of such a plan from the consumer standpoint was fueled by the revisions in the income tax code. As the plans grew, both in number and complexity of requirements, concern also grew among various trade associations, consumer groups and Congress as to whether or not consumers were being adequately advised concerning the obligations and risks associated with such plans. The Federal Reserve Board determined that the current disclosure requirements of Regulation Z for Home Equity Lines are not sufficient in their timing, format and content to ensure that consumers understand the terms and conditions of a particular program before committing to it. Accordingly, the Federal Reserve Board has proposed extensive amendments to Regulation Z to apply to open end credit lines secured by the consumer's principal residence.

- D. Congress has also reacted to a slightly different problem in addressing consumer complaints that many variable rate loans provided for no cap or ceiling on the interest rate. Congress added a section to the Competitive Equality Banking Act of 1987 which requires that any adjustable rate mortgage loan originated by a creditor to include a limitation on the maximum interest rate which may be charged during the term of the mortgage loan.
- E. In a different area, the "Big 3" regulatory agencies recently published "Guidelines for Real Estate Appraisal Policies and Review Procedures." The primary thrust of the guidelines is to require banks to obtain proper real estate appraisals from qualified independent appraisers in making real estate secured loans.

II. GENERAL OBSERVATIONS

- A. The terminology used in describing and discussing variable-rate programs are often interchanged and intermixed, which leads to great confusion among financial institution personnel as well as counsel. For instance, some institutions declare that they offer variable rate mortgages but not ARM's. Likewise, some institutions declare that they have Home Equity Loan Programs but not open-end credit. It is therefore important that certain basic terms be accepted to have defined meanings and then those terms applied consistently.

B. Distinguishing between open-end credit and closed-end credit: Often times financial institutions will create internal confusion by failing to recognize the difference between open-end credit and closed-end credit.

1. Section 226.2(a)(20) of Regulation Z provides a very specific definition for the term "open-end credit". That term means "consumer credit" extended by a creditor under a plan in which:

- . The creditor reasonably contemplates repeated transactions;
- . The creditor may impose a finance charge from time to time on an outstanding unpaid balance;
- AND
- . The amount of the credit that may be extended to the consumer during the term of the plan (up to a limit set by the creditor) generally is made available to the extent that any outstanding balance is repaid.

To be open-end credit, the credit must be extended under a plan and the plan must contain all three elements as set out above.

2. The regulation also provides a specific definition for closed-end credit. That definition, however, is very simple: all credit which is not open-end is closed-end. Regulation Section 226.2(a)(10).

3. FAILURE TO RECOGNIZE THE DIFFERENCE BETWEEN OPEN-END AND CLOSED-END CREDIT WILL RESULT IN SERIOUS DISCLOSURE VIOLATIONS.

III. NEW REQUIREMENTS: CLOSED-END RESIDENTIAL REAL ESTATE SECURED LOANS - WHICH INVOLVE A VARIABLE INTEREST RATE.

A. Effective Date.

The effective date of this amendment to Regulation Z was December 28, 1987. However, financial institutions are not required to comply until October 1, 1988, and during the transition period, may comply with the old regulation or may comply with the new amendment.

B. Source Material.

1. The amendment to Regulation Z, 52 FR 48665 (12-24-87). Appendix A.
2. Proposed Official Commentary to the new amendment, 52 FR 48707 (12-24-87). The comment period on this commentary closed January 29, 1988.

NOTE: THE ANALYSIS IN THIS MATERIAL IS BASED UPON THE AMENDMENTS AND PROPOSED COMMENTARY. CHANGES IN THE FINAL ADOPTED VERSION OF THE COMMENTARY COULD RESULT IN CHANGES IN THE FOLLOWING MATERIAL.

C. Coverage and Scope.

1. The amendment applies 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. As with the old regulation, all purchase money loans are included.
 - 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).

D. 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, the initial or pre-application 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 creditors 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 and a statement that the consumer should ask about the amount of the discount. 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 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 may 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 F).
 - 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 proposed Official Commentary provides sample language which may be used to meet these disclosure requirements.

E. 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.

F. 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.
 - 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.

IV. NEW REQUIREMENTS: OPEN-END CREDIT PLANS SECURED BY CONSUMER'S PRINCIPAL DWELLING.

CAVAET: AS OF THIS WRITING, THE CHANGES ARE IN PROPOSAL FORM ONLY. THE FINAL VERSION MAY RESULT IN SUBSTANTIAL CHANGES IN THE FOLLOWING MATERIAL.

A. Effective Date.

While not officially announced, it is believed that this amendment will be adopted in some form and that the effective date will be immediately upon final adoption. However, to conform with the approach taken under the ARM amendments, compliance will probably be optional until October 1, 1988.

B. Source Material.

As of this writing, the only source material is the proposed amendment set out in 52 FR 48702. Appendix

B. The comment period on these proposals closed February 8, 1988.

C. Coverage and Scope.

1. Unlike the ARM amendments, these changes will apply to all open-end credit plans secured by the consumer's principal dwelling, regardless of whether the interest rate is fixed or variable.
2. Coverage is limited to plans secured by the consumer's principal dwelling and the amendment would not apply to Home Equity Lines secured by other consumer dwellings, such as vacation homes, or any other type of real estate.

D. Initial - Pre-Application - Disclosures (NEW CONCEPTS)

1. The initial home equity disclosure statement - containing both the existing and proposed disclosures - must be given to the consumer when an application is initially furnished or before the consumer pays a non-refundable application fee, whichever is earlier. (Note: The financial institution would not be required to provide the consumer with additional Truth-In-Lending Disclosures under Section 226.6 at the time the account is opened.)
 - a. If after furnishing an application, the financial institution makes a change in its home equity program, it must provide a written notice of the changes at the time the

consumer submits a completed application. This change of terms notice would not be required to be furnished to consumers who had merely received the initial disclosures and application but did not follow through and actually apply.

2. Format of disclosures (NEW).
 - a. Financial institutions will no longer be permitted to include the disclosures in loan contracts or in the agreement and no longer will be able to provide additional information along with the disclosures. All disclosures required by Section 226.6 must be segregated from everything else and may not contain any information which is not directly related to the disclosures required under that Section.
 - b. In addition to the new segregation requirement, the disclosures concerning the financial institutions security interest {required under 226.6(c)} and the first three disclosures under the new Section 226.6(e) - see paragraph 4 below - must precede all other disclosures.
3. The pre-application disclosures fall into two general categories.

- a. First, a booklet or brochure which describes home equity lines of credit. The Board is currently working on a brochure to meet the requirement and the Board's official brochure or a "suitable substitute" may be used.
 - b. Second, specific disclosures relating to the creditor's program. In addition to the customary disclosures required by Section 226.6, some eight additional aspects of the program, as applicable, must be addressed.
4. The additional disclosures required by new Section 226.6(e) must include, as applicable:
- a. A statement that loss of the consumer's home may occur in the event of default.
 - b. A statement of the circumstances under which the consumer or the creditor may terminate the plan, any fees that might be imposed on termination, and whether the creditor may require payment of the outstanding balance in full at such time.
 - c. A statement that the creditor has the right to change the terms and conditions during the plan, if in fact such a right exists.

(NOTE: THE ABOVE THREE DISCLOSURES ARE THE ONES WHICH MUST PRECEDE THE OTHER DISCLOSURES IN THE DISCLOSURE STATEMENT.)

- d. The payment terms of the plan including a statement of the length of the plan, an explanation of how the minimum monthly or periodic payment is determined (including a statement regarding any other payment, if such exists) and an example based on a \$10,000.00 balance and a recent interest rate, showing a minimum monthly or periodic payment and any one time payment of the outstanding balance. The payment terms must be separately stated if they differ for the period when advances may be obtained and the period when repayment is made without new advances.
- e. A statement that the minimum monthly or periodic payment may or will not reduce the outstanding principal balance if that is a fact.
- f. Any minimum outstanding balance or minimum draw requirements, stated as dollar amounts.
- g. A statement that disclosure forms are available for the creditor's other open-end programs secured by the consumer's principal dwelling.

h. If the plan has a variable rate, the following additional disclosures: (i) the index or formula and a source of information about the index; (ii) an explanation as to how the interest rate will be determined, such as by the addition of a margin; (iii) a statement that the consumer should ask about the current index value, margin, and interest rate; (iv) the frequency of interest rate and payment changes; (v) any rules relating to changes in the index, interest rate and payment amount and outstanding loan balance; (vi) an historical table showing how interest rates would have been affected by changes in the index value over a 15 year period; (vii) a statement of the most recent index interest rate shown in the historical table and the maximum interest rate and corresponding payments based on a \$10,000.00 advance; and (viii) a statement that interest rate information will be provided on or with the first periodic statement after each rate change.

E. Periodic Statement Disclosures.

1. If the plan is a variable rate plan, then on or with the first periodic statement after an interest rate adjustment, certain disclosures must be made.

2. The disclosures must include as applicable:
 - a. The current and prior interest rates;
 - b. The index values on which the current and prior interest rates are based;
 - c. The extent to which the creditor has foregone any increase in the interest rate; and,
 - d. The contractual effects of the adjustment including the payment due after the adjustment is made.

F. Expanded Advertising Coverage.

The primary amendments referred to in the above material have been added to Section 226.6. Even though the section on advertising, Section 226.16, has not been amended, the present regulation states that if any of the matters required to be disclosed under Section 226.6 are mentioned in an advertisement, then the cost information as set out in Section 226.16(b) must be included. Thus, the full advertising requirements will usually be triggered in open-end home equity type advertising.

V. NEW REQUIREMENTS: ADJUSTABLE RATE MORTGAGE INTEREST RATE CAPS.

A. Effective Date.

The effective date of the Act mandating this change was December 9, 1987. The amendment to Regulation Z was

also effective December 9, 1987. However, footnote 50 to the Regulation provides in effect that if the limitation or cap is in the Promissory Note or other debt instrument, inclusion in the disclosure statement itself is not required until October 1, 1988.

B. Source Material

1. The Act: Section 1204 of the Competitive Equality Banking Act of 1987 - Public Law 100-86.
2. Amendment to Regulation Z, adding Section 226.30. Appendix C.
3. Proposed Official Commentary to the new Amendment. Appendix D. The comment period on this commentary closed February 12, 1988.

C. Coverage and Scope.

1. The amendment applies to all consumer credit obligations - open-end or closed-end - which provide for a variable interest rate and which are secured by a dwelling.
2. Dwelling is defined as a residential structure which contains one to four units, and it is not necessary that the structure be attached to real property. The term also includes an individual condominium unit, cooperative unit, mobile home, or trailer, if it is used as a residence. Section 226.2(19).
3. Note that the new Amendment does not require that the security to be the principal dwelling of the consumer.

D. Compliance - Generally.

1. Neither the Act nor the Regulation sets a maximum interest rate which may be charged. State law will set that limit, if any. The Regulation merely requires that a maximum rate be included in the obligation and/or plan as a matter of contract.
2. A lifetime maximum interest rate ceiling must be specified in the credit contract - that instrument which creates personal liability on the consumer and generally contains the terms and conditions of the arrangement between the consumer and the creditor (for example, a Promissory Note or a Home-Equity Line of Credit Agreement).
3. The maximum interest rate must be stated either as a specified amount or in any other manner which allows the consumer to easily ascertain, at the time the obligation is entered into, what the lifetime interest rate will be over the term of the obligation.
 - a. The following statements would be sufficiently specific:
 - . The maximum interest rate will not exceed X%
 - . The interest rate will never be higher than X percentage points over the initial rate of Y%.

- . The interest rate will not exceed X% or X percentage points above (a rate to be determined at some future point in time), whichever is less.
- . The maximum rate will not exceed X% or the state usury ceiling, whichever is less.
- b. The following statements would not comply with the Regulation:
 - . The interest rate will never be higher than X percentage points over the going market rate.
 - . The interest rate will never be higher than X percentage points above (a rate to be determined at some future point in time).
 - . The interest rate will not exceed the state usury ceiling which is currently X%.

VI. NEW REQUIREMENTS: UNIFORM APPRAISAL GUIDELINES

A. Effective Date.

The guidelines were adopted and published in December 1987.

B. Source Material.

The official policy statements released by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency. Appendix E.

C. Substantive Requirements.

1. The Board of Directors of each institution is charged with the responsibility to ensure that the institution's written lending policy includes a well defined and effective appraisal process.
2. While the form, length and content of appraisal reports may vary, all appraisals should:
 - a. Be performed by qualified, independent staff or fee-paid appraisers who are competent and knowledgeable of relevant markets. The appraiser may not be involved in the lending or collecting functions or have any interest, financial or otherwise, in the property.
 - b. Result in the market value as defined by major appraisal associations.
 - c. Follow reasonable valuation methods which address all recognized approaches to market value.
 - d. Support current valuation of the real estate.
 - e. Document and explain how discount and capitalization rates used in generating present value were derived.
 - f. Makes provision for all appropriate deductions and discounts for development-type property.

- g. Includes a sales history analysis in cases where values have increased significantly over a relatively short period of time.
- h. Addresses proposed project marketability and feasibility prospects.

D. Supervisory Policy.

Examiners are mandated to review appraisal reports to determine that the appraiser's methods, assumptions, findings and conclusions are reasonable. Appraisals which fail to meet the standards are subject to criticism and corrective action. Also, inadequate appraisal procedures may be considered an unsafe and unsound banking practice, if the failure to accurately reflect the value of assets on a timely basis misrepresents the institution's financial condition. Formal corrective measures will be pursued "as appropriate".

REVISION OF REGULATION Z
NEW ADJUSTABLE RATE MORTGAGE DISCLOSURES

Subpart C - Closed-End Credit

2. Section 226.17 is amended by revising paragraph (b) to read as follows:

Section 226.17 -- General Disclosure Requirements

* * * * *

(b) Time of disclosures. The creditor shall make disclosures before consummation of the transaction. In certain residential mortgage transactions, special timing requirements are set forth in § 226.19(a). In certain variable-rate transactions, special timing requirements for variable-rate disclosures are set forth in § 226.19(b) and § 226.20(c). In certain transactions involving mail or telephone orders or a series of sales, the timing of disclosures may be delayed in accordance with paragraphs (g) and (h) of this section.

* * * * *

3. Section 226.18 is amended by revising footnote 43 and paragraph (f) to read as follows:

Section 226.18 -- Content of Disclosures

* * * * *

(f) Variable rate. (1) If the annual percentage rate may increase after consummation in a transaction not secured by the consumer's principal dwelling or in a transaction secured by the consumer's principal dwelling with a term of one year or less, the following disclosures:

- (i) The circumstances under which the rate may increase.
- (ii) Any limitations on the increase.
- (iii) The effect of an increase.
- (iv) An example of the payment terms that would result from an increase.

(2) If the annual percentage rate may increase after consummation in a transaction secured by the consumer's principal dwelling with a term greater than one year, the following disclosures:

⁴³ Information provided in accordance with §§ 226.18(f)(2) and 226.19(b) may be substituted for the disclosures required by paragraph (f)(1) of this section.

(i) The fact that the transaction contains a variable-rate feature.

(ii) A statement that variable-rate disclosures have been provided earlier.

* * * * *

4. Section 226.22 is amended by redesignating footnote 45a as 45d.

5. Section 226.19 is revised to read as follows:

Section 226.19 -- Certain Residential Mortgage and Variable-Rate Transactions.

(a) Residential mortgage transactions subject to RESPA.

(1) Time of disclosure. In a residential mortgage transaction subject to the Real Estate Settlement Procedures Act (12 USC 2601 et seq.) the creditor shall make good faith estimates of the disclosures required by § 226.18 before consummation, or shall deliver or place them in the mail not later than three business days after the creditor receives the consumer's written application, whichever is earlier.

(2) Redisclosure required. If the annual percentage rate in the consummated transaction varies from the annual percentage rate disclosed under § 226.18(e) by more than 1/8 of 1 percentage point in a regular transaction or more than 1/4 of 1 percentage point in an irregular transaction, as defined in § 226.22, the creditor shall disclose the changed terms no later than consummation or settlement.

(b) Certain variable-rate transactions.^{45a} If the annual percentage rate may increase after consummation in a transaction secured by the consumer's principal dwelling with a term greater than one year, the following disclosures must be provided at the time an application form is provided or before^{45b} the consumer pays a non-refundable fee, whichever is earlier:

^{45a} Information provided in accordance with variable-rate regulations of other federal agencies may be substituted for the disclosures required by paragraph (b) of this section.

^{45b} Disclosures may be delivered or placed in the mail not later than three business days following receipt of a consumer's
(Footnote Continued)

(1) The booklet titled Consumer Handbook on Adjustable Rate Mortgages published by the Board and the Federal Home Loan Bank Board, or a suitable substitute.

(2) A loan program disclosure for each variable-rate program in which the consumer expresses an interest. The following disclosures, as applicable, shall be provided:

(i) The fact that the interest rate, payment, or term of the loan can change.

(ii) The index or formula used in making adjustments, and a source of information about the index or formula.

(iii) An explanation of how the interest rate and payment will be determined, including an explanation of how the index is adjusted, such as by the addition of a margin.

(iv) A statement that the consumer should ask about the current margin value and current interest rate.

(v) The fact that the interest rate will be discounted, and a statement that the consumer should ask about the amount of the interest rate discount.

(vi) The frequency of interest rate and payment changes.

(vii) 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 carryover.

(viii) An historical example, based on a \$10,000 loan amount, illustrating how payments and the loan balance would have been affected by interest rate changes implemented according to the terms of the loan program. The example shall be based upon index values beginning in 1977 and be updated annually until a 15-year history is shown. Thereafter, the example shall reflect the most recent 15 years of index values. The example shall reflect all significant loan program terms, such as negative amortization, interest rate carryover, interest rate discounts, and interest rate and payment limitations, that would have been affected by the index movement during the period.

(Footnote Continued)
application when the application reaches the creditor by telephone, or through an intermediary agent or broker.

(ix) An explanation of how the consumer may calculate the payments for the loan amount to be borrowed based on the most recent payment shown in the historical example.

(x) The maximum interest rate and payment for a \$10,000 loan originated at the most recent interest rate shown in the historical example assuming the maximum periodic increases in rates and payments under the program; and the initial interest rate and payment for that loan.

(xi) The fact that the loan program contains a demand feature.

(xii) The type of information that will be provided in notices of adjustments and the timing of such notices.

(xiii) A statement that disclosure forms are available for the creditor's other variable-rate loan programs.

5. Section 226.20 is amended by adding paragraph (c) to read as follows:

Section 226.20 -- Subsequent Disclosure Requirements

* * * * *

(c) Variable-rate adjustments.^{45c} An adjustment to the interest rate with or without a corresponding adjustment to the payment in a variable-rate transaction subject to § 226.19(b) is an event requiring new disclosures to the consumer. At least once each year during which an interest rate adjustment is implemented without an accompanying payment change, and at least 25, but no more than 120, calendar days before a payment at a new level is due, the following disclosures, as applicable, must be delivered or placed in the mail:

- (1) The current and prior interest rates.
- (2) The index values upon which the current and prior interest rates are based.
- (3) The extent to which the creditor has foregone any increase in the interest rate.

^{45c} Information provided in accordance with variable-rate subsequent disclosure regulations of other federal agencies may be substituted for the disclosure required by paragraph (c) of this section.

(4) The contractual effects of the adjustment, including the payment due after the adjustment is made, and a statement of the loan balance.

(5) The payment, if different from that referred to in paragraph (c)(4) of this section, that would be required to fully amortize the loan at the new interest rate over the remainder of the loan term.

* * * * *

6. Appendix H is amended by redesignating H-4 as H-4(A) and adding a heading, by adding H-4(B), H-4(C), and H-4(D), and by revising H-14 by adding a heading to read as follows:

Appendix H - Closed-end Model Forms and Clauses

H-4(A) Variable-Rate Model Clauses
(§ 226.18(f)(1))

H-4(B) Variable-Rate Model Clauses
(§ 226.18(f)(2))

H-4(C) Variable-Rate Model Clauses
(§ 226.19(b))

H-4(D) Variable-Rate Model Clauses
(§ 226.20(c))

* * * * *

H-14 Variable-Rate Mortgage Sample
(§ 226.19(b))

* * * * *

H-4(A) Variable-Rate Model Clauses

* * * * *

H-4(B) Variable-Rate Model Clauses

Your loan contains a variable-rate feature. Disclosures about the variable-rate feature have been provided to you earlier.

H-4(C) Variable-Rate Model Clauses

This disclosure describes the features of the Adjustable Rate Mortgage (ARM) program you are considering. Information on other ARM programs is available upon request.

How Your Interest Rate and Payment are Determined

- Your interest rate will be based on [an index plus a margin] [a formula].
- Your payment will be based on the interest rate, loan balance, and loan term.
- [The interest rate will be based on (identification of index) plus our margin. Ask for our current interest rate and margin.]
- [The interest rate will be based on (identification of formula). Ask us for our current interest rate.]
- Information about the index [formula for rate adjustments] is published [can be found] _____.
- [The initial interest rate is not based on the (index) (formula) used to make later adjustments. Ask us for the amount of current interest rate discounts.]

How Your Interest Rate Can Change

- Your interest rate can change (frequency).
- [Your interest rate cannot increase or decrease more than ___ percentage points at each adjustment.]
- Your interest rate cannot increase [or decrease] more than ___ percentage points over the term of the loan.

How Your Payment Can Change

- Your payment can change (frequency) based on changes in the interest rate.
- [Your payment cannot increase more than (amount or percentage) at each adjustment.]
- You will be notified in writing ___ days before the due date of a payment at a new level. This notice will contain information about your interest rates, payment amount, and loan balance.

- [You will be notified once each year during which interest rate adjustments, but no payment adjustments, have been made to your loan. This notice will contain information about your interest rates, payment amount, and loan balance.]
- For example, on a \$10,000 [term] loan with an initial interest rate of ___ (the rate shown in the interest rate column below for the year 19__), the maximum amount that the interest rate can rise under this program is ___ percentage points, to ___%, and the monthly payment can rise from a first-year payment of \$___ to a maximum of \$___ in the ___ year.

Example

The example below shows how your payments would have changed under this ARM program based on actual changes in the index from 1977 to 1991. This does not necessarily indicate how your index will change in the future.

The example is based on the following assumptions:

Amount of loan	\$10,000	Caps _____	[periodic interest rate cap]
Term	_____	_____	lifetime interest rate cap
Change date	_____	_____	[payment cap]
Payment adjustment. (frequency)	_____		[Interest rate carryover]
Interest adjustment (frequency)	_____		[Negative amortization] **
[Margin]	_____		[Interest rate discount]
		Index	(identification of index or formula)

<u>Year</u>	<u>Index</u> (%)	<u>Margin</u> (percentage points)	<u>Interest Rate</u> (%)	<u>Monthly Payment</u> (\$)	<u>Remaining Balance</u> (\$)
1977					
1978					
1979					
1980					
1981					
1982					
1983					
1984					
1985					
1986					
1987					
1988					
1989					
1990					
1991					

* This is a margin we have used recently; your margin may be different.

** This is the amount of a discount we have provided recently; your loan may be discounted by a different amount.

To see what your payments would have been during that period, divide your mortgage amount by \$10,000; then multiply the monthly payments by that amount. (For example, in 1991 the monthly payment for a mortgage amount of \$60,000 taken out in 1977 would be: $\$60,000 \div \$10,000 = 6$; $6 \times \underline{\hspace{1cm}} = \$\underline{\hspace{1cm}}$ per month.)

H-4(D) Variable-Rate Model Clauses

Your new interest rate will be %, which is based on an index value of %.

Your previous interest rate was %, which was based on an index value of %.

[The new interest rate does not reflect a change of percentage point in the index value which was not added because of .]

[The new payment will be \$.]

[Your new loan balance is \$.]

[Your (new) (existing) payment will not be sufficient to cover the interest due and the difference will be added to the loan amount. The payment amount needed to pay your loan in full by the end of the term at the new interest rate is \$.]

[The following interest rate adjustments have been implemented this year without changing your payment: . These interest rates were based on the following index values: .]

* * * * *

H-14 Variable-Rate Mortgage Sample

This disclosure describes the features of the Adjustable Rate Mortgage (ARM) program you are considering. Information on other ARM programs is available upon request.

How Your Interest Rate and Payment are Determined

- Your interest rate will be based on an index rate plus a margin.
- Your payment will be based on the interest rate, loan balance, and loan term.
- The interest rate will be based on the weekly average yield on United States Treasury securities adjusted to a constant maturity of 1 year (your index), plus our margin. Ask us for our current interest rate and margin.
- Information about the index rate is published weekly in the Wall Street Journal.
- Your interest rate will equal the index rate plus our margin unless your interest rate "caps" limit the amount of change in the interest rate.

How Your Interest Rate Can Change

- Your interest rate can change yearly.
- Your interest rate cannot increase or decrease more than 2 percentage points per year.
- Your interest rate cannot increase or decrease more than 5 percentage points over the term of the loan.

How Your Monthly Payment Can Change

- Your monthly payment can change yearly based on changes in the interest rate.
- For example, on a \$10,000, 30-year loan with an initial interest rate of 9.71% (the rate shown in the interest rate column below for the year 1987), the maximum amount that the interest rate can rise under this program is 5 percentage points, to 14.71%, and the monthly payment can rise from a first-year payment of \$85.62 to a maximum of \$123.31 in the fourth year.
- You will be notified in writing 25 days before the annual payment adjustment may be made. This notice will contain information about your interest rates, payment amount, and loan balance.

Example

The example below shows how your payments would have changed under this ARM program based on actual changes in the index from 1977 to 1987. This does not necessarily indicate how your index will change in the future. The example is based on the following assumptions:

Amount \$10,000	Caps 2 percentage points
Term 30 years annual interest rate
Payment adjustment 1 year 5 percentage points
Interest adjustment 1 year lifetime interest
Margin 3 percentage points rate
	Index Weekly average yield
 on U.S. Treasury
 securities adjusted to
 a constant maturity of
 one year

<u>Year</u> (as of 1st week ending in July)	<u>Index</u> (%)	<u>Margin</u> (percentage points)	<u>Interest</u> <u>Rate</u> (%)	<u>Monthly</u> <u>Payment</u> (\$)	<u>Remaining</u> <u>Balance</u> (\$)
1977	5.72	3	8.72	78.46	9,927.64
1978	8.34	3	10.72**	92.89	9,874.67
1979	9.44	3	12.44	105.67	9,832.70
1980	8.51	3	11.51	98.79	9,776.04
1981	14.94	3	13.51**	113.51	9,731.98
1982	14.41	3	13.72***	115.07	9,683.39
1983	9.78	3	12.78	108.25	9,618.21
1984	12.17	3	13.72***	114.96	9,554.39
1985	7.66	3	11.72**	101.08	9,456.03
1986	6.36	3	9.72**	88.13	9,311.25
1987	6.71	3	9.71	88.07	9,151.55

To see what your payments would have been during that period, divide your mortgage amount by \$10,000; then multiply the monthly payment by that amount. (For example, in 1987 the monthly payment for a mortgage amount of \$60,000 taken out in 1977 would be: $\$60,000 \div \$10,000 = 6$; $6 \times \$88.07 = \528.42 .)

* This is a margin we have used recently; your margin may be different.
 ** This interest rate reflects a 2 percentage points annual interest rate cap.
 *** This interest rate reflects a 5 percentage points lifetime interest rate cap.

* * * * *

**PROPOSED REVISION TO REGULATION Z
HOME EQUITY LINES OF CREDIT**

SUBPART B -- OPEN-END CREDIT

SECTION 226.5--General Disclosure Requirements

(a) Form of disclosures. * * *

▶(3) In a plan secured by the consumer's principal dwelling, the disclosures required by section 226.6 shall be grouped together, shall be segregated from everything else^{10a} and shall not contain any information not directly related to the disclosures required under section 226.6. The disclosures required by section 226.6(c) and (e)(1)-(3) shall precede all other disclosures.^{10b}◀

(b) Time of disclosures. * * *

▶(2) Initial disclosures for plans secured by the consumer's principal dwelling. In a plan secured by the consumer's principal dwelling, the creditor shall furnish the initial disclosure statement and brochure required by section 226.6

^{10a}▶ The disclosures may include an acknowledgment of receipt, the date of the transaction, and the consumer's name, address, and account number.◀

^{10b}▶ The disclosures required by section 226.6(d) and (f) may be separated from the other disclosures. Creditors also may use an insert or attachment for disclosing information that is subject to change, such as the index, interest rate, and payment example.◀

at the time an application form is provided or before the consumer pays a nonrefundable fee, whichever is earlier.^{10c} The creditor may furnish the disclosures required by section 226.6(d) in accordance with section 226.5(b)(1).◀

* * * * *

3. Section 226.6 is amended by adding paragraph (e) and (f) to read as follows:

SECTION 226.6 -- Initial Disclosure Statement

* * * * *

►(e) Additional disclosures for plans secured by the consumer's principal dwelling. In a plan secured by the consumer's principal dwelling, the following additional disclosures:

(1) A statement that loss of the consumer's home may occur in the event of default.

(2) A statement of the circumstances under which the consumer or the creditor may terminate the plan, any fees that may be imposed upon termination, and whether the creditor may require payment of the outstanding balance in full at such time.

(3) If the creditor has the right to change the terms and conditions during the plan, a statement of that fact.

(4) The payment terms for the plan (separately stated, if applicable, for the period when advances may be obtained and the period when repayment is made without new advances), including:

(i) The length of the plan.

(ii) An explanation of how the minimum monthly or periodic payment will be determined, including a statement of any other payment, such as a one-time payment of the outstanding balance.

◀^{10c} In the case of telephone or mail applications or when an application reaches the creditor through an intermediary agent or broker, disclosures may be delivered not later than three business days after the creditor receives the consumer's application.◀

(iii) An example, based on a \$10,000 amount outstanding and a recent interest rate, showing the minimum monthly or periodic payment, and any one-time payment of the outstanding balance.

(5) If the minimum monthly or periodic payment may not or will not reduce the outstanding principal balance, a statement of that fact.

(6) Any minimum outstanding balance or minimum draw requirements, stated as dollar amounts.

(7) A statement that disclosure forms are available for the creditor's other open-end programs secured by the consumer's principal dwelling.

(8) If the plan has a variable rate, the following additional disclosures:

(i) The index or formula used in making adjustments, and a source of information about the index.

(ii) An explanation of how the interest rate will be determined, including an explanation of how the index is adjusted, such as by the addition of a margin.

(iii) A statement that the consumer should ask about the current index value, margin, and interest rate.

(iv) The frequency of interest rate and payment changes.

(v) 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 carryover.

(vi) An historical table showing how interest rates would have been affected by changes in index values over a 15-year period. The historical table would start in 1977 and be updated annually until 15 years of index, margin, and interest rate values are shown.

(vii) A statement of the most recent interest rate shown in the historical table and maximum interest rate and corresponding payments based on a \$10,000 advance.

(viii) A statement that interest rate information will be provided on or with the first periodic statement after each rate change.

(f) Brochure for plans secured by the consumer's principal dwelling. In a plan secured by the consumer's principal dwelling, the home equity brochure published by the Board, or a suitable substitute.◄

4. Section 226.7 is amended by adding paragraph (1) to read as follows:

SECTION 226.7 -- Periodic Statement

* * * * *

►(1) Additional disclosures for variable rate plans secured by the consumer's principal dwelling. On or with the first periodic statement after an interest rate adjustment of a variable-rate plan secured by the consumer's principal dwelling, notification of the rate change. The notice shall contain the following information:

- (1) The current and prior interest rates.
- (2) The index values upon which the current and prior interest rates are based.
- (3) The extent to which the creditor has foregone any increase in the interest rate.
- (4) The contractual effects of the adjustment, including the payment due after the adjustment is made.◄

* * * * *

5. Footnote 36 to paragraph (a)(3) of section 226.15 is revised to read as follows:

SECTION 226.15 -- Right of Rescission

(a) * * *

(3) * * *³⁶

³⁶The term "material disclosures" means the information that must be provided to satisfy the requirements in section 226.6 with regard to the method of determining the finance charge and the balance upon which a finance charge will be imposed, the annual percentage rate, [and] the amount or method of determining the amount of any membership or participation fee that may be imposed as part of the plan[.], and those items set forth in section 226.6(e).◄

* * * * *

APPENDIX

Editorial Note: This appendix will not appear in the Code of Federal Regulations.

Sample Disclosure

IMPORTANT TERMS OF OUR HOME EQUITY LINE OF CREDIT

Security Interest: You must give us a security interest in your home. You could lose your home if you do not meet the obligations in your agreement with us.

Termination and Payment Upon Termination: We can cancel your account and require you to pay the entire outstanding balance immediately: (1) if the interest rate that would apply to your account should exceed 18%; (2) if changes in the law either prohibit or increase our risk or burden of offering the plan; (3) if you fail to comply with the requirements in your agreement with us.

You may close your account at any time by notifying us in writing. If you close your account, we can require you to pay the entire outstanding balance immediately.

Changes in Terms: We can change the terms and conditions that apply to your account during the life of the plan.

Payment Requirements: You can obtain advances for fifteen years. During this period, your minimum monthly payment will equal the amount of interest accrued and unpaid on your account at the end of the billing period or \$10, whichever is greater. For example, if you had an outstanding balance of \$10,000, the minimum monthly payment at an interest rate of 10.25% would be \$85.42. Outstanding balances of less than \$200 must be paid in full.

The minimum monthly payment (when it equals accrued interest) will not reduce the outstanding principal balance on your account.

At the end of fifteen years, you must pay the entire outstanding balance immediately. For example, if after fifteen years you had an outstanding balance of \$10,000, you would have to make one payment of \$10,000.

Variable Rate Feature: The interest rate is variable and can change quarterly. The rate will not exceed 18%.

The interest rate equals an "index" plus a "margin." The index is the average prime rate charged by banks as published in the Federal Reserve Bulletin for the first month of the preceding quarter. The margin was 2 percentage points on 10/1/87. Ask us for the current index value, margin, and interest rate.

How the Finance Charge is Determined: Finance charges begin to accrue on the date a transaction is posted to your account. To determine the finance charge for a billing period, we multiply the "average daily balance" on your account by the "periodic rate." The "average daily balance" equals the total of the balances outstanding at the end of each day during the billing period divided by the number of days in the billing period. (The balance outstanding at the end of each day is determined by taking the beginning balance in your account each day, adding new advances, and subtracting any payments and credits and unpaid finance charges.) The "periodic rate" equals the interest rate (the index plus the margin) divided by the number of billing periods in a year (12).

Currently, the periodic rate is .8542% and the corresponding ANNUAL PERCENTAGE RATE is 10.25%.

Other Finance Charges: You must pay a loan processing fee FINANCE CHARGE of \$200 when we open your account.

Other Charges:	Application fee: \$150	Closing costs (estimated): \$750
	Annual fee: \$45	Title search/Insur: \$200
	Late payment fee: \$5	Appraisal fee: \$150
	(or 5% of the late payment, whichever is greater)	Attorney/Doc. prep: \$250
		Recording fees: \$150

Minimum Draw Requirements: The minimum amount of an advance is \$500.

Effects of the Variable-Rate Feature: Increases in the interest rate will increase the amount of your minimum monthly payment. For example, if the interest rate increased from 10.25% to the 18% maximum permitted under the plan, the minimum monthly payment on a \$10,000 balance would increase from \$85.42 to \$150.

You will be notified of changes in the interest rate on the monthly periodic statement you receive following the change.

Rate History: This table shows how the interest rate would have been affected by actual changes in the index that occurred between 1977 and 1987. It does not necessarily indicate how the index will change in the future.

<u>Year</u>	<u>Index</u> (%)	<u>Margin</u> (%)	<u>Interest Rate</u> (%)
1977	6.75	2	8.75
1978	9.00	2	11.00
1979	11.54	2	13.54
1980	11.48	2	13.48
1981	20.39	2	18.00 *
1982	16.26	2	18.00 *
1983	10.50	2	12.50
1984	13.00	2	15.00
1985	9.50	2	11.50
1986	8.16	2	10.16
1987	8.25	2	10.25

* This interest rate reflects the 18% lifetime interest rate cap.

Information on our other home equity programs is available on request.

REVISION TO REGULATION Z
ADJUSTABLE RATE MORTGAGE CAPS

SUBPART D - MISCELLANEOUS

* * * * *

Section 226.30 Limitation on Rates

A creditor shall include in any consumer credit contract secured by a dwelling and subject to the act and this regulation the maximum interest rate that may be imposed during the term of the obligation⁵⁰ when:

(a) in the case of closed-end credit, the annual percentage rate may increase after consummation, or

(b) in the case of open-end credit, the annual percentage rate may increase during the plan.

⁵⁰Compliance with this section will constitute compliance with the disclosure requirements on limitations on increases in footnote 12 to section 226.6(a)(2) and section 226.18(f)(2) until October 1, 1988.

PROPOSED REVISION OF REGULATION Z COMMENTARY
ADJUSTABLE RATE MORTGAGE CAPS

►SECTION 226.30 - Limitation on Rates

1. Scope of coverage. The requirement of this section applies to dwelling-secured consumer credit obligations -- both open-end and closed-end credit -- entered into on or after December 9, 1987 that are subject to the Truth in Lending Act and Regulation Z, in which the annual percentage rate may increase after consummation (or during the term of the plan, in the case of open-end credit) as a result of an increase in the interest rate component of the finance charge -- whether those increases are tied to an index or formula or are within a creditor's discretion. The section applies to credit sales as well as loans. Examples of obligations subject to this section include:

- ° Dwelling-secured credit obligations that require variable rate disclosures under the regulation because the interest rate may increase during the term of the obligation. (See the commentaries to sections 226.6(a)(2)n.12 and 226.18(f).)
- ° Dwelling-secured open-end credit plans that do not require variable rate disclosures under the regulation but where the creditor reserves the contractual right to increase the interest rate -- periodic rate and corresponding annual percentage rate -- during the term of the plan.

In contrast, the following obligations are not subject to this section, because there is no contractual right to increase the interest rate during the term of the obligation.

- ° "Shared-equity" or "shared-appreciation" mortgages as described in comment 18(f)-6.
- ° Fixed-rate closed-end balloon payment mortgage loans and fixed-rate open-end plans with a stated term that the creditor may, but does not have a contractual legal obligation to, renew at maturity.

2. Refinanced obligations. On or after December 9, 1987, when a credit obligation is refinanced, as defined in section 226.20(a), the new obligation is subject to the requirement of this section if it is dwelling-secured and allows for increases in the interest rate.

3. Assumptions. On or after December 9, 1987, when a credit obligation is assumed, as defined in section 226.20(b), the obligation becomes subject to the requirement of this section if it is dwelling-secured and allows for increases in the interest rate.

4. Modifications of obligations. Modifications of agreements entered into prior to December 9, 1987 are generally not covered by this section. For example, increasing the credit limit on a dwelling-secured, open-end plan with a variable interest rate entered into before the effective date of the rule does not make the obligation subject to the requirement of this section. If, however, a security interest in a dwelling is added on or after December 9, 1987 to a pre-existing credit obligation that allows for interest rate changes, the obligation becomes subject to the requirement of this section. Similarly, if on or after December 9, 1987, a variable interest rate feature is added to a

pre-existing dwelling-secured credit obligation, the obligation becomes subject to the requirement of this section.

5. Land trusts. In some states, a land trust is used in residential real estate transactions. (See discussion in comment 3(a)-8.) If a consumer-purpose loan that allows for interest rate changes is secured by an assignment of a beneficial interest in a land trust that holds title to a consumer's dwelling, that loan is subject to the requirement of this section.

6. Relationship to other sections. Unless otherwise provided for in the commentary to this section, other provisions of the regulation such as definitions, exemptions, rules and interpretations also apply to this section where appropriate. To illustrate:

- ° An adjustable interest rate business-purpose loan is not subject to this section even if the loan is secured by a dwelling because such credit extensions are not subject to the regulation. (See generally section 226.3(a))
- ° Creditors subject to the requirement of this section are only those that fall within the definition of a creditor in section 226.2(a)(17).

7. Consumer credit contract. Creditors are required to specify a lifetime maximum interest rate ceiling in their credit contracts -- the instrument that creates personal liability and generally contains the terms and conditions of the agreement (for example, a promissory note or home-equity line of credit agreement). This requirement is subject to the general "clear and conspicuous"

standard of the regulation, but no specific rule is prescribed regarding the format of the requirement. In some states, the signing of a commitment letter may create a binding obligation, for example, constituting "consummation" as defined in section 226.2(a)(13). The maximum interest rate ceiling must be included in the credit contract, but a creditor has the option of including the rate ceiling in the commitment instrument as well.

8. Manner of stating the rate ceiling." The maximum interest rate must be stated either as a specified amount or in any other manner that would allow the consumer to easily ascertain, at the time of entering into the obligation, what the lifetime interest rate ceiling will be over the term of the obligation." For example, the following statements would be sufficiently specific:

- ° The maximum interest rate will not exceed X%.
- ° The interest rate will never be higher than X percentage points above the initial rate of Y%.
- ° The interest rate will not exceed X%, or X percentage points above [a rate to be determined at some future point in time], whichever is less.
- ° The maximum interest rate will not exceed X%, or the state usury ceiling, whichever is less.

The following statements would not comply with this section:

- ° The interest rate will never be higher than X percentage points over the going market rate.
- ° The interest rate will never be higher than X percentage points above [a rate to be determined at some future point in time].

- ° The interest rate will not exceed the state usury ceiling which is currently X%.

A creditor may state the maximum rate in terms of a maximum annual percentage rate that may be imposed. Under an open-end credit plan, this would be the corresponding annual percentage rate. (See generally section 226.6(a)(2).)

9. Multiple interest rate ceilings. Creditors are not prohibited from setting multiple interest rate ceilings. For example, on loans with multiple variable rate features, creditors may establish a maximum interest rate for each feature. To illustrate, in a variable rate loan that has an option to convert to a fixed rate, a creditor may set one maximum interest rate for the initially imposed index-based variable rate feature and another for the conversion option. Of course, a creditor may establish one maximum interest rate applicable to all features.

10. Interest rate charged after default. State law may allow an interest rate after default higher than the contract rate in effect at the time of default; however, the interest rate after default must be subject to a maximum interest rate set forth in a credit obligation that is otherwise subject to the requirement of this section. This rule applies only in situations in which a post-default agreement is still considered part of the original obligation.

11. Increasing the interest rate ceiling - general rule.

Generally, a creditor may not increase the maximum interest rate originally set on a credit obligation unless the consumer and the creditor enter into a new obligation. Therefore, under an

open-end plan subject to this section, a creditor may not increase the maximum rate ceiling imposed merely because there is an increase in the credit limit. If an open-end plan is closed and another opened, a new rate ceiling may be imposed. Furthermore, where an open-end plan subject to this section has a fixed maturity and a creditor renews the plan at maturity, or converts the plan to closed-end credit, without having a legal obligation to renew or convert, a new maximum interest rate may be set at that time. If under the initial agreement, the creditor is obligated to renew or convert the plan, the maximum interest rate originally imposed cannot be increased upon renewal or conversion. For a closed-end credit transaction, a new interest rate ceiling may be set only if the transaction is satisfied and replaced by a new obligation that is dwelling-secured and allows for increases in the interest rate. (The exceptions to the general rule on refinancings in section 226.20(a)(1)-(5) do not apply with respect to increases in the rate ceiling.)

12. Increasing the interest rate ceiling - assumption of an obligation. If an obligation subject to this section is assumed by a new obligor and the original obligor is released from liability, the maximum interest rate set on the obligation may be increased as part of the assumption agreement. (This rule applies whether or not the transaction constitutes an assumption as defined in section 226.20(b).)

13. Transition rules. Under footnote 50, if creditors properly include the maximum rate ceiling in their credit contracts,

creditors need not revise their Truth in Lending disclosure statement forms to add the disclosures about limitations on an increase required by sections 226.6(a)(2) n.12 and 226.18(f)(2) until October 1, 1988. After that date, creditors are required to state the limitations on a increase as part of their Truth in Lending disclosures as well as stating the maximum interest rate ceiling in their credit contracts.

References

Statute: Competitive Equality Banking Act of 1987, Pub. L. No 100-86, 101 Stat. 552

Other sections: §§ 226.6(a)(2) n.12 and 226.18(f)(2)

Previous regulation: None

1987 changes: This section implements section 1204 of the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 which provides that, effective December 9, 1987, adjustable rate mortgages must include a limitation on the interest rate that may apply during the term of the mortgage loan. An adjustable rate mortgage loan is defined in section 1204 as "any loan secured by a lien on a one-to-four family dwelling unit, including a condominium unit, cooperative housing unit, or mobile home, where the loan is made pursuant to an agreement under which the creditor may, from time to time adjust the rate of interest." The rule in this section incorporates section 1204 into Regulation Z and limits the scope of section 1204 to dwelling-secured consumer credit subject to the Truth in Lending Act, in which a creditor has the contractual right to increase the interest rate during the term of the credit obligation. ◀

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
FEDERAL DEPOSIT INSURANCE CORPORATION
OFFICE OF THE COMPTROLLER OF THE CURRENCY

GUIDELINES FOR REAL ESTATE APPRAISAL POLICIES
AND REVIEW PROCEDURES

PURPOSE

These guidelines remind bank boards of directors and managements of the importance of sound real estate appraisal policies and procedures and reaffirm supervisory policies regarding acceptable appraisal practices.

BACKGROUND

Analyzing real estate collateral at a loan's inception and over its life requires a sufficient understanding of the appraisal process and report to identify inconsistencies or irregularities in the valuation of real property. While the appraisal plays an important role in the loan approval process, undue reliance should not be placed upon the collateral value in lieu of an adequate assessment of the borrower's repayment ability. However, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's capacity to repay to the value of the collateral. For these reasons, it is important that banks have sound appraisal policies and procedures.

APPRAISAL STANDARDS

The objective of an appraisal report is to communicate the appraiser's reasoning and conclusions in a logical manner so that the reader is led to the appraiser's estimation of market value. The contents of appraisal reports should generally conform to the accepted and established professional standards of the nationally recognized professional appraisal organizations. The form, length and content of appraisal reports may vary, depending on the type of property being appraised and the nature of the assignment. Therefore, appraisals should:

- Be performed by a qualified, independent staff or fee-paid appraiser selected by the bank who is competent and knowledgeable of relevant markets. An independent appraisal is one in which the appraiser is not involved in the lending and collection functions and has no interest, financial or otherwise, in the property.
- Result in a market value as defined by the major appraisal associations.

- Follow a reasonable valuation method which addresses all recognized approaches to market value unless the appraiser fully explains and documents the elimination of an approach.
- Support the current valuation of the real estate. All assumptions and projections should be supported and conform to current market conditions. In the case of income property, the capitalization rate, discount rate, net income and/or loss projections, cash flow, financing terms, and absorption rate should be reasonable.
- Document and explain how discount and capitalization rates used in generating present value estimates were derived.
- Take into consideration and make provision for all appropriate deductions and discounts for any development-type property.
- Include a sales history analysis in cases where values have increased significantly over a short period of time.
- Address a proposed project's marketability and feasibility prospects. Studies prepared by a party other than the appraiser must be verified to the extent assumptions are utilized. The appraiser's acceptance or rejection of the third party study and its impact on value must be fully explained.

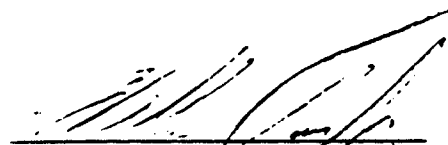
BANK APPRAISAL POLICIES AND PROCEDURES

The board of directors has the responsibility to ensure that a bank's written lending policy includes a well-defined and effective appraisal program. The program should include acceptable standards regarding appraiser qualifications and independence; ensure adequate appraisals are obtained and proper appraisal procedures are followed; and include a process for reviewing new appraisal reports for adequacy and for ordering reappraisals where needed. The need for reappraisals should receive particular attention in the case of loan renewals, extensions and problem credits. Nonproblem credits with amortizing repayment programs may need to be included in the review procedures in certain circumstances. For example, deteriorating economic conditions in an overbuilt area may prompt a bank to conduct an overall review of its real estate collateral. Or, as an audit procedure, the bank may reappraise a sample of properties to compare the results to the original appraisal reports to identify overvaluation of collateral or unsatisfactory appraisers.

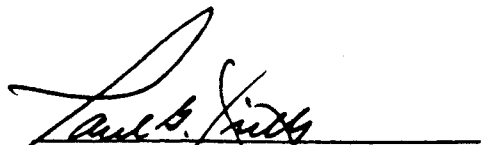
SUPERVISORY POLICY

A bank's appraisal policies and procedures will be reviewed as part of the examination of an institution's overall lending activities. When analyzing individual credits, examiners will review appraisal reports to determine that the appraiser's methods, assumptions, findings and conclusions are reasonable.

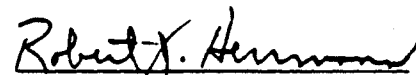
Significant failures to meet standards and procedures as outlined above will be criticized and corrective action required. In addition, inadequate appraisal procedures may be considered an unsafe and unsound banking practice if the failure to accurately reflect the value of assets on a timely basis misrepresents the bank's financial condition. In this situation, the institution of formal corrective measures will be pursued as appropriate.



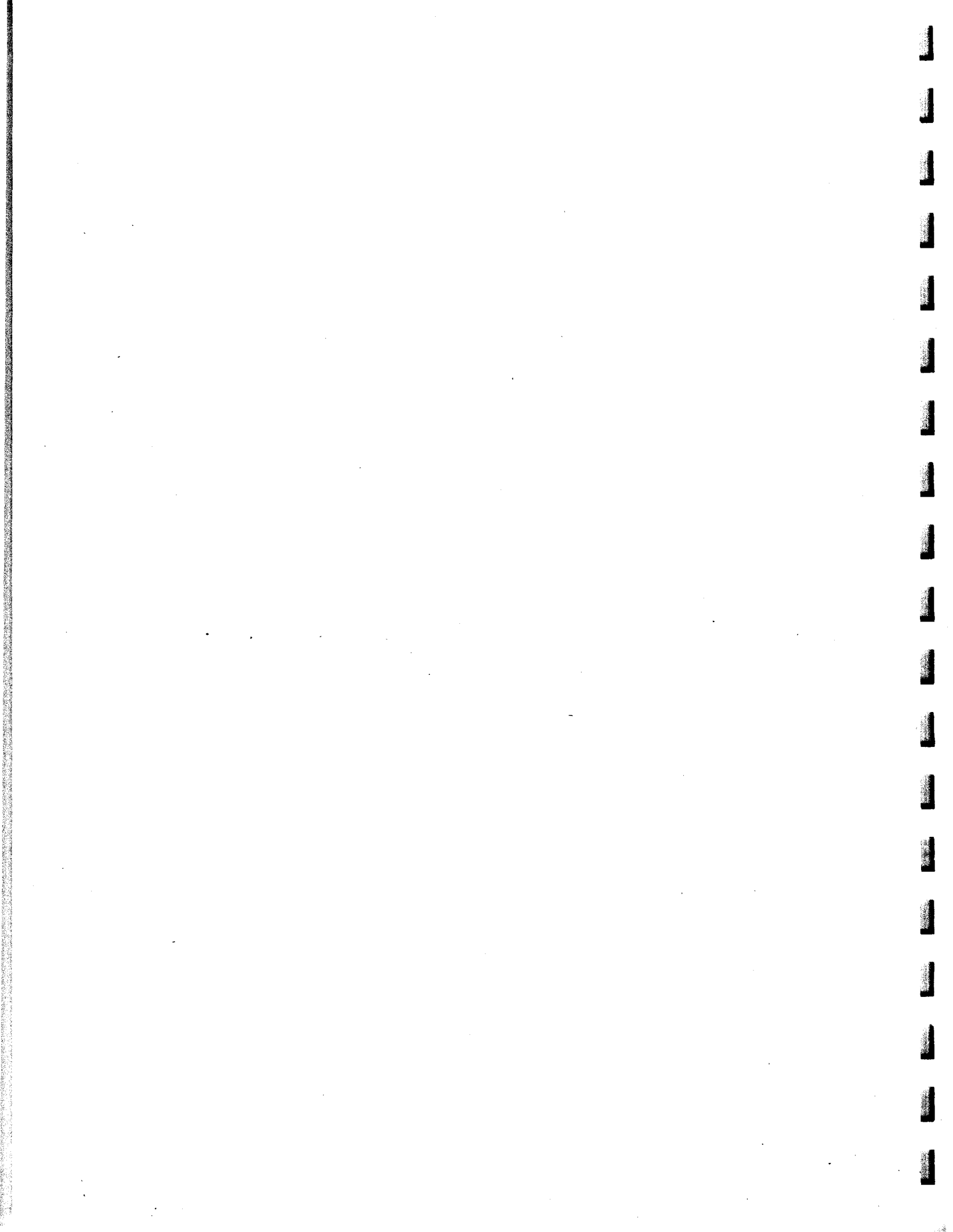
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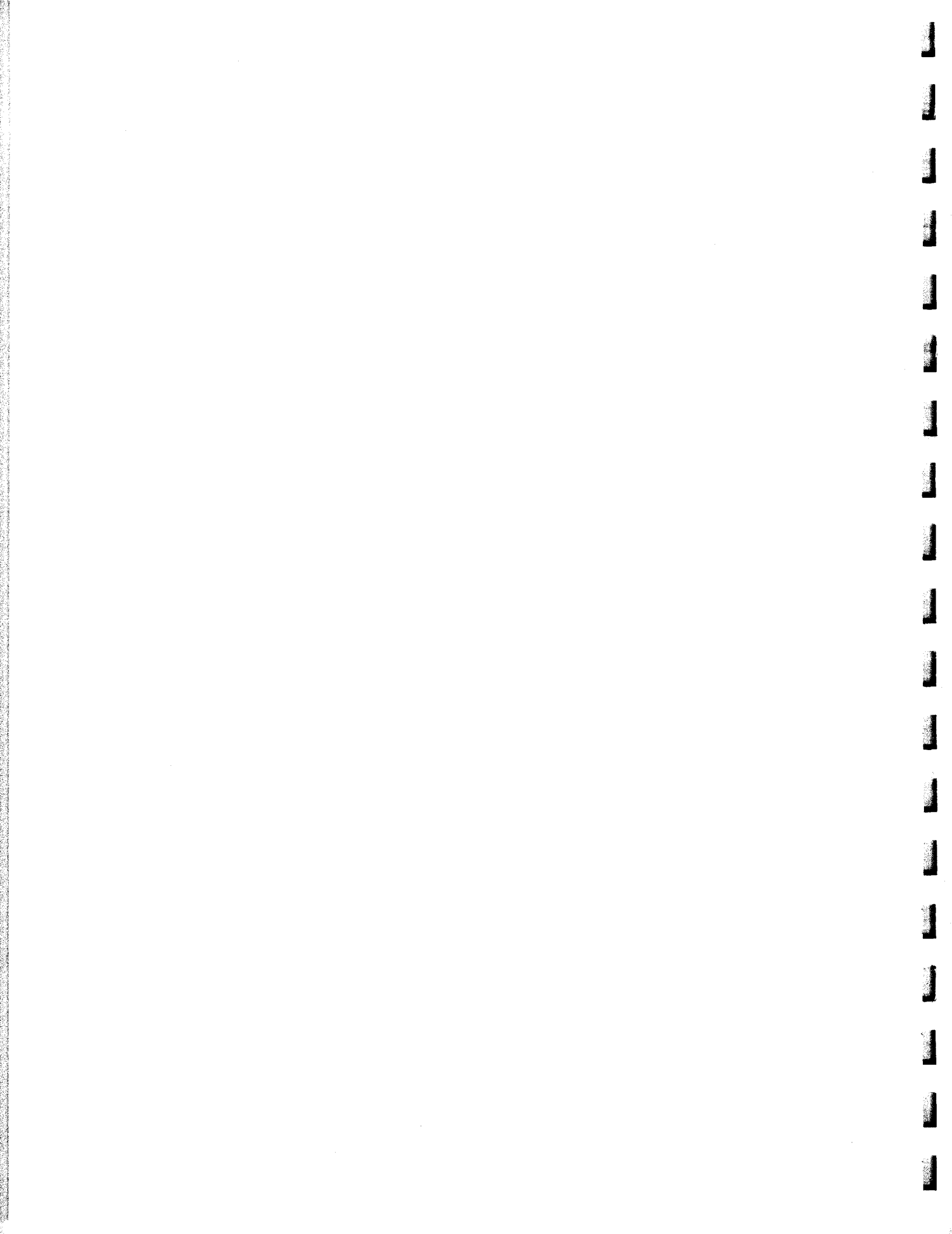
BANK REPORTING: RECENT DEVELOPMENTS

Bank Secrecy Act/Mandatory IRS Reporting/IRS Compliance:
Foreclosure, Interest and Broker Reporting

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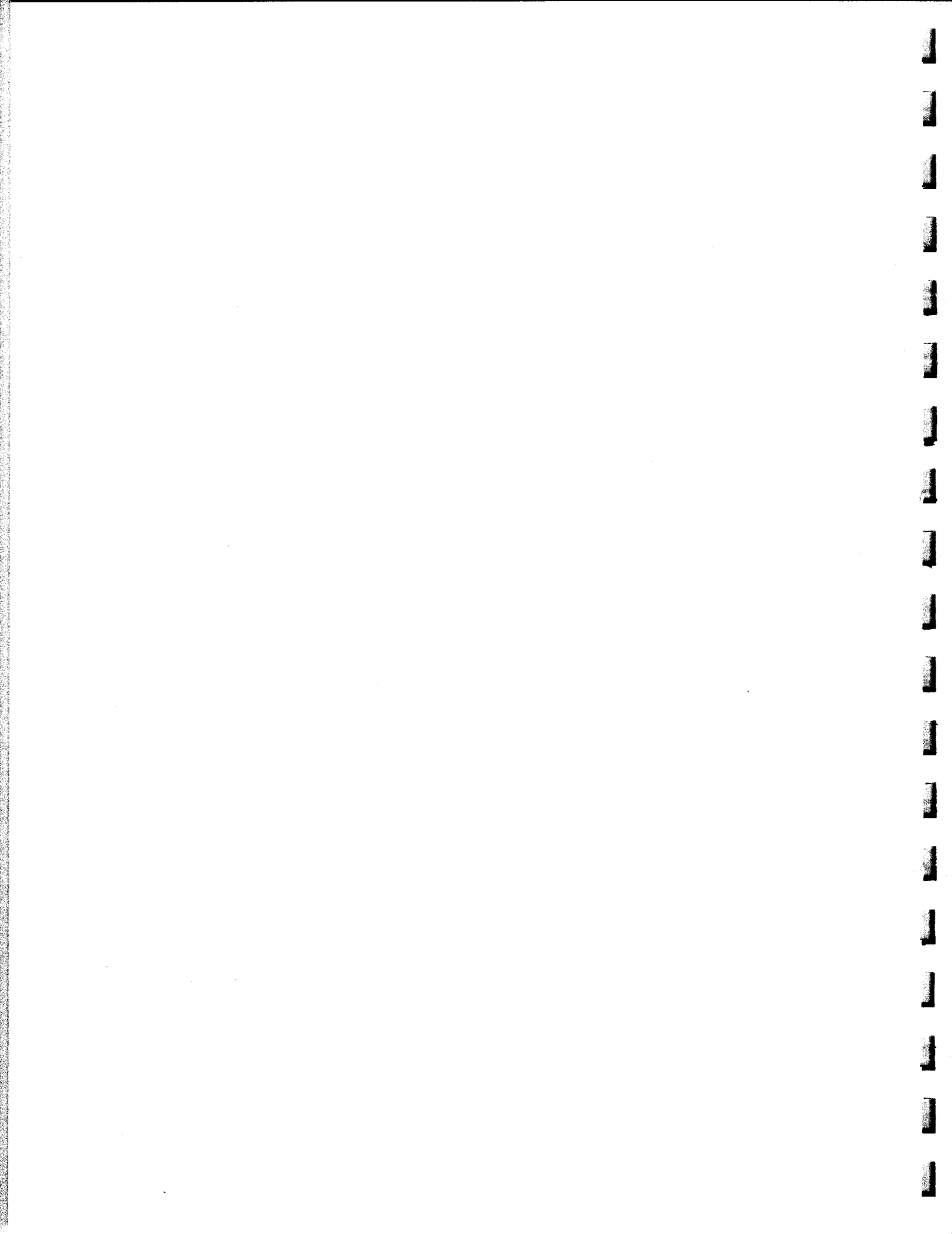
SECTION F



BANK REPORTING: RECENT DEVELOPMENTS

TABLE OF CONTENTS

	Page
A. BANK SECRECY ACT: Recordkeeping and Currency Transaction Reporting	F-1
*Financial Institutions Affected By The Act	F-2
*Records Required To Be Maintained	F-3
*Currency Transaction Reporting	F-6
*Monetary Instruments Sold	F-18
*Foreign Transactions Reporting	F-19
*Reports of Foreign Financial Accounts	F-22
*Requesting Administrative Rulings	F-22
*Bank Secrecy Act Policies and Enforcement	F-25
*Criminal Reporting	F-30
B. MANDATORY IRS REPORTING: TIN'S and Due Diligence	F-32
*Withholding From Interest and Dividends	F-33
*Information Returns	F-37
*Magnetic Media Reporting	F-37
*Penalties	F-37
*Exhibit 1: Instructions and Forms For Information Reporting (Forms 1099, W-8, and W-9)	F-40
C. IRS COMPLIANCE: Forclosure, Interest and Broker Reporting	F-79
*Forclosures, Transfers and Abandonments of Security	F-80
*Mortgage Interest Received	F-81
*Real Estate Transaction Reporting	F-82
*Penalties (Code Section 6652)	F-84



BANK SECRECY ACT
Recordkeeping and Currency Transaction Reporting

"The Congress finds that adequate records maintained by financial institutions have a high degree of usefulness in criminal, tax and regulatory proceedings."

Bank Secrecy Act of 1970

BANK SECRECY ACT - SUBSTANTIVE PROVISIONS

The Bank Secrecy Act (BSA), a federal statute, was enacted October 26, 1970. Subchapter II of BSA, the Currency and Foreign Transactions Reporting Act, was restated and recodified in 1982, then amended in 1986 by the Anti-Drug Abuse Act.

Actually, BSA does nothing to promote bank secrecy. Rather, Subchapter II of the Act requires financial institutions to preserve certain records regarding customer transactions for potential examination by the government. Some records need only be retained by the institution. Others, dealing with large currency transactions, are to be transmitted directly to a government agency.

This outline focuses on the BSA related duties of banks; it does not encompass the concerns of other entities which are affected.

- I. FINANCIAL INSTITUTIONS AFFECTED BY THE ACT - Each agent, agency, branch or office within the United States of any one of the following:
 - A. A bank, which includes:
 1. A commercial bank or trust company organized under state or federal law;
 2. A private bank;
 3. A savings and loan or building and loan association organized under state or federal law;
 4. An insured institution as defined in Section 401 of the National Housing Act;
 5. A savings bank, industrial bank or other thrift institution;

6. A credit union organized under state or federal law;
 7. Any other organization chartered under the banking laws of any state and thereby subject to a state bank supervisory authority;
 8. A bank organized under foreign law;
 9. An Edge Act corporation.
- B. A broker or dealer in securities.
 - C. A currency dealer or exchanger, including a person engaged in the business of a check casher.
 - D. An issuer, seller or redeemer of travelers checks or money orders, except one who is a selling agent exclusively and does not sell more than \$150,000 of such instruments within any given 30-day period.
 - E. A licensed transmitter of funds, or other person engaged in the business of transmitting funds.
 - F. A telegraph company.
 - G. A casino, licensed as such by a state or local government, having gross annual gaming revenues in excess of \$1,000,000.
 - H. A person subject to supervision by any state or federal bank supervisory authority.

II. RECORDS REQUIRED TO BE MAINTAINED - Banks have the broadest responsibility for the retention of customer records and information. Records may consist of originals, copies or microfilm copies. Records made in the ordinary course of business may be used to meet these requirements. If not generated by routine recordkeeping, the records are to be prepared in writing by the financial institution. Required records must be

retained for a period of five years and be accessible within a reasonable period of time. The records which must be maintained relate to:

- A. TAXPAYER IDENTIFICATION NUMBERS (TINs) - Financial institutions must obtain the appropriate TIN for customers purchasing a certificate of deposit or opening a deposit or share account.
- B. EXTENSIONS OF CREDIT - The name and address of the borrower, the amount of the credit, its nature, purpose and date must be obtained by the financial institution. This requirement is applicable only to extensions of the credit in excess of \$10,000 not secured by real property.
- C. FUNDS TRANSFERRED TO OR FROM U. S. - Each advice, request, or instruction received or given regarding any transaction resulting in the transfer of currency or other monetary instruments, funds, checks, investment securities, or credit of more than \$10,000 to or from any person, account or place outside the United States. (Records regarding cancelled transactions of this type are required only if they are normally made.)
- D. SIGNATURE CARDS - Documents granting signature authority over each deposit or share account.
- E. TRANSACTION RECORDS - Each statement, ledger card or other record on each deposit or share account.
- F. ON-US CHECKS - Each check, clean draft or money order over \$100 drawn on the bank or issued and payable by it. (Instruments drawn on certain high activity accounts, dividends, payroll, etc., are exempted.)
- G. DEBITS TO CUSTOMER ACCOUNTS - All debits or charges in excess of \$100 other than bank or periodic charges.

- H. ITEMS FROM TRANSFERS OUTSIDE U. S. - Each item, including checks, drafts or transfers of credit, of more than \$10,000 remitted or transferred to a person, account or place outside the United States.
- I. RECORDS OF TRANSFERS OUTSIDE U. S. - A record of each remittance or transfer of funds, currency, checks, investment securities, other monetary instruments or credits of more than \$10,000 to a person, account or place outside the United States.
- J. FOREIGN CHECKS PRESENTED FOR PAYMENT - Checks or drafts in excess of \$10,000 drawn on or issued by a foreign bank which the domestic bank has paid or presented to a nonbank drawee for payment.
- K. ITEMS RECEIVED FROM FOREIGN BANKING INSTITUTIONS - Each item, including checks, drafts or transfers of credit of more than \$10,000 received directly and not through a domestic financial institution, by letter, cable or any other means, from a bank, broker or dealer in foreign exchange outside the United States.
- L. RECORD OF RECEIPTS FROM FOREIGN BANKING INSTITUTIONS - A record of each receipt of currency, other monetary instruments, investment securities or checks, and each transfer of funds or credit, of more than \$10,000 received on any one occasion directly and not through a domestic financial institution, from a bank, broker or dealer in foreign exchange outside the United States.
- M. CHECKS DEPOSITED - All bank records prepared or received in the ordinary course of business which would be necessary to reconstruct items in excess of \$100 deposited in a transaction account.

- N. CERTIFICATES SOLD - The name, address and TIN of the purchaser of each certificate of deposit, a description of the instrument and notation of the method of payment as well as the date of the transaction.
 - O. CERTIFICATES REDEEMED - The name, address and TIN of any person presenting a certificate of deposit for payment, a description of the instrument and the date of the transaction.
 - P. DEPOSIT SLIPS OR CREDIT TICKETS - All deposit slips and credit tickets reflecting transactions in excess of \$100 and equivalent records for direct deposits and wire transfers. The amount of currency involved must be reflected on the slip or ticket.
 - Q. CURRENCY TRANSACTION REPORTS - Copies of all CTRs filed.
- III. CURRENCY TRANSACTION REPORTING - Financial Institutions must report large currency transactions, those exceeding an established threshold amount of \$10,000, to the Internal Revenue Service. To be reportable, there must be a physical transfer of currency from one person to another. Currency includes both coin and paper money which circulates as legal tender and is customarily accepted as a medium of exchange either in the United States or a foreign country. (A transaction which is a transfer of funds by means of bank check, bank draft, wire transfer or other written order, and does not include the physical transfer of currency is not a reportable transaction.)

A. CURRENCY TRANSACTION - Whenever a single deposit, withdrawal, exchange of currency or other payment or transfer, by, through or to a financial institution exceeds the threshold amount it must be reported.

EXAMPLE: The sale of a cashiers check for \$12,000 in cash to a retailer and the receipt of an \$11,000 loan payment in cash are both reportable transactions. (Remember, you're not just looking for deposits and withdrawals.)

B. MULTIPLE CURRENCY TRANSACTIONS - For reporting purposes, multiple currency transactions taking place on the same business day are treated as a single transaction if the bank has knowledge that they are by or on behalf of the same person or account.

1. THE SAME BUSINESS DAY - That day on which a bank, as normally communicated to its depository customers, routinely posts a particular transaction to its customer's account.

EXAMPLE: Although a local bank remains open until 4 p.m., its business day "cuts off" at 2:30 p.m.; deposits and withdrawals made after 2:30 p.m. are posted on the following business day. If a customer deposit \$6,000 in cash at 10:00 a.m. on July 1 and another \$6,000 in cash at 3:30 p.m. on July 1, no reportable transaction has occurred; the deposits are posted on separate business days and need not be aggregated.

EXAMPLE: A local bank is closed on Saturday and Sunday and a merchant makes night deposits of \$6,000 in cash on each of those

days. Since both deposits will be processed or posted to the customer's account on the same banking day (Monday) they must be added together for reporting.

2. TOTAL "INS" OR TOTAL "OUTS" - A reportable transaction occurs when the total of all "ins" for the same account or customer exceed the threshold amount or when the total of all "outs" exceeds the threshold amount.

EXAMPLE: If a customer made two \$6,000 cash withdrawals on the same business day it would be reportable as \$12,000. However, if a customer made a \$6,000 cash withdrawal and later makes a \$6,000 cash deposit, no report is necessary.

EXAMPLE: If a customer comes in with \$12,000 in cash and deposits it into two accounts, with neither receiving more than \$10,000, it is reportable.

EXAMPLE: If customer A makes a \$6,000 cash deposit to the XYZ account and later on the same business day customer B makes a second \$6,000 cash deposit to the XYZ account, it is reportable.

3. THE BANK - For the purposes of reporting, the transactions at all the bank's branch offices are considered together.

EXAMPLE: If the bank has knowledge that two \$6,000 deposits are made to the same account on a single business day it must file a report, even if the transactions occur at different branches.

4. "HAS KNOWLEDGE" - This is the most difficult and troublesome concept under BSA. It means knowledge on the part of a bank director, officer or employee or knowledge on the part of an existing system at the bank which permits it to aggregate transactions.

EXAMPLE: A \$6,000 cash deposit is made into the XYZ account through Teller A. Later in the same business day, a second \$6,000 cash deposit is made to the XYZ account through the same teller. The bank "has knowledge" and must report the transaction.

EXAMPLE: The bank has voluntarily adopted the use of currency transaction logs where cash transactions above an internally established "notice amount" are recorded as they occur. If the same individual conducts multiple transactions which, when aggregated, exceed the reporting amount, proper utilization and review of the currency transaction logs will bring the multiple transfers to the attention of BSA compliance personnel. In this case, the bank "has knowledge" and must report the transaction.

COMMENT: Banks have no responsibility to adopt or purchase systems or EDP programs to reveal the existence of multiple same day transactions. However, if a bank has a system which provides information on transactions which may require reporting as aggregated transactions, the bank must make use of that system. This is a classic "Catch 22" situation: Although the Treasury would like for banks to adopt systems that allow them to aggregate

multiple transactions, banks are not required to do so.

However, if they voluntarily adopt such a system they raise the standard of care to which they are subjected in the area of BSA compliance, they are judged on whether the system actually works or is properly used.

- C. REPORT FORM - Large currency transactions are to be reported on a government prescribed form, Currency Transaction Report (CTR), IRS Form 4789.

In order to properly file a CTR, a financial institution must verify and record information regarding:

1. The individual presenting a transaction:
 - a. Name
 - b. Address
2. Any person or entity for whose account the transaction is to be effected:
 - a. Identity
 - b. Account number
 - c. TIN
3. Prior to effecting a reportable transaction, the bank must verify the customer's identity by a physical examination of proper identification. In each instance, the method of identification used shall be noted on the report. It may consist of:
 - a. Identification used when cashing checks, for example, a driver's license or credit card.

- b. If the individual is an alien or nonresident, verification must be made by passport, alien I.D. or other official document.
- c. In the case of a bank customer, identifying information may be obtained from a previously existing bank signature card under very limited circumstances. To be valid for reporting purposes, the signature card must have been issued only after documents establishing the identity of the individual were examined and notation of the specific information (license number, issuer, etc.) was made on the signature card.

COMMENT: In the absence of adequate identifying information the bank should consider declining the transaction.

- D. ERRORS IN FORM COMPLETION - Although Form 4789 is relatively simple, filing errors are common and recent IRS estimates are that 10% of the forms filed are incorrect or incomplete. A review of the form's instructions provides adequate guidance in avoiding these common problems.
- E. FILING REQUIREMENTS - CTRs must be filed within 15 days after the transaction. If the 15th day is a holiday or a nonbusiness day (Sunday), the next business day is acceptable as the date of filing. A report is considered filed on the date it is postmarked or hand delivered to any local IRS office. A bank should never delay the filing of a CTR even though information called for in the report cannot be obtained before the filing deadline.
- F. CTR AMENDMENTS - Incorrect or incomplete CTRs can be amended after filing:

1. On a copy of the CTR originally filed, circle in red the incorrect, illegible or missing information.
 2. On a blank CTR, enter "AMENDED" or "CORRECTED" in the top margin above the Currency Transaction Report legend.
 3. Enter only the correct or amended information on the blank form in the appropriate line item or box.
 4. Sign and date the amended or corrected form.
 5. Staple the amended or corrected form on top of the copy of the originally filed form.
- G. CUSTOMER REQUESTS FOR EXEMPTION - To be considered, all new exemptions must be supported by a written request. The Treasury expects to develop a model form in the near future. In the interim, banks are free to design their own exemption request forms or purchase them from commercial vendors. For each exemption granted after October 27, 1986, the bank's records must contain:
1. Customer's name;
 2. Address;
 3. TIN;
 4. Account number;
 5. Whether the exemption covers deposits, withdrawals, or both;
 6. The dollar limit of the exemption;
 7. Whether the exemption is limited to certain types of deposits or withdrawals, such as withdrawals for payroll purposes;
 8. A written statement, signed by the customer, describing and detailing the reasons why such person is qualified for an exemption;

9. An attestation clause prescribed by regulation:

"The information contained above is true and correct to the best of my knowledge and belief. I understand that this information will be read and relied upon by the government."

10. The customer's signature, including his title and position.

11. Whether the exemption request is to be analyzed by the bank or the IRS, all reportable transfers occurring between application and final approval must be reported.

H. BANK EXEMPTIONS - When a written request is made and mandatory procedures are strictly adhered to, a bank may unilaterally exempt from reporting requirements:

1. Deposits or withdrawals of currency from an existing account by an established depositor who is a United States resident and operates a retail type business in the United States.

a. A "retail type business" is one primarily engaged in providing goods to ultimate consumers, and

b. For which the business is paid in substantial portion by currency.

2. Deposits or withdrawals of currency from an existing account by an established depositor who is a United States resident and operates a sports arena, racetrack, amusement park, bar, restaurant, hotel, check cashing service licensed by state or local government, vending machine company, theatre, regularly scheduled passenger carrier or public utility.

3. Deposits, withdrawals, exchanges or other payments and transfers of currency by local or state governments, or the United States or any of its agencies or instrumentalities.
4. Withdrawals for payroll purposes from an existing account by an established depositor who is a United States resident and operates firm that regularly withdraws more than \$10,000 in order to pay its employees in currency.

I. PROBLEMS IN BANK EXEMPTIONS - All language regarding allowable exemptions should be construed narrowly; i.e., each word in the exemption language is critical. Unless the circumstances are in strict compliance with the exemption language, no exemption should be given. For example:

1. No specific time period for determining how long it takes to be an "established customer" is set out in the regulation, but it is apparent that no exemption can be granted to a new business customer. The required time frame will be established by bank policy and probably based on the date(s) the customers' account(s) were opened.
2. The bank is responsible for independently verifying the activity in the account and determining applicable dollar limits for exempted deposits or withdrawals. Prior cash transfers - in and out - should be reviewed for a period established by bank policy before acting on any request.

3. Exemptions for businesses are available only for deposits and/or withdrawals. Cash purchases of official checks, currency exchanges and other cash transactions are not eligible for exemption. This is true even if the customer has an account for which deposits and withdrawals have been exempted.
4. A curiosity relating to government entities is the absence of the requirements for "...an existing account (or) an established depositor ...". Thus, it appears that a bank may exempt government entity cash transactions regardless of these criteria.
5. An exemption for a retail type business does not include an enterprise which sells services rather than goods. Where a business sells both goods and services or where a service is tied to the sale of goods, it may be difficult to tell how the business should be categorized. For example, a retail store, such as a liquor outlet, may have a policy of cashing customer payroll checks. The presence of large numbers of payroll checks in the store's deposits would verify its extraordinary need for cash. In deciding whether to grant the exemption, the bank would have to decide whether the activity was customary for similar businesses within the area.
6. A bank exemption is available to a check cashing service licensed by state or local government. However, the Treasury has indicated that in order to qualify for the exemption the involvement of government must be greater than the simple issuance of a business license - there should be a government presence in the ongoing regulation and supervision of the business.

7. Banks may establish a dollar limit for exempt deposits for the first day of the week which is higher than that for other days of the week. For example, a business depositing its weekend receipts on Monday may actually be making deposits for two business days. Thus, Monday deposits could have a higher exemption amount.
 8. Exemptions are only issued for transactions up to specified amounts, whenever a customer's cash transaction(s) exceed the amount of the exemption it is reportable.
 9. The regulation says a bank may exempt certain transactions; there is no requirement that it do so. Those banks who report transactions that are clearly exempt or below the threshold amount may be criticized for "malicious reporting," but there is no penalty involved.
- J. IRS EXEMPTIONS - A bank may apply to the Commissioner of Internal Revenue for authority to grant an exemption which the bank itself is not allowed to grant.
1. The IRS has authority to extend the powers of a bank to grant exemptions, it does not have the authority to grant exemptions on its own.
 2. The request must originate from the bank, not the customer.
 3. The bank must believe that the circumstances warrant the exemption.

4. The request should include:
 - a. a written statement, signed by a bank officer, explaining the circumstances that warrant special treatment;
 - b. a copy of the customer's signed request for exemption including all required information;
 - c. a listing of daily amounts of currency deposited during a recent two month period;
 - d. a listing of daily amounts of currency withdrawn during a recent two month period;
 - e. the ordinary percentage of the amount of withdrawals made up of \$100 bills;
 - f. the name and telephone number of the bank officer who should be contacted if there are any questions regarding the request.

5. Such requests should be addressed to:

Chief, Currency & Banking Reports Branch
Exemption Review Staff
IRS Data Center
P. O. Box 32063
Detroit, Michigan 48232

K. RETENTION OF EXEMPTION REQUESTS - The bank must retain each statement that it obtains pursuant to a request for exemption (including those that are denied) as long as the customer is on the exempt list and for a period of five years after removal.

L. TRANSACTIONS NOT SUBJECT TO REPORTING - The regulations do not require reports:

1. Of transactions with Federal Reserve Banks or Federal Home Loan Banks;

2. Of transactions between domestic banks (includes credit unions, S&Ls, etc.); or
3. By nonbank financial institutions of transactions with commercial banks. (Commercial banks must report transactions with nonbank financial institutions.)

M. EXEMPTION LISTS AND IRS REVOCATION - The bank must maintain a centralized list of all exemptions and the reason for the exemption. The record shall include:

1. The names and addresses of domestic banks (includes credit unions, S&Ls, etc.) with which transactions have been exempted.
2. The name, address, business, TIN and account number of each customer whose transactions have not been reported due to an exemption and the scope of any exemption granted.

The above information shall be furnished to the Treasury within 15 days of its request. In turn, the Secretary of the Treasury may revoke an exemption, requiring a bank to file CTRs regarding future cash transfers for an otherwise properly exempted customer.

IV. MONETARY INSTRUMENTS SOLD - At the time of this printing, there are no specific reporting requirements for monetary instruments; e.g., cashiers checks, travelers checks, etc., sold for \$10,000 or less in cash. In its Congressional testimony the Treasury has indicated that it no longer feels this type of reporting would be of value to law enforcement. However, some key members of Congress disagree. Additional requirements may be mandated by law or regulation at a later date.

V. FOREIGN TRANSACTIONS REPORTING - The transportation or receipt of currency or monetary instruments between the United States and foreign countries must be reported. Reporting responsibilities are not limited to financial institutions.

A. CURRENCY AND MONETARY INSTRUMENTS - Currency includes both coin and paper money which circulates as legal tender and is customarily accepted as a medium of exchange, either in the United States or a foreign country. "Monetary instruments" include currency, negotiable instruments in bearer form or made out to a fictitious payee, incomplete instruments and securities in bearer form or in such form that title passes upon delivery. (Does not include warehouse receipts or bills of lading.)

B. TRANSPORTATION OF CURRENCY OR MONETARY INSTRUMENTS - Each person involved in the importation or exportation of currency or monetary instruments in an amount greater than \$10,000 on any one occasion must file a report of the transaction. Parties responsible for reporting include:

1. Persons who attempt to or actually transport, mail or ship the currency or monetary instruments, and
2. Persons who cause or attempt to cause the physical transportation, mailing, shipment of currency or other monetary instruments, in conjunction with a financial institution or any other person.

C. RECEIPT OF CURRENCY OR MONETARY INSTRUMENTS - Each person who receives in the United States currency or other monetary instruments in an aggregate amount exceeding \$5,000 on any one occasion which have been transported, mailed or shipped to such person from any place outside the United States must file a report which includes:

1. The amount;
2. Date of receipt;
3. Form of monetary instruments;
4. The person from whom received.

This reporting requirement is applicable when no report regarding the transportation of the funds has been filed. This is applicable even though no transportation-related report was required to be filed.

D. WAIVER OF REPORTING RESPONSIBILITIES - Certain persons are excused from reporting requirements, whether they are senders or receivers of currency or monetary instruments:

1. A Federal Reserve bank;
2. A bank, foreign bank, or broker dealer in securities when the currency or monetary instruments are mailed or shipped through the postal service or by a common carrier;
3. A state or federally chartered commercial bank regarding overland shipments shipped or received from an established customer maintaining a deposit relationship with the bank, as long as those items are commensurate with the customer's ordinary business conduct;

4. A nonresident, noncitizen of the United States who mails through the postal service or ships by a common carrier from abroad to a bank, broker or dealer in securities in the United States;
 5. A common carrier of passengers regarding items in the possession of passengers and a common carrier of goods regarding shipments not declared by the shipper;
 6. An issuer of traveler's checks regarding the transportation of traveler's checks before their delivery to selling agents for sale to the public;
 7. A person engaged in the business of transporting currency or monetary instruments overland between foreign persons and between established offices of banks, brokers or dealers in securities.
- E. FILING REQUIREMENTS - Reports are to be filed on forms designated by the Commissioner of Customs. The report of international transportation of currency or monetary instruments is U. S. Customs Form 4790.
1. Reports regarding transportation of currency are to be filed at the time of entry into the United States or at the time of departure, mailing or shipping from the United States. If the currency or other monetary instruments are not in the possession of a person entering or departing the United States, the reports may be filed by mail on or before the date of entry, departure, mailing or shipping.
 2. Reports regarding receipt of funds shall be filed within 15 days after receipt of the currency or other monetary instrument.

VI. REPORTS OF FOREIGN FINANCIAL ACCOUNTS - Persons subject to the jurisdiction of the United States, except foreign subsidiaries of United States entities, must report foreign accounts on a form prescribed by the Treasury.

A. ANNUAL FILING - Each person having a financial interest in or signature authority over such an account must annually file a report with the appropriate federal income tax return.

B. RECORDS - Each person having a financial interest or signature authority must retain records including:

1. The name in which the account is maintained;
2. The number or designation of the account;
3. The name and address of the foreign bank or other person with whom the account is maintained;
4. The type of account;
5. The maximum value of the account during the reporting period.

VII. REQUESTING ADMINISTRATIVE RULINGS - Requests for Treasury Department interpretations of the Bank Secrecy Act increased dramatically after it was amended in 1986. Many questions were repetitive or involved similar issues. To assure that the advice given is uniform and that frequently requested interpretations are publicly available, Treasury instituted a system for providing administrative rulings on October 22, 1987.

A. TELEPHONE INQUIRIES - Treasury will continue to answer telephone inquiries at 202-566-8022. However, Treasury's verbal advice is nonbinding; it cannot be used as a defense to an alleged violation. Treasury will not issue a written administrative ruling based on an oral request.

- B. WRITTEN INQUIRIES - Any party may make a written request for an administrative ruling on a real or hypothetical fact situation. The request should include:
1. A complete description of the situation for which the ruling is requested;
 2. A complete statement of all material facts related to the subject transaction;
 3. A concise and unambiguous question to be answered;
 4. A statement certifying that the question is not related to any ongoing government investigation or proceeding;
 5. A statement identifying any information in the request that is to be exempt from disclosures under the Freedom of Information Act (FIA) and the reasons for exemption;
 6. If the situation is hypothetical, a statement justifying why it warrants the issuance of a ruling;
 7. A signature of the person making the request. (If a request is made by an agent, the agent must provide a statement certifying his or her authority to make the request.)
 - a. requests filed by a corporation must be signed by a corporate officer.
 - b. requests filed by a partnership must be signed by a partner.
 8. A request may encourage Treasury to accept a particular interpretation and set forth both legal and factual arguments in support of that interpretation.

C. ADDRESSEE - Requests should be sent to:

Director, Office of Financial Enforcement
Office of the Assistant Secretary (Enforcement)
U. S. Department of the Treasury
1500 Pennsylvania Avenue, N.W., Room 4320
Washington, DC 20220

D. TREASURY RESPONSES - Depending on the circumstances, Treasury's response may take a variety of forms:

1. **Nonconforming requests - Parties sending requests which do not adhere to the standards in Section B, above, receive a written notice from Treasury specifying the deficiency. If the request is not supplemented with the appropriate information, it is treated as having been withdrawn.**
2. **Private rulings (binding) - A ruling on an actual fact situation binds the Treasury in its future actions regarding the requesting party and the same facts; i.e., it may be cited as legal precedent by the party requesting the ruling in defense of an alleged violation.**
3. **Published rulings - If a private ruling is published in the Federal Register, it has precedential value for others in identical fact situations; it is legal authority for following a course of action approved in that ruling.**
4. **Private rulings (nonbinding) - A ruling on a hypothetical fact situation does not bind Treasury, but may be a valuable source of guidance to the parties involved.**

5. Notice of Freedom of Information Act's applicability - Although published rulings are gleaned of identifying information, normally any part of a published administrative ruling may be disclosed pursuant to a request under FIA. If the party requesting the ruling has indicated that some portion of the request should be exempt from FIA disclosures and Treasury reaches a contrary conclusion, the requesting party is notified. The requesting party then has ten days in which it may withdraw the request.

E. MODIFICATION AND REVOCATION - Treasury may modify or revoke previous rulings. Modification or revocation may be retroactive as to any party when: the original request is materially inaccurate or incomplete; it is not supplemented by additional information when facts changed; or it is relied upon in bad faith.

VIII. BANK SECRECY ACT POLICIES AND ENFORCEMENT - The 1986 amendments to BSA and Bank Regulatory statutes greatly increase the formality required of financial institutions in monitoring and reporting large currency transactions. They also establish dual responsibility for BSA compliance between the Treasury and the federal bank regulatory agencies. Those agencies are required to establish regulations mandating that supervised banks take certain steps toward assuring BSA compliance.

As a result, federal bank regulatory agencies will undoubtedly be more active in this area, primarily monitoring compliance through on-site examinations. Civil and criminal penalties have been dramatically increased, running the gamut from regulatory enforcement actions and fines to criminal prosecution.

A. COMPLIANCE PROCEDURES REQUIRED FOR BANKS - Each federal bank supervisory agency has prescribed regulations requiring insured banks to establish and maintain procedures designed to assure and monitor compliance with Subchapter II of BSA. Jointly issued on January 27, 1987, the regulations were described as "...those requirements that we considered to be the minimum necessary for any compliance procedure. Consequently, the agencies are considering whether to establish more detailed compliance procedures in the future." The regulations promulgated actually include very little that had not been previously recommended by the supervisory agencies in their routine examinations.

1. Formal Compliance Programs - Each bank must have a compliance program that is reduced to writing, approved by the Board of Directors and noted in the minutes. The program must have been adopted by April 27, 1987. (This deadline was extended to August 1, 1987 for credit unions.) The minimal contents of any acceptable compliance program are:

- a. internal controls to assure on-going compliance;
- b. independent testing by bank personnel or an outside party to assure on-going compliance;
- c. training for appropriate personnel;
- d. the appointment of an individual or individuals responsible for coordinating and monitoring day to day compliance.

B. TREASURY ENFORCEMENT - The Department of the Treasury has primary responsibility for BSA's interpretation and enforcement. Penalties may be imposed for both willful and negligent violations of BSA reporting and recordkeeping requirements.

1. In connection with civil enforcement actions under BSA, the Treasury may examine any books, papers, records or other bank data dealing with recordkeeping or reporting requirements (This is the equivalent of on-site examination authority). It may also summon both financial institution testimony and records relevant to an investigation of compliance with any reporting or recordkeeping provisions.
2. Willful violations of reporting requirements may generate civil penalties of not more than the greater of the amount involved in the transaction (not to exceed \$100,000) or \$25,000. The penalty may be assessed against the institution and the partner, director, officer and/or employee. If the willful violation consists of a failure to maintain appropriate procedures to assure compliance, then a separate violation occurs for each day the violation continues at each office, branch or place of business where it occurs.
3. Willful violations of recordkeeping requirements may generate penalties not to exceed \$1,000. The penalty may be assessed against the institution and the partner, director, officer and/or employee.
4. Negligent violation of any reporting or recordkeeping requirements may generate penalties not to exceed \$500 per violation.

5. The civil penalties mentioned above may be assessed at any time before the end of a six year period which begins on the day of the transaction.
6. Willful violations of any part of BSA are also punishable as criminal acts with fines of up to \$250,000 and prison sentences up to five years, or both.
7. Willful violations of BSA which occur while violating another United States law or as a part of a pattern of illegal activity involving more than \$100,000 in a 12 month period are punishable as criminal acts and may generate fines of up to \$500,000, imprisonment of up to 10 years, or both.
8. Civil and criminal penalties may be assessed against those who:
 - a. cause or attempt to cause a bank to fail to file a required report;
 - b. cause or attempt to cause a bank to file a report that contains a material omission or misstatement of fact;
 - c. structure or assist in structuring (smurfing), or attempt to structure or assist in structuring, any transaction with one or more financial institutions.
9. The Treasury may pay a reward to an individual who provides information leading to fines, penalties or forfeitures in excess of \$50,000.

C. BANK REGULATORY AGENCIES - The regulatory agencies now have direct responsibility for BSA compliance and can be expected to be much more active in seeking out and pursuing violations. Each agency is required to:

1. Include a review of the mandatory compliance procedures under BSA at each (emphasis added) examination of an insured bank;
2. Describe any problems with the BSA related procedures maintained by the insured bank and its written report of examination.
3. If the bank regulatory agency determined that an insured bank has:
 - a. failed to establish and maintain the required procedures; or
 - b. failed to correct any previously criticized problems relating to its procedures which the agency had drawn to the bank's attention.

The agency shall (emphasis added) issue a cease and desist order regarding the violation.

4. Bank regulatory agencies may also assess civil monetary penalties against the bank, its officers or directors.
5. Under previous policies, bank regulatory agencies filed quarterly reports with the Treasury regarding BSA violations noted during the examination process. Where a violation was found to be serious, the report was filed with the Treasury immediately rather than waiting until the end of the calendar quarter.

IX. CRIMINAL REPORTING - As mentioned above, some BSA violations are criminal acts. Also, the Anti Drug Abuse Act of 1986 criminalized money laundering and avoidance of required currency transaction reporting.

A. MANDATORY CRIMINAL REFERRALS - Federally supervised financial institutions have an affirmative responsibility to report certain federal crimes to their regulatory agencies and the Department of Justice. Violations of federal law which involve or affect banks are to be reported within 30 days on forms provided by the supervisory agency. BSA is specifically listed as one of the federal statutes under which violations are reportable and the newly created crime of money laundering will undoubtedly be added to the list of reportable crimes.

B. VOLUNTARY CRIMINAL REFERRALS - Under an exception to the Right to Financial Privacy Act, a financial institution may voluntarily disclose customer information to federal government authorities when it believes that information may be relevant to a possible violation of law, statute or regulation. The CTR is not the appropriate method for voluntarily reporting transactions of \$10,000 or less which are suspicious; no model reporting form or sample format is provided.

The institution cannot be held civilly liable for disclosures to federal authorities where the information disclosed is limited to:

1. The name or names of the individuals conducting a suspect transaction and other identifying information. ("Other identifying information" may include the individual's home and/or business address and TIN.)

2. The account number or other identifying information concerning the account. ("Other identifying information: may include the type of account, the interest rate paid and the office or branch where the account is maintained.)
3. The nature of the suspected illegal activity. (If a specific offense is known, it should be listed. If not, the activity giving rise to suspicion should be described.)

**MANDATORY IRS REPORTING:
TIN'S AND DUE DILIGENCE**

**A. Withholding From Interest and Dividends
(Code Section 3046)**

I. Backup Withholding - The Interest and Dividend Tax Compliance Act of 1983 requires certain payors to withhold 20% of payments of interest and dividends, etc. under certain conditions. This happens when:

- a. The payee fails to furnish his taxpayer identification number (TIN) in the required manner.**
- b. The IRS notifies the payor that the TIN of the payee is incorrect.**
- c. The IRS notifies the payor that backup withholding is required because the payee has failed to properly report his interest and dividend income.**
- d. The payee has failed to certify to the payor that he is not subject to backup withholding.**

II. Reportable Payments

- a. Includes interest, premiums, annuities and dividends, rent payments of remuneration for services, amounts received by brokers and barter exchanges, etc.**
- b. Does not apply to payments that are less than \$10 on an annual basis.**

III. Payee TIN Obligations

On monetary accounts established or acquired after December 31, 1983, payees are required to furnish payors, under penalty of perjury, a certified taxpayer identification number (TIN).

Payees are required to certify that the TINs they have furnished to payors are correct in the case of interest, dividend, patronage dividend payments and payments subject to broker reporting.

Form W-9, Payee's Request for Taxpayer Identification Number, or an IRS approved substitute form must be used by payees to certify the TIN given to the payor is correct and that for post 1983 accounts, the payer is not subject to backup withholding.

Payor may elect to refuse to open any account for which a certified TIN or compliance status is not submitted at the time the account is being opened.

IV. Payee Subject to Backup Withholding

a. Failure to properly report income

Payees who are determined by the IRS to have failed to properly report interest, dividends, or certain other income on their return are subject to backup withholding by payors of such income.

Payees will not be subject to backup withholding in such cases until four notices have been sent to them by the IRS over a period of not more than 120 days. After these notices have alerted the payee of the situation and advising him that backup withholding will begin, the payor will be instructed by the IRS to withhold 20% from the payments.

Backup withholding will remain in effect until the IRS notifies the payor that backup withholding is no longer required. Upon notification by the IRS, the payor must begin backup withholding within 30 days or sooner.

b. Nature of incorrect TIN

If the service or a broker notifies the payer that a payee TIN is incorrect, then the payer must:

1. Determine if that incorrect TIN is being used on the customer's account.
2. Mail a copy of the notice to the customer within 5 business days along with a W-9 (or acceptable substitute) and a reply envelope.
3. Upon failure of customer to furnish a new W-9 within 30 days of payors original notification begin withholding on reportable payments.
4. Cease withholding within 30 days after receiving a new W-9

V. Collection of Backup Withholding

- a. Payors must report amounts collected under backup withholding on Form 941 or 941E. Schedule A of Form 941 may only be used by payors who treat backup withholding as a separate tax. Backup withholding amounts combined with other employment taxes must be reported by payors on Form 941.
- b. Transfer or paying agents who deposit withholding taxes on behalf of payors may use their own names and TINs by making application to use this procedure with the Director of their Internal Revenue Service Center.

VI. Payor Awaiting - TIN

- a. Payor has the option to open an account without a TIN if the customer submits Form W-9, filling it out as required but writing "applied for" in the space for the TIN.

The payee must have applied or will apply for the TIN in order to use this procedure.

- b. If "awaiting - TIN" status is obtained, the account is subject to information reporting, but not to backup withholding for 60 days. If no TIN is provided, after 60 days, backup withholding must be provided for all payments made to the payee, back to the date the account was opened.
- c. Awaiting TIN - post 87 - any account opened after 1987 with an awaiting TIN status will be subject to penalty if the TIN is not received within 60 days even if backup withholding has begun. The only way to prevent the penalty is to close the account or obtain the certified TIN.

VII. Window Transactions

- a. Redemptions of U. S. Savings Bonds and payments upon interest coupons, commercial paper, and banker's acceptances.
- b. A Form W-9 is not required, but payor is responsible for backup withholding from such payments if the payee does not provide a TIN.
- c. Payors remain obligated to make an information return with respect to window obligations. A payor may furnish an information return at the time of such transaction or any time prior to January 31 of the year following the calendar year in which the transaction occurs.

VIII. Exemptions from Backup Withholding

- a. Payees specifically exempt are:
 - 1. Corporations;
 - 2. Financial institutions;
 - 3. Tax-exempt organizations, or individual retirement plans;
 - 4. United States or any agency or instrumentality thereof;
 - 5. States, the District of Columbia, a possession of the United States, or any subdivision or instrumentality thereof;
 - 6. Foreign governments, a political subdivision of a foreign government, or any agency or instrumentality thereof;
 - 7. International organizations or any agency or instrumentality thereof;

8. Registered dealer in securities or commodities registered in the U. S. or a possession of the U. S.;
9. Real estate investment trust;
10. Common trust fund operated by a bank under Code Sec. 584(a);
11. Entity registered at all times under the Investment Company Act of 1940;
12. Foreign central bank of issue;
13. Futures commission merchant registered with the Commodity Futures Trading Commission; and
14. Middleman known in the investment community as a nominee or listed in the American Society of Corporate Secretaries, Inc., Nominee List.

Payments of interest and dividends that are made to the above recipients are subject to information reporting.

Two additional classes of exempt recipients are noted in the regulations: beneficiaries of trusts and estates; and certain foreign persons. In some cases, these payees may be exempt for only a specified period of time and not indefinitely. In addition, the exemption may be for one type of payment, and not another type.

IX. Form W-8 "Certificate of Foreign Status"

- a. Is used to certify non-resident alien (NRA) status.
- b. Is valid for 3 calendar years.
- c. Is required of each holder of an account held jointly by multiple NRAs.

X. Storage and Retrieval of Forms W-9 and W-8

- a. Forms W-9 and W-8 received in connection with new accounts should be filed with the new accounts forms and retained for the life of the account plus three years.
- b. Only one Form W-9 or W-8 need be filed by a customer with multiple accounts so long as the bank can cross-reference the accounts and access the Form W-9 or W-8 when necessary.

XI. Deposit of Withholding Receipts

- a. Use wage withholding deposit rules for remittance of monies withheld. Some flexibility is available.
- b. Remit funds with Federal Tax Deposit Coupon.
- c. File Form 941 and Schedule A as required.

B. Information Returns

- I. Forms 1099-DIV, 1099-INT, etc. - A separate Form 1099 is required for reportable payments, or an approved substitute form may be issued.
- II. Due Date of Returns - Must be filed by February 28 of the year following the calendar year in which the payment occurs. The payor must also furnish a copy to the payee no later than January 31.
- III. Backup Withholding - Amounts withheld are reported in Box 4 of Forms 1099-INT and 1099-DIV.

C. Magnetic Media Reporting

Magnetic media reporting may be required for filing information returns 1099-INT and 1099-DIV.

- I. Interest and Dividends - If you are required to file more than 50 returns on 1099-DIV, -INT, -OID, or -PATR, you are required to file on magnetic media. All the above forms are included in the count to 50.
- II. Undue hardship waivers are obtainable by filing Form 8508 at least 90 days before the due date of the return. These waivers must be requested separately for each type of form and are only good for one tax year at a time. Therefore, they must be requested every year the payor is required to file more than 50 returns.

D. Penalties

I. Failure to supply identifying numbers (IRC Sec. 6676)

- a. Interest, Dividends, or Royalties Returns - Payor who fails to include a TIN or who includes an incorrect TIN on any required return is subject to a \$50 penalty for each failure unless due diligence has been exercised. For returns due after 1986, the maximum penalty amount is \$100,000.
- b. Due Diligence vs. Reasonable Cause - The IRS has issued temporary regulations specifically detailing the circumstances when a payor will be considered to have exercised due diligence in complying with the law or TINs. Reasonable cause is not a defense against the penalty. In general, the regulations require the following:
 1. Post-1984 Accounts - must obtain a TIN at the time the account is opened.

2. Pre-1984 accounts -

- a. On or before 12/31/83, the payor must solicit a certified TIN from any payer who has not previously provided a certified TIN. This must be a separate mailing including only the required notice explaining backup withholding, Form W-9 or acceptable substitute, and a postage-prepaid reply envelope.
- b. If no TIN exists or is obviously incorrect, payer must begin backup withholding for reportable payments made after 12/31/83.
- c. Use reasonable care in processing TIN's.
- d. Annually solicit certified TIN's to all payer's who have not previously certified. This annual solicitation need not be a separate mailing.
- e. The 12/31/83 date can be deferred to 3/31/84 in certain circumstances not covered here.

3. Exceptions:

- a. TIN provided by a broker
 - b. Certain account transfers
 - c. Awaiting TIN status
 - d. Under hardship
- c. Self-Assessed Penalty - The payor is responsible for assessing the penalty for failure to supply a TIN on required information returns. The penalty is treated as an excise tax and is due on April 1 of the year following the calendar year for which the return or statement applies. Interest will accrue from April 1 for failure to pay. The penalty is a non-deductible business expense.

II. Failure to File or Delinquent Filing

- a. Information Returns or Statements (IRC Sec. 6721 & 6722) - The penalty for failure to file or delinquent filing of an information return is \$50 for each return, up to a maximum of \$100,000 per person failing to file.
- b. Reasonable Cause - The penalty may be abated if the failure to file is excused by reasonable cause and is not due to willful neglect. If the return is filed late, a Form 4571, Explanation for Filing Return Late, should be attached to avoid the penalty.
- c. Intentional Disregard of Rules - Where the failure to file any of the above information returns is due to intentional disregard of the filing requirements, the \$100,000 limit does not apply.

In addition, where there is intentional disregard, the penalty imposed cannot be less than 10 percent of the aggregate amount of the items required to be reported, or \$100 whichever is greater.

III. TIN Matching Program

- a. The IRS matches the TIN supplied on Form 1099 against its master file.
- b. If it is a valid number (i.e., has been issued to some one) the name reported on the 1099 is matched against the name(s) on the master file belonging to the number.
- c. If the first four letters of the name on the master file match any four letter sequence on the name line on the Form 1099, the combination is good.
- d. If no match is found, a penalty could be imposed.

IV. Penalty Notices

The IRS prepares lists for accounts for which no TIN was reported or for which the TIN/name combination was not valid. These lists are sent to the payors along with a letter describing due diligence and a return certification. The payor should return the certification indicating for what portion of the penalty accounts it performed due diligence. If the payor returns the certification indicating due diligence was performed, the IRS initially will accept at face value such representation.

If the payor returns the certification admitting to some lapse in its due diligence procedures, the IRS will impose the penalty on the number admitted by the payor. If the certification is not returned, the IRS will impose a penalty on the payor based on the number of failures on the notice.

If a financial institution is audited by the IRS, the individual examiner may, at his discretion, ask for proof that due diligence was done.

EXHIBIT 1

INSTRUCTIONS AND FORMS FOR INFORMATION REPORTING
FORMS 1099
&
W-8 AND W-9

1987

 Department of the Treasury
Internal Revenue Service

Instructions for Forms 1099, 1098, 5498, 1096, and W-2G

(Including Forms 1099-A, 1099-B, 1099-DIV,
1099-G, 1099-INT, 1099-MISC, 1099-OID,
1099-PATR, 1099-R, and 5754)

(Section references are to the Internal Revenue Code, unless otherwise noted.)

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

Changes You Should Note Separate Mailing Requirement for Recipient Statements Relaxed

For statements due to be furnished after 1986, payers of interest, dividends, patronage dividends, and royalties must provide the required statement to recipients in person or in a statement mailing by first-class mail. For the meaning of "statement mailing," see part H under *General Instructions*.

Penalties Changes

For returns due after 1986, the following new penalty provisions apply:

- (1) The maximum penalties for failure to file information returns, for failure to furnish statements to payees, and for failure to supply taxpayer identification numbers (TINs) are increased from \$50,000 to \$100,000 per calendar year. No maximum applies to payments of certain interest and dividends.
- (2) A new penalty of \$5 per document is imposed for failure to include correct information on a return or statement. The maximum penalty is \$20,000, but no maximum applies to certain interest or dividend returns or statements.
- (3) The self-assessed penalty for failure to furnish the recipient's correct TIN on an information return (section 6676(b)) also applies to royalty payments unless the payer exercised due diligence.

Real Estate Broker Reporting

At the time of publication of this document, instructions for filing Form 1099-B, Statement for Recipients of Proceeds From Real Estate, Broker, and Barter Exchange Transactions, to report real estate transactions were not available. Those instructions will be issued later.

Form 1099-DIV Changes

The \$100 (\$200 on a joint return) dividend exclusion has been repealed. Therefore, box 2, "Dividends qualifying for exclusion," and box 3, "Dividends not qualifying for exclusion," have been eliminated. In

addition, new box 2 has been added for a shareholder's pro rata share of amounts deductible by a regulated investment company in computing its taxable income. The remaining boxes have been renumbered and/or repositioned.

Form 1099-MISC Changes

For payments made after 1986, gross royalty payments must be reported if they total \$10 or more. The old reporting requirement was \$600 or more.

A checkbox has been added in new box 10 to indicate that an amount reported in box 7, "Nonemployee compensation," is crop insurance proceeds.

Form 1099-R Changes

For distributions of qualified deductible voluntary employee contributions (DECs) made in 1987 and later years, do not report the distribution in box 8, as you did in the past. Rather, report it in boxes 1 and 3. Continue to report the distribution of IRAs and SEPs in box 8.

Form 5498 Changes

The box for reporting contributions to a simplified employee pension (SEP) has been eliminated. Do not report employer contributions to a SEP on Form 5498. Deductible voluntary employee contributions (DECs) can no longer be made. Therefore, they have been eliminated from the form.

A new box for the value of the account has been added to the form. Trustees and issuers of IRAs and SEPs should file Form 5498 and complete this box for accounts in existence during the year, even if no contributions were made during the year.

You must furnish a statement of the value of the account to each participant by January 31.

Backup Withholding

Interest, dividends, rents, royalties, commissions, nonemployee compensation, and certain other payments (including broker and barter exchange transactions, and certain payments made by fishing boat operators) may be subject to backup withholding at a 20% rate. To be subject to backup withholding, a payment must be a reportable interest or dividend payment under sections 6049(a), 6042(a), or 6044 (if at least 50% of the patronage dividend is in money), or a reportable other payment under sections 6041, 6041A(a), 6045, 6050A, or 6050N. If the payment is one of

these reportable payments, backup withholding will apply if:

- (1) The payee fails to furnish his or her taxpayer identification number (TIN) to you, OR
- (2) IRS notifies you to impose backup withholding because the payee furnished an incorrect TIN, OR
- (3) You are notified that the payee is subject to backup withholding (under section 3406(a)(1)(C)), OR
- (4) For interest and dividend accounts opened or instruments acquired after 1983, the payee fails to certify to you, under penalties of perjury, that he or she is not subject to backup withholding under (3) above, OR
- (5) For interest, dividend, broker, or barter exchange accounts opened or instruments acquired after 1983, or broker accounts considered inactive in 1983, the payee fails to certify, under penalties of perjury, that the TIN provided is correct.

Reportable other payments are subject to backup withholding only if (1) or (2) above applies.

Some payees are exempt from backup withholding. For a list of types of exempt payees and other information, please see Form W-9, Payer's Request for Taxpayer Identification Number and Certification.

Unless otherwise provided in regulations, real estate transactions are not subject to backup withholding.

Generally, the period for which the 20% should be withheld is as follows:

- (1) Failure to furnish TIN in the manner required.—Withhold on payments made until the TIN is furnished in the manner required, unless the payee has applied for a TIN. The payee may certify to this on Form W-9 by noting "Applied For" in the TIN block and by signing the form. This form then becomes an "awaiting-TIN certificate." If the TIN is not received and certified, if required, within 60 days, begin withholding and continue until you receive a TIN in the manner required.
- (2) Notice from IRS that payee's TIN is incorrect.—Start withholding on payments made on the 30th day after the date you receive notification from IRS. Stop withholding when another TIN is furnished in the manner required. Note: IRS will furnish an additional copy of the notice to you, and you are required to promptly furnish such notice to the payee. If the payee furnishes you with another TIN, you are required to promptly notify IRS of the new TIN.
- (3) Notice from IRS that payee is subject to backup withholding.—Start withholding on payments made on the 30th day after the date you receive notification from IRS. IRS will notify you in writing when to stop withholding, or the payee may furnish you with a written certification from IRS stating when withholding is to stop. In most cases, the stop date will be before January 1 of the year following the year of the notice. Note: You must notify the payee when withholding under this procedure starts.
- (4) Payee failure to certify that he or she is not subject to backup withholding.—Withhold on reportable interest and dividends until certification has been received.

For exceptions to these general timing rules, see section 3406(e).

Note: For information about backup withholding on gambling winnings, see the *Specific Instructions for Form W-2G for the specific type of gambling winnings.*

Reporting and Payment of Backup Withholding.—Backup withholding amounts must be reported on Form 941, Employer's Quarterly Federal Tax Return, (or Form 941-E, Quarterly Return of Withheld Federal Income Tax and Hospital Insurance (Medicare) Tax). For more information, see the instructions for Form 941 (or Form 941-E).

Penalties

The following penalties generally apply to the person required to file information returns (payer). The penalties apply to paper filers as well as magnetic media filers.

A penalty of \$50 per failure applies to:

- Each failure to timely file an information return, including failure to file on magnetic media, if required, and failure to file forms that are machine readable. The maximum penalty is \$100,000, except no maximum applies to certain interest or dividend payments. (Section 6721. But see section 6652(e) for returns filed under section 6047.)

- Each failure to furnish the recipient's TIN on an information return other than for payments of certain interest, dividends, and royalties. For mortgages in existence before 1985, you will not be subject to the penalty for failure to provide the TIN of the payer of record on Form 1098 if you followed the rules for requesting TINs contained in Temporary Regulations section 1.6050H-1T, and you properly and promptly processed the responses. (Section 6676(a))

- Each failure to report the recipient's correct TIN on an information return for payments of certain interest, dividends, and royalties. There is no maximum penalty. (Section 6676(b))

- Each failure to timely furnish a statement to a payee. The maximum penalty is \$100,000, except no maximum applies to certain interest or dividend payments. (Section 6722)

- Each failure to provide reports on individual retirement arrangements on Form 5498. There is no maximum penalty. (Section 6693)

A penalty of \$5 per failure applies to:

- Each failure by a payer to include his or her TIN in any return, statement, or document. (Section 6676)

- Each failure to include correct information on a return or statement. This penalty applies to the omission of information as well as to the inclusion of incorrect information. The maximum penalty is \$20,000, except no maximum applies to returns or statements reporting interest or dividends. This penalty does not apply to an information return if a penalty for failure to supply a correct TIN has been imposed with respect to that return. (Section 6723)

Interest, Dividend, and Royalty Payments; Self-Assessed Penalties.—The penalties relating to information returns for interest and dividend payments apply unless you exercised due diligence in attempting to satisfy the requirements for such TIN, statement, or return. In addition, the

Page 2

penalties relating to payments of interest and dividends are self-assessed. For royalties, the penalty for failure to furnish the recipient's TIN on an information return applies unless you exercised due diligence; in addition, such penalty is self-assessed. Use Form 8210, Self-Assessed Penalties Return, for this purpose. For information on due diligence, see Temporary Regulations section 35a.9999 and the instructions for Form 8210. In the case of intentional disregard of the filing and correct information requirements, higher penalties may be imposed.

Other Payments.—The penalties relating to information returns for payments other than interest and dividends (and royalties in the case of the TIN penalty) apply unless the failures were due to reasonable cause and not willful neglect. However, in the case of intentional disregard of the filing and correct information requirements, higher penalties may be imposed.

Magnetic Media Reporting

Magnetic media reporting may be required for filing all information returns discussed in this publication. Payers have found magnetic media reporting to be economical, efficient, and more flexible for integrating the reporting required under the Internal Revenue Code with their reporting to other government agencies. Magnetic media consists of magnetic tape, diskette, cassette, or mini-disk. Revenue procedures for magnetic media reporting are available at Internal Revenue Service district offices. Different types of payments, such as interest, dividends, and rents, may be reported on the same tape or other submission.

Interest and Dividends.—If you are required to file, or were required to file for the prior year, more than 50 returns on Forms 1099-DIV, 1099-INT, 1099-OID, or 1099-PATR, you are required to file on magnetic media. For example, if you must file 30 Forms 1099-DIV and 25 Forms 1099-INT, magnetic media reporting is required. This requirement shall not apply if you establish that this requirement would result in undue hardship. See *Waiver Request*, below.

Brokers and Barter Exchanges.—Regulations section 1.6045-1(l) requires brokers and barter exchanges to use magnetic media in reporting all Form 1099-B data to the IRS. Regulations also require the use of magnetic media when reporting payments received in lieu of dividends or tax-exempt interest on behalf of a customer during a short sale on Form 1099-MISC. New brokers and new barter exchanges may request an undue hardship exception by filing an application by the end of the second month following the month in which they became a broker or barter exchange.

Other Information Returns.—If you are required to file, or were required to file for the prior year, 250 or more returns on Forms 1098, 1099-A, 1099-G, 1099-MISC (except for substitute payments reported in Box 8), 1099-R, 5498, or W-2G, you are required to file on magnetic media. For purposes of determining the number of returns you are required to file, or were required to file last year, count each type of form separately. For example, if you must file 500 Forms 1098 and 100 Forms 1099-

A, you are not required to file Forms 1099-A on magnetic media, but you must file Forms 1098 on magnetic media.

Approval.—Form 4419, Application for Magnetic Media Reporting of Information Returns, must be filed at least 90 days before the due date of the returns. IRS will provide a written reply to the applicant and further instructions at the time of approval, usually within 30 days. Send the application to Magnetic Media Reporting, Internal Revenue Service, National Computer Center, P.O. Box 1359, Martinsburg, WV 25401-1359. Processing of magnetic media is centralized at the National Computer Center and all applications and information returns filed on magnetic media should be sent to the National Computer Center address. A magnetic media reporting package, which includes all the necessary transmittals, labels, and instructions, will be mailed to all approved filers when revenue procedures are available, but not later than October of the year for which the information returns are required.

Payers who file information returns on magnetic media should be sure that duplicate returns are not filed on paper forms.

The due dates for magnetic media reporting are the same as for paper document reporting.

Waiver Request.—To receive a waiver from the required filing of information returns on magnetic media, you must submit Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, or a written statement requesting an undue hardship waiver from magnetic media filing for a period of time not to exceed one tax year. You cannot apply for a waiver for more than one tax year at a time. If you require a waiver for a longer period of time, you must reapply at the appropriate time each year (90 days before the due date of the return). Separate waiver requests must be filed for each type of form. Please use Form 8508 to request a waiver, whenever possible. Rather than a Form 8508, you may send a written statement providing the information required by Rev. Proc. 86-31, 1986-1 C.B. 681.

Waiver requests should be filed 90 days before the due date of the return, except as stated under *Brokers and Barter Exchanges*, earlier, and sent to Magnetic Media Reporting, Internal Revenue Service, National Computer Center, P.O. Box 1359, Martinsburg, WV 25401-1359.

If you are seeking, in a single application, approval for filing returns on magnetic media and, alternatively, a waiver from the magnetic media filing requirement if approval is not granted, submit both Forms 4419 and 8508 (or a written request).

If you receive an approved waiver, do not send a copy of it to the service center where you file your paper returns. Keep the waiver for your records only.

Penalty.—If you are required to file on magnetic media but fail to do so, and you do not have an approved waiver on record, you may be subject to a penalty of \$50 per return for failure to file information returns unless you establish reasonable cause or in some cases due diligence.

Paper Document Reporting

Payers filing returns on paper forms must use a separate transmittal, Form 1096.

Annual Summary and Transmittal of U.S. Information Returns, for each different type of form.

Format.—All Forms 1096, 1098, 1099, and 5498 must be prepared in accordance with the following instructions. If these instructions are not followed, you may be subject to a penalty of \$50 per incorrectly filed document.

- (1) Type or machine print data entries using a carbon-based black ink ribbon. Print must be in 10 pitch (pica) or 12 pitch (elite) black type. Use block print, not script characters. Any other print is not acceptable. Entries cannot be handwritten. Dot matrix print must be letter quality 7 x 9 per character, minimum. Insert data in the middle of the blocks well separated from other printing and guidelines, and take other measures to guarantee a dark black, clear, sharp image.
- (2) **DO NOT CUT OR SEPARATE** the forms that are three to a page. Forms 1098, 1099, and 5498 are printed three to an 8" x 11" page. Form 1096 is printed one to an 8" x 11" page. These forms must be submitted to IRS on the 8" x 11" page. If at least one form on the page is correctly completed, you must submit the entire page.
- (3) **NO PHOTOCOPIES** of any forms are allowable. Official forms are available from your IRS district office.
- (4) **DO NOT STAPLE, tear, or tape** any of these forms. It will interfere with the ability to scan the documents. Send the forms to IRS in a flat mailing (not folded).
- (5) Pinfeed holes on the form are **NOT** acceptable. Pinfeed holes must not be in the 8" x 11" page. If they are outside that area, they must be removed before submission, taking the necessary precautions against tearing or ripping the form.
- (6) **DO NOT** change the title of any box on any form. Do not use a form to report information that is not properly reportable on that form. If you are unsure of where to report the data, call your local IRS office.
- (7) Report information only in the appropriate boxes provided on the forms unless otherwise indicated in these instructions.
- (8) **DO NOT** submit any copy other than Copy A to the IRS.
- (9) **DO NOT** use prior year forms. Because forms are "read" by machine, the current form **MUST** be used.
- (10) If a document is not correct, void it by placing a black "X" in the VOID box. Also see part J under *General Instructions*, later.
- (11) If you are submitting corrected or amended returns, place a black "X" in the CORRECTED box. **DO NOT** type "Corrected" or "Amended" on the forms. Also see part J under *General Instructions*, later.
- (12) Use the official forms or forms that meet the specifications for substitute forms in the current Publication 1179, *Specifications for Paper Document Reporting and Paper Substitutes for Forms 1096, 1098, 1099, 5498, and W-2G*. If you submit substitute forms that do not meet the current

specifications and that are not machine scanable, you will be subject to a penalty of \$50 for each return.

- (13) You may use the account number box for an account number designation. This number must not appear anywhere else on the form, and this box may not be used for any other item. Showing the account number is optional. However, it may be to your benefit to include the recipient's account number on paper documents if your system of records uses the account number rather than the name, social security number, or employer identification number for identification purposes. If you furnish the account number, IRS will include it in future notices to you about backup withholding. If window envelopes are used to mail statements to recipients, be sure the account number does not appear in the window because the Postal Service may not accept these for reduced rate mail.
- (14) Print money amounts without ampersands (&), asterisks (*), commas (,), or other special characters. Do use decimal points to indicate dollars and cents.

General Instructions

A. Who Must File.—See the *Specific Instructions* for each form.

Nominee/Middleman Returns.—Anyone receiving a Form 1099 for amounts that actually belong to another person should file a Form 1099 showing the actual owner as the recipient and the nominee as the payer.

Mergers.—If two corporations merge and the surviving corporation becomes the owner of all the assets and assumes all the liabilities of the absorbed corporation, the reporting requirements explained in this publication will be met if the surviving corporation files Forms 1098, 1099, 5498, and/or W-2G for reportable payments of both corporations. See Rev. Rul. 69-556, 1969-2 C.B. 242.

Payments to Foreign Persons.—See Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and the related instructions for reporting requirements relating to payments of income items to foreign persons.

B. When To File.—File Form 1096 to transmit Forms 1098, 1099, or W-2G by February 29, 1988. Brokers (other than real estate brokers) may file Form 1096 and Form 1099-B anytime after the reporting period they elect to adopt (month, quarter, or year), but not later than February 29, 1988. File Form 1096 to transmit Forms 5498 by May 31, 1988. See part H under *General Instructions* about providing Forms 1098, 1099, 5498, and W-2G to recipients.

For paper or magnetic media filing, you may request an extension of time to file by sending a letter to the National Computer Center. Include in the letter your name and address, TIN, tax year for which you are requesting an extension, phone number, type and volume of returns, the reason for the delay, and whether the extension is required for filing paper forms or magnetic media.

C. Where To File.—Send all information returns filed on magnetic media to: Magnetic Media Reporting, Internal Revenue Service, National Computer Center, P.O. Box 1359, Martinsburg, WV 25401-1359. Send all information returns filed on paper to the following:

If your principal business, office or agency, or legal residence in the case of an individual, is located in

Use the following Internal Revenue Service Center address

Alabama, Florida, Georgia, Mississippi, South Carolina	Atlanta, GA 39901
New Jersey, New York (New York City and counties of Nassau, Rockland, Suffolk, and Westchester)	Holtsville, NY 00501
New York (all other counties), Connecticut, Maine, Massachusetts, Minnesota, New Hampshire, Rhode Island, Vermont	Andover, MA 05501
Illinois, Iowa, Missouri, Wisconsin	Kansas City, MO 64999
Delaware, District of Columbia, Maryland, Pennsylvania	Philadelphia, PA 19255
Kentucky, Michigan, Ohio, West Virginia	Cincinnati, OH 45999
Kansas, Louisiana, New Mexico, Oklahoma, Texas	Austin, TX 73301
Alaska, Arizona, California (counties of Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Mendocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo, and Yuba), Colorado, Idaho, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming	Ogden, UT 84201
California (all other counties), Hawaii	Fresno, CA 93888
Arkansas, Indiana, North Carolina, Tennessee, Virginia	Memphis, TN 37501

If you have no legal residence, principal place of business, or principal office or agency in any Internal Revenue district, file your return with the Internal Revenue Service Center, Philadelphia, PA 19255.

If you pay nontaxable dividends to your shareholders, complete and file Form 5452, *Corporate Report of Nontaxable Dividends*, by February 28, following the close of the calendar year, with the Director, Corporation Tax Division, CC:C:1:1, Internal Revenue Service, Washington, DC 20224.

D. Reporting Period.—Forms 1098, 1099, and W-2G are used to report amounts received, paid, or credited during the calendar year. Form 5498 is used to report amounts contributed during or after the calendar year.

E. Recipient Names and Taxpayer Identification Numbers.—Taxpayer identification numbers (TINs) are used to associate and verify amounts reported to the IRS with corresponding amounts on tax returns. Therefore, it is important that you furnish correct social security or employer identification numbers for recipients on the forms or magnetic media sent to IRS. (There is a penalty for reporting an incorrect TIN. See *Penalties* on page 2.)

The taxpayer identification number for individual recipients of information returns (including sole proprietors) is the social security number. For other recipients, it is the employer identification number.

Social security numbers have nine digits separated by two hyphens (000-00-0000), and employer identification numbers have nine digits separated by only one hyphen (00-0000000).

Show the full name and address in the section provided on the return. If payments have been made to more than one individual recipient, on all forms other than Form W-2G, show as the ONLY name on the first name line the name of the recipient whose TIN is on the return. Show the names of any other individual recipients in the area below the first line.

F. Filer Names and Identification Numbers.—The taxpayer identification number for filers of information returns, including sole proprietors and nominees/middlemen, is the Federal employer identification number. However, sole proprietors and nominees/middlemen who are not otherwise required to have an employer identification number should use their social security numbers. The filer's name and taxpayer identification number should be consistent with the name and number used on the filer's other tax returns. The name of the filer's paying agent or service bureau must not be used in place of the name of the filer.

G. Shipping and Mailing.—Persons who file on paper forms and who use more than one type of form should group the forms by form number and prepare separate transmittals for each group. For example, if you pay both interest and dividends, file Forms 1099-INT with one Form 1096 and Forms 1099-DIV with a second Form 1096.

If you are sending many forms, you may send them in conveniently sized packages. On each package write your name and TIN, number the packages consecutively, and place Form 1096 in package number one. At the top of Form 1096 show the number of packages. Postal regulations require forms and packages to be sent by first-class mail.

H. Statements to Recipients (Borrowers, Participants, Payers, or Winners on Certain Forms).—Different rules apply to furnishing statements to recipients depending on the type of payment you are reporting and the form you are filing. **Interest, dividend, and royalty payments.**—For payments of dividends or interest (including original issue discount) under sections 6042, 6044, or 6049 (reported on Forms 1099-DIV, 1099-PATR, 1099-INT, or 1099-OID), or substitute payments in lieu of dividends and tax-exempt interest (reported on Form 1099-MISC), you are required to furnish an official Form 1099 to a payee either in person or in a statement mailing by first-class mail. Payers of royalties are also required to furnish the statement in person or in a statement mailing by first-class mail, but the statement may not be the official form. Statements may be sent by intraoffice mail if you use intraoffice mail to send account information and other correspondence to the payee.

Statement mailing.—In addition to the items already permitted—Forms W-8, W-9, or other 1098, 1099, and 5498 statements—the following enclosures are permitted in a statement mailing: (1) a check, (2) a letter explaining why no check is enclosed, and (3) a statement of the person's account. You may also include Forms W-2 and W-2P. A letter limited to an explanation of the tax consequences of the information shown on a payee statement may also be included. However, an enclosure with a perforated payee statement set forth on the same document violates the statement mailing requirement. No additional enclosures, such as advertising, promotional material, or a quarterly or annual report, are permitted. Even a sentence or two on the year-end statement describing new services offered by the payer is not permitted. However, logos are permitted on the envelope or other enclosures.

For a statement mailing, the legend "Important Tax Return Document Enclosed" must appear on the outside of the envelope and on each check, letter, or account statement in a bold and conspicuous manner. The legend is not required on any tax form, tax statement, or permitted letter of tax consequences included in a statement mailing. Further, you do not have to pluralize the word "document" in the legend simply because more than one payee statement is enclosed.

Note: If you follow the more stringent "separate mailing" requirements of prior law—your mailing contains only payee statements, Form W-8 and W-9, and a letter limited to the explanation of the tax consequences of the information shown on a payee statement included in the envelope—you are not required to include the legend "Important Tax Return Document Enclosed" on the envelope.

You may use substitute Forms 1099 if they contain substantially similar language to the official forms and you comply with all revenue procedures relating to substitute Forms 1099. Copy B (For Recipient) of the substitute forms must contain the statement: "This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported." The substitute form must contain the instructions as on the back of Copy B of the official form.

Other payments.—Statements to recipients for Forms 1098, 1099-A, 1099-B, 1099-G, 1099-MISC (except in the case of substitute payments in lieu of dividends and tax-exempt interest), 1099-R, 5498, or W-2G need not be a copy of the paper form filed with the IRS. It is important that income items be properly classified for Federal tax purposes on the statement you give to recipients. The following messages must appear on the statements as indicated:

- (1) Forms 5498 and 1099-R—"This information is being furnished to the Internal Revenue Service."
- (2) Forms 1099-G and W-2G—"This is important tax information and is being furnished to the Internal Revenue

Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported."

- (3) Forms 1099-B and 1099-MISC—Same as item (2) above, except change "may" to "will" in the second sentence.
- (4) Form 1099-A—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported."
- (5) Form 1098—(a) "The amount in Box 1 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if the IRS determines that an underpayment of tax results because you failed to properly show this amount on your return."

(b) "The amount shown may not be fully deductible by you on your Federal income tax return. Limitations based on the cost and value of the secured property may apply. In addition, you may only deduct an amount of mortgage interest to the extent it was actually paid by you and not reimbursed by another person, and to the extent the interest is attributable to a loan for which you are liable for repayment."

You may combine the statements with other reports or financial or commercial notices, or expand them to include other information of interest to the recipient. Be sure that all copies of the forms are legible. Also provide the recipient with applicable instructions similar to those that appear on the back of the recipient's copy of the official IRS form so that the information may properly be used by the recipient in meeting his or her tax obligations.

For more information about paper substitutes, see Publication 1179. **Time for furnishing forms or statements.**—Generally, you must provide Forms 1098, 1099, and W-2G information by January 31 of the following year. However, you may issue them earlier in some situations, as provided by the regulations. For example, you may furnish Form 1099-INT to the recipient on redemptions of U.S. Savings Bonds at the time of redemption. Brokers and barter exchanges may furnish Form 1099-B anytime but not later than January 31.

Trustees or issuers of IRAs or SEPs must provide participants with a statement of the value of the participant's account by January 31. IRA contribution information must be furnished to the participant by May 31.

Filers of Form 1099-G who report state or local income tax refunds, credits, or offsets must furnish the statements to recipients during January of the following year. **I. Filing Returns With IRS.**—IRS strongly encourages the quality review of data before filing to prevent erroneous notices being mailed to payees (or others for whom information is being reported).

If you must file any Form 1098, 1099, 5498, or W-2G with IRS, and you are filing paper documents, a Form 1096, Annual Summary and Transmittal of U.S. Information Returns, must be sent with each type of form as the transmittal document. You must group the forms by form number and submit each group with a separate Form 1096. Specific instructions for completing Form 1096 are included on Form 1096. Also see *Transmitters, paying agents, etc.*, below.

If you are filing using magnetic media, Form 4804, Transmittal of Information Returns Reported on Magnetic Media, must accompany your submissions.

For information on the preparation of transmittal documents for magnetic media and paper document reporting (Forms 4804 and 1096), see Rev. Proc. 84-24, 1984-1 C.B. 465, or other current revenue procedure.

If you use paper forms, report payments on the appropriate form, as explained in the *Specific Instructions*, later. Do NOT report payments to employees, such as Christmas bonuses or reimbursements for travel or car expenses, on Forms 1099. Report these on Form W-2, Wage and Tax Statement.

See the revenue procedures on specifications for private printing of information documents. You may not request special consideration. Only forms that conform with the official form and the specifications in the revenue procedures are acceptable.

Transmitters, paying agents, etc.—A transmitter, service bureau, paying agent, or disbursing agent (hereafter referred to as "agent") may sign Form 1096 or 4804 on behalf of any person required to file (hereafter referred to as "the payer") if the conditions in items (1), (2)(i) or (2)(ii), and (3) are met:

- (1) The agent has the authority to sign the form under an agency agreement (oral, written, or implied) that is valid under state law.
- (2)(i) The agent has the responsibility (oral, written, or implied) conferred on it by the payer to request the TINs of recipients (or others for whom information is being reported).

OR

(ii) If the return of more than one payer is included in a single magnetic media submission, covered by a single Form 4804, each payer has attested by affidavit to the agent that the payer has complied with the law in attempting to secure correct TINs.

- (3) The agent signs the form and adds the caption "For: (Name of payer)."

Signing of the form by an authorized agent on behalf of the payer does not relieve the payer of the liability for penalties for not filing a correct, complete, and timely Form 1096 or 4804 and attachments.

Forms 1098, 1099, 5498, W-2G, or other statements to recipients issued by a service bureau or agent should show the same payer's name as shown on the information return filed with IRS.

For information about the election to report and deposit backup withholding under the agent's TIN and how to prepare forms if the election is made, see Rev. Proc. 84-33, 1984-1 C.B. 502.

J. Corrected Returns.—If a return has been prepared and submitted to IRS

improperly, you must file a complete corrected return as soon as possible. All boxes must be completed on the appropriate forms with the correct information, not just the boxes needing correction. Submit Form 1096 and Copies A of corrected forms to the appropriate service center. If you are making corrections on magnetic media, see the current revenue procedure on magnetic media.

Statements to the recipient (etc.) identified as corrected should be provided to them as soon as possible.

On all Forms 1098, 1099, and 5498, a box is provided for the account number. If the account number was provided on the original return, use this number on the corrected return to help identify the appropriate incorrect return filed when more than one return was filed for a particular individual. The account number may be a checking account number, savings account number, serial number, or any other number assigned to the payee by the filer that is unique and will distinguish the specific account. This number must appear on both the original and corrected returns to properly identify and process the correction.

A Form 1096 must be used to transmit all paper forms including corrections. Do not staple the paper forms to Form 1096. Use a separate Form 1096 for each type of return being corrected. Do not cut forms that are three to a page, but submit the entire page.

If a completed or partially completed Form 1098, 1099, or 5498 is incorrect and you want to void it, enter an "X" in the "VOID" box at the top of the form. DO NOT CUT the forms that are three to a page.

If you make an error while typing or printing a Form 1098, 1099, or 5498, enter an "X" in the "VOID" box at the top of the form. The return will then be disregarded during processing by IRS. DO NOT CUT or separate the forms that are three to a page. The entire page must be submitted.

The following chart gives step-by-step instructions for filing corrected returns for three of the most frequently made errors. Correction of errors may require the submission of more than one return. Be sure to read each entire section thoroughly.

Guidelines for Filing Corrected Returns on Paper Forms

Error Made on the Original Return	How To File the Corrected Return on Paper Forms
1. No Payee TIN (SSN or EIN) or incorrect Payee TIN.	<p>A. Form 1096:</p> <ol style="list-style-type: none"> 1. Prepare a new transmittal Form 1096. 2. Enter an "X" in the "CORRECTED" box at the top of the form. 3. Provide all requested information on the form correctly. <p>B. Forms 1098, 1099, 5498, or W-2G:</p> <ol style="list-style-type: none"> 1. Prepare a new information return on the proper type of form. 2. Enter an "X" in the "CORRECTED" box at the top of the form(s). 3. Include all the correct information on supplying the correct TIN (SSN or EIN). 4. File Form 1096 and Copies A of the returns with the appropriate service center. 5. Do NOT include copies of the original return that was filed incorrectly.

Error Made on the Original Return	How To File the Corrected Return on Paper Forms
2. Incorrect money amount(s).	<p>A. Form 1096:</p> <ol style="list-style-type: none"> 1. Prepare a new transmittal Form 1096. 2. Enter an "X" in the "CORRECTED" box at the top of the form. 3. Provide all requested information on the form correctly. <p>B. Forms 1098, 1099, 5498, or W-2G:</p> <ol style="list-style-type: none"> 1. Prepare a new information return on the proper type of form. 2. Enter an "X" in the "CORRECTED" box at the top of the form(s). 3. Enter the payer, recipient, and account number information exactly as it appeared on the original incorrect return. HOWEVER, enter all correct money amounts in the correct boxes as they should have appeared on the original return. 4. File Form 1096 and Copies A of the returns with the appropriate service center. 5. Do NOT include copies of the original return that was filed incorrectly.

3. Original return was filed using the WRONG type of return. For example, a Form 1099-DIV was filed when a Form 1099-INT should have been filed. This will require two separate transactions to make the correction properly. Read and follow all instructions for both transactions 1 and 2.	<p>TRANSACTION 1: Identify incorrect return submitted.</p> <p>A. Form 1096:</p> <ol style="list-style-type: none"> 1. Prepare a new transmittal Form 1096. 2. Enter an "X" in the "CORRECTED" box at the top of the form. 3. Provide all requested information on the form correctly. <p>B. Forms 1098, 1099, 5498, or W-2G:</p> <ol style="list-style-type: none"> 1. Prepare a new information return utilizing the same type of form that was used initially. 2. Enter an "X" in the "CORRECTED" box at the top of the form(s). 3. Enter the payer, recipient, and account number information exactly as it appeared on the original incorrect return. HOWEVER, enter "0" (zero) for all money amounts. 4. File Form 1096 and Copies A of the returns with the appropriate service center. 5. Do NOT include copies of the original return that was filed incorrectly.
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TRANSACTION 2: Report correct information on the correct type of return.	<p>A. Form 1096:</p> <ol style="list-style-type: none"> 1. Prepare a new transmittal Form 1096. 2. Do NOT enter an "X" in the "CORRECTED" box at the top of the form for this type of correction. Rather, enter the words "Filed To Correct Document Type" in the bottom margin of the form. 3. Provide all requested information on the form correctly.
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Error Made on the Original Return

How To File the Corrected Return on Paper Forms

B. Forms 1098, 1099, 5498, or W-2G:

1. Prepare a new information return utilizing the proper type of form.
2. Do NOT enter an "X" in the "CORRECTED" box at the top of the form(s). Submit the new return(s) as though it was an original.
3. Include all the correct information on the form.
4. File Form 1096 and Copies A of the returns with the appropriate service center. You MUST NOT use the same Form 1096 used in Transaction 1.
5. Do NOT include copies of the original return that was filed incorrectly.

K. Other Information Returns.—The income information you report on the following returns must not be repeated on the returns discussed in the *Specific Instructions* in this document:

- (1) Returns filed with Form W-3:
 - (a) Form W-2 reporting wages and other employee compensation.
 - (b) Form W-2P reporting certain annuities, pensions, retirement pay, and IRA payments.
- (2) Forms 1042S, 1000, and 1001 reporting income.
- (3) Form 2439 reporting undistributed long-term capital gains of a regulated investment company.
- (4) Schedule K-1 of Form 1065 reporting distributive shares to members of a partnership.
- (5) Schedule K-1 of Form 1041 reporting distributions to beneficiaries of trusts or estates.
- (6) Schedule K-1 of Form 1120S reporting distributive shares to shareholders of S corporations.
- (7) Schedule K of Form 1120-IC-DISC reporting actual and constructive distributions to shareholders and deferred DISC income.

L. Payments to Corporations and Partnerships.—Reporting generally is not required for payments to corporations except in the case of (1) medical payments, (2) withheld Federal income tax or foreign tax, (3) barter exchange transactions, and (4) substitute payments in lieu of dividends and tax-exempt interest. For example, reporting is not required for payments of architectural fees to corporations.

However, reporting generally is required for payments to partnerships. For example, payments of \$600 or more made in the course of your trade or business to a law firm that is a partnership are reportable on Form 1099-MISC.

M. Earnings on an IRA or SEP.—Any income with respect to an IRA or SEP such as interest or dividends, should not be reported on Forms 1099 unless a designated distribution is made. Distributions should be reported on Form 1099-R or Form W-2P.

Specific Instructions

If a distribution includes noncash property, show the fair market value of the property at the time of payment.

Although you generally need not report payments smaller than the minimum described for each form, you may prefer, for economy and your own convenience, to file Copies A for all payments. IRS encourages this.

Form 1098

Use Form 1098, Mortgage Interest Statement, to report mortgage interest of \$600 or more received by you during the year in the course of your trade or business from an individual.

Mortgage Defined.—For obligations in existence on December 31, 1984, a mortgage is any obligation secured primarily by real property that is located inside or outside the U.S., unless, at the time the obligation was incurred, the interest recipient reasonably classified the obligation as other than a mortgage, real property loan, real estate loan, or other similar type of obligation. For example, if an obligation incurred in 1983 was secured primarily by real property, but the interest recipient reasonably classified the obligation as a commercial loan because the proceeds were used to finance the borrower's business, the obligation is not considered a mortgage for purposes of this reporting requirement. However, if a majority of obligations in a class established by the interest recipient are primarily secured by real property, it is not reasonable to classify such obligations as other than mortgages for purposes of this reporting requirement.

For obligations incurred after 1984, a mortgage is any obligation secured primarily by real property that is located inside or outside the U.S. An obligation secured primarily by real property is a mortgage for purposes of this reporting requirement even though the interest recipient classifies it as other than a mortgage, for example, as a commercial loan.

Real property includes stock in a cooperative housing corporation, but a mortgage does not include a credit card obligation or a line of credit either of which is secured primarily by real property.

Who Must File.—File this form if you are engaged in a trade or business and, in the course of such trade or business, you receive from an individual \$600 or more of mortgage interest on any one mortgage during the calendar year. You are not required to file this form if the interest is not received in the course of your business. For example, you hold the mortgage on your former personal residence. The buyer makes mortgage payments to you. You are not required to file Form 1098.

You must file a separate Form 1098 for each mortgage on which you received interest of \$600 or more. If you received less than \$600 of interest on a mortgage, no reporting is required on that mortgage. Further, no reporting is required for interest received from a corporation, partnership, trust, estate, association, or company (other than a sole proprietor). A governmental unit (or any agency or instrumentality thereof) receiving mortgage interest from an individual of \$600 or more or a cooperative housing corporation that receives mortgage interest of \$600 or more from a tenant-stockholder individual must file this form.

If you receive \$600 or more of mortgage interest in the course of your trade or business, you are subject to the requirement to file Form 1098, even if you are not in the business of lending money. For example, if you are a real estate developer and you provide financing to an individual to buy a home in your subdivision, and that home is the primary security for the financing, you are subject to this reporting requirement. However, if you are a physician not engaged in any other business and you lend money to an individual to buy your home, you are not subject to this reporting requirement because you did not receive the interest in the course of your trade or business as a physician.

Collection agents.—If you receive reportable interest payments on behalf of someone else and you are the first person to receive the interest, for example, if you are a servicing bank collecting payments for a lender, you must file this form and enter your name, address, and TIN in the recipient entity area. You must file this form even though you do not include the interest received in your income but you merely transfer it to another person. If you wish, you may enter the name of the person for whom you collected the interest in Box 2. The person for whom you are receiving the interest need not file Form 1098.

Multiple Borrowers.—Even though there may be more than one borrower on the mortgage, you are required to prepare Form 1098 only for the payer of record showing the total interest received on the mortgage.

The payer of record is the individual carried on your books and records as the principal borrower or the individual you designate as the payer of record.

Payments by Third Party.—Report all interest received on the mortgage as received from the borrower, except as explained under *Seller Payments*. For example, if the borrower's mother makes payments on the mortgage, the interest received from the mother is reportable on Form 1098 as received from the borrower.

However, do not report any interest received as housing assistance payments from the Department of Housing and Urban Development (HUD) on mortgages insured under section 235 of the National Housing Act. Do not report mortgage interest received from any other governmental unit (or any agency or instrumentality thereof).

Seller Payments.—Do not report in Box 1 of Form 1098 any interest paid by a seller on a purchaser-borrower's mortgage, such as on a "buy-down" mortgage. For example, if a real estate developer deposits an amount in escrow and tells you to draw on that escrow account to pay interest on the borrower's mortgage, do not report in Box 1 the interest received from that escrow account. As another example, do not report in Box 1 any lump sum paid by a real estate developer to pay interest on a purchaser's/borrower's mortgage. However, if you wish, you may use Box 2 to report to the payer of record any interest paid by the seller.

Rule of 78s Method of Accounting.—If you are permitted by Rev. Proc. 83-40, 1983-1 C.B. 774, to use the Rule of 78s method to calculate interest earned with respect to a transaction, you may report

interest earned under the Rule of 78s method on that transaction as interest received from the borrower in a calendar year. In this case, you must notify borrowers that the Rule of 78s method was used to calculate interest received and that the borrowers may not deduct the amount reported unless the borrowers are also properly using the Rule of 78s method to determine interest deductions. The notification must also state that the Rule of 78s method may be used only in the case of a self-amortizing consumer loan that requires level payments, at regular intervals (at least annually), over a period not in excess of 5 years (with no balloon payment at the end of the loan term), and only when the loan agreement provides for use of the Rule of 78s method to determine interest earned (see Rev. Proc. 83-40).

Report in:

Recipient's/Lender's Name and Address Box.—The name and address of the filer of Form 1098.

Payer's/Borrower's Name and Address Box.—The name and address of the person who paid the interest.

Note: Be careful to enter the recipient's and payer's information in the proper boxes.

Box 1.—The total interest received on the mortgage from borrowers during the calendar year, excluding points and other prepaid interest. Points and other prepaid interest received during the year are not reportable on Form 1098. Prepaid interest is interest that a borrower pays in a year that has not properly accrued as of the end of that year.

Box 2.—Any other item you wish to report to the payer, such as real estate taxes or insurance. This box is optional and is provided only for your convenience. You do not have to report to IRS any information provided in this box.

Form 1099-A

File Form 1099-A, Information Return for Acquisition or Abandonment of Secured Property, for each borrower if you lend money in connection with your trade or business and, in full or partial satisfaction of the debt, you acquire an interest in property that is security for the debt, or you have reason to know that the property has been abandoned. You need not be in the business of lending money to be subject to this reporting requirement.

Property means real property, such as a personal residence, intangible property, or tangible personal property held for investment or used in a trade or business. No reporting is required for a loan made to an individual and secured by an interest in tangible personal property that is neither held for investment nor used in a trade or business. However, you must file Form 1099-A if the personal property is held for both personal use and either for use in a trade or business or for investment.

If there are multiple owners of undivided interests in a single loan, such as is the case in pools, fixed investment trusts, or other similar arrangements, the trustee, record owner, or person acting in a similar capacity must file Form 1099-A on behalf of all the owners of beneficial interests or participations. In this case, only one form for each borrower must be filed on behalf of all

owners with respect to the loan. Similarly, in the case of bond issues, only the trustee or similar person is required to report.

A governmental unit, or any of its agencies or instrumentalities, that lends money secured by property must file Form 1099-A.

A subsequent holder of a loan is treated as the lender for purposes of the reporting requirement for events occurring after the loan is transferred to the new holder.

If more than one person lends money secured by property and one lender forecloses or otherwise acquires an interest in the property and the sale or other acquisition terminates, reduces, or otherwise impairs the other lenders' security interests in the property, the other lenders must file Form 1099-A with respect to each of their loans. For example, if a first trust holder forecloses on a building, and the second trust holder knows or has reason to know of such foreclosure, the second trust holder must file Form 1099-A with respect to the second trust even though no part of the second trust was satisfied by the proceeds of the foreclosure sale.

No reporting is required if the property securing the loan is located outside the U.S. and the borrower has furnished the lender a statement, under penalties of perjury, that the borrower is an exempt foreign person (unless the lender knows that the statement is false).

An abandonment occurs when the objective facts and circumstances indicate that the borrower intended to and has permanently discarded the property from use. You have "reason to know" of an abandonment based on all the facts and circumstances concerning the status of the property. You will be deemed to know all the information that would have been discovered through a reasonable inquiry when, in the ordinary course of business, the lender becomes aware or should become aware of circumstances indicating that the property has been abandoned. If you expect to commence a foreclosure, execution, or similar sale within 3 months of the date you had reason to know that the property was abandoned, reporting is required as of the date you acquire an interest in the property or a third party purchases the property at such sale. If you expect to but do not commence such action within 3 months, the reporting requirement arises at the end of the 3-month period.

For information about the requirement of furnishing a statement to the borrower, see part H under *General Instructions*.

Report in:

Box 1.—The date of your acquisition of the secured property or the date you first knew or had reason to know that the property was abandoned. An interest in the property is generally acquired on the earlier of the date title is transferred to the lender or the date possession and the burdens and benefits of ownership are transferred to the lender. If an objection period is provided by law, use the date the objection period expires. If you purchase the property at a sale held to satisfy the debt, such as at a foreclosure or execution sale, use the later of the date of sale or the date the borrower's right of redemption expires. Please use the following format to indicate the date: MMDDYY. For example, for January 9, 1987, enter

010987. "MMDDYY" is printed in this box to indicate the format. You may make your entry for the date over this print.

For an abandonment, enter the date you knew or had reason to know that the property was abandoned unless you expect to commence a foreclosure, execution, or similar action within 3 months, as explained earlier. If a third party purchases the property at a foreclosure, execution, or similar sale, the property is treated as abandoned, and you have reason to know of its abandonment on the date of sale.

Box 2.—The amount of the debt outstanding at the time the interest in the property was acquired or on the date you first knew or had reason to know that the property was abandoned. Include only unpaid principal on the original debt.

Box 3.—The amount of the debt no longer owed as a result of the acquisition or abandonment.

Box 4.—If the borrower is personally liable for the debt, the fair market value of the property at the time of acquisition or abandonment. In the case of a foreclosure, execution, or similar sale, the proceeds of sale will be considered the fair market value of the property in the absence of clear and convincing evidence to the contrary.

Box 5.—Whether the borrower is personally liable for repayment of the debt. Check the applicable box.

Box 6.—A general description of the property. For real property, generally you must enter the address of the property, or, if the address does not sufficiently identify the property, enter the section, lot, and block. For personal property, enter the applicable type, make, and model. For example, describe a car as "Car—1987 Buick Regal." Use a category such as "Office Equipment" to describe more than one piece of personal property, such as six desks and seven typewriters. Enter "CCC" for crops forfeited on Commodity Credit Corporation loans.

Form 1099-B

Any person, including a governmental unit and any agency or instrumentality thereof, doing business as a broker or barter exchange must file Form 1099-B, Statement for Recipients of Proceeds From Real Estate, Broker, and Barter Exchange Transactions, for each person (a) for whom the broker has sold (including short sales) stocks, bonds, commodities, regulated futures contracts, foreign currency contracts, forward contracts, debt instruments, real estate, etc., or (b) who exchanged property or services through the barter exchange.

Brokers (other than real estate brokers)

The term broker means a person that, in the ordinary course of a trade or business, stands ready to effect sales to be made by others. A corporation is a broker if it regularly stands ready to redeem its stock or retire its debt. However, if there are no facts that indicate otherwise, a corporation that purchases odd-lot shares from its stockholders is not a broker. For a sale of securities through a "cash on delivery" or similar account, only the broker that receives the gross proceeds from the sale against delivery of the securities sold is

required to report the sale. However, if such broker's customer is a "second-party broker" that is an exempt recipient, only the second-party broker is required to report the sale.

If the proceeds of a sale are paid in convertible foreign currency, the amount to be reported must be converted into U.S. dollars. You may use the exchange rate on the sales date or the exchange rate on the last business day of the reporting period in which the sale occurs.

Brokers must report each transaction (other than regulated futures or foreign currency contracts) on a separate Form 1099-B. Transactions involving regulated futures or foreign currency contracts are to be reported on an aggregate basis.

No return is required by brokers for:

- (1) Sales by exempt recipients. (Common examples include corporations, charitable organizations, individual retirement plans, the United States, a state and political subdivisions.)
- (2) Sales initiated by dealers in securities and financial institutions.
- (3) Sales by certain custodians and trustees.
- (4) Sales at issue price of interests in certain regulated investment companies.
- (5) Obligor payments on:
 - (a) Nontransferable obligations, such as savings bonds.
 - (b) Obligations for which gross proceeds are reported on other Forms 1099, such as stripped coupons issued prior to July 1, 1982.
 - (c) Retirement of short-term obligations with original issue discount (reported on Form 1099-INT). However, Form 1099-B is required for the retirement of short-term state obligations having no original issue discount.
 - (d) Callable demand obligations that have no premium or discount.
- (6) Sales of foreign currency unless under a forward or regulated futures contract that requires delivery of foreign currency.
- (7) Sales of fractional shares of stock if gross proceeds are less than \$20.
- (8) Retirements of book-entry or registered form obligations if no interim transfers have occurred.
- (9) Exempt foreign persons.

Barter exchanges

The term barter exchange means any person with members or clients who contract either with each other or with such person to trade or barter property or services either directly or through such person. The term does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis. Persons who are not a barter exchange but who trade services do not file Form 1099-B. However, they may be required to file Form 1099-MISC.

Barter exchanges must report each transaction involving noncorporate members or clients of a barter exchange on a separate Form 1099-B. Transactions

involving corporate members or clients of a barter exchange may be reported on an aggregate basis.

No return is required by barter exchanges for:

- (1) Exchanges through a barter exchange with less than 100 transactions during the calendar year.
- (2) Exempt foreign persons.

Real estate broker reporting

At the time of publication of this document, instructions for real estate broker reporting were not available. Those instructions will be issued later.

Report in:

Box 1a.—For broker transactions, the date of the sale or exchange. Enter the trade date or the settlement date. If you use the settlement date, enter an "S" before the date. For barter exchanges, enter the date that cash, property, a credit, or scrip is actually or constructively received. Please use the following format to indicate the date: MMDDYY. For example, for January 9, 1987, enter 010987. For aggregate reporting, no entry is required.

Box 2a.—The gross proceeds from any disposition of securities (including short sales), commodities, or forward contracts. To determine gross proceeds, you may take into account commissions and option premiums if this treatment is consistent with your books. Check the applicable box to indicate which amount has been reported to IRS. Do not include amounts shown in Boxes 6 through 9. Any accrued interest on bonds sold between payment dates should not be included in this box. Instead, report this accrued interest on Form 1099-INT. A loss from a closing transaction on a forward contract must be shown as a negative amount by enclosing it in parentheses.

Box 2b.—For transactional reporting by brokers, the CUSIP (Committee on Uniform Security Identification Procedures) number of the obligation.

Box 3.—Gross amounts received by a member or client of a barter exchange for goods or services. This includes cash received, property or services received, a credit on your books, or scrip issued. Do not report negative amounts.

Box 4.—Amounts for backup withholding. For example, persons who have not furnished their taxpayer identification number to you in the manner required are subject to withholding at a 20% rate on certain amounts required to be reported on this form. Real estate transactions are not subject to backup withholding.

Box 5.—For broker transactions, a brief description of the disposition item, e.g., 100 shares of XYZ Corp. stock. If necessary, abbreviate the description so that it fits within Box 5. For regulated futures contracts and forward contracts, enter "RFC" or other appropriate description and any amount subject to backup withholding, under A-23 of section 35a.9999-3 of the Temporary Employment Tax Regulations. Note: The amount withheld in these situations is to be included in Box 4.

For bartering transactions, show the services or property provided.

Box 6.—The profit or (loss) realized by the customer on closed regulated futures or foreign currency contracts in 1987. For

more information on reporting foreign currency contracts, see A-26 of section 35a.9999-3 of the Temporary Employment Tax Regulations.

Box 7.—The unrealized profit or (loss) on open regulated futures or foreign currency contracts at the end of 1986.

Box 8.—The unrealized profit or (loss) on open regulated futures or foreign currency contracts as of December 31, 1987.

Box 9.—The aggregate profit or (loss) for the year from regulated futures or foreign currency contracts. Use Boxes 6, 7, and 8 to figure the aggregate profit or (loss).

Form 1099-DIV

File Form 1099-DIV, Statement for Recipients of Dividends and Distributions, for each person (a) to whom you have paid gross dividends and other distributions on stock (Box 1) of \$10 or more, (b) for whom you have withheld and paid any foreign tax on dividends and other distributions on stock if the recipient can claim credit for the tax on his or her income tax return, (c) for whom you have withheld any Federal income tax under the backup withholding rules, or (d) to whom you paid \$600 or more as part of a liquidation.

Also, report on Form 1099-DIV dividends distributed under section 404(k) on stock held by an employee stock ownership plan (ESOP) or a tax credit ESOP. However, if a section 404(k) distribution is made in the same year as a total qualified distribution, the entire amount should be reported as an amount includible in income on Form 1099-R.

Give a copy of the official form, or a substitute form containing substantially similar language, to each recipient. See regulations under section 6042 for a definition of dividends.

Note: Certain distributions commonly referred to as "dividends" are actually interest and are to be reported on Form 1099-INT. These include so-called "dividends" on deposit or on share accounts in cooperative banks, credit unions, domestic building and loan associations, domestic and Federal savings and loan associations, and mutual savings banks.

An exempt-interest dividend from a regulated investment company retains its tax-exempt status and is not reported on Form 1099-DIV or 1099-INT.

For information about reporting dividends on restricted stock, see Rev. Procs. 80-11, 1980-1 C.B. 616, and 83-38, 1983-1 C.B. 773, and Rev. Rul. 83-22, 1983-1 C.B. 17.

Report in:

Box 1.—Gross dividends, including those from money market funds, and other distributions on stock. Also include amounts shown in Boxes 2, 3, and 5. Do not include in Box 1 amounts reported in Boxes 8 and 9.

Box 2.—The stockholder's pro rata share of certain amounts deductible by a regulated investment company in computing its taxable income. This amount is taxable to the stockholder under section 67(c) and must also be included in Box 1.

Box 3.—Capital gain distributions. Also include this amount in Box 1.

Box 4.—Amounts for backup withholding. For example, persons who have not furnished their taxpayer identification

number to you in the manner required are subject to withholding at a 20% rate on certain dividend payments reported on this form.

Box 5.—Nontaxable distributions, if determinable. Also include this amount in Box 1. (File Form 5452 if you pay nontaxable dividends to shareholders.)

Box 6.—Foreign tax withheld and paid on dividends and other distributions on stock. Report this amount in U.S. dollars.

Box 7.—The name of the foreign country or U.S. possession to which the withheld tax applies.

Note: Boxes 8 and 9 apply only to corporations in partial or complete liquidation.

Box 8.—Cash distributed as part of a liquidation. Do not include this amount in Box 1.

Box 9.—Noncash distributions made as part of a liquidation. Show the fair market value as of the date of distribution. Do not include this amount in Box 1.

S Corporations.—

Box 1.—Report as dividends on Form 1099-DIV only distributions made during 1987 out of accumulated earnings and profits. (See section 1368 for more information.)

Form 1099-G

File Form 1099-G, Statement for Recipients of Certain Government Payments, if you have made payments as a unit of a Federal, state, or local government. Furnish a copy of Form 1099-G or a statement to each recipient, except as explained below under Box 2.

Report in:

Box 1.—Payments of \$10 or more in unemployment compensation including Railroad Retirement Board payments for unemployment.

Box 2.—Refunds, credits, or offsets of state or local income tax of \$10 or more you made to recipients. If recipients deducted the tax paid to a state or local government on their Federal income tax returns, any refunds, credits, etc., may be taxable to them. If you can determine that the recipient did not claim itemized deductions on the recipient's Federal income tax return for the tax year giving rise to the refund, credit, or offset, you are not required to furnish a copy of Form 1099-G or a statement to the recipient. However, you must file Form 1099-G with IRS in all cases.

A tax on dividends, a tax on net gains from the sale or exchange of a capital asset, and a tax on the net taxable income of an unincorporated business are taxes on gain or profit rather than on gross receipts. Therefore, they are income taxes, and any refund, credit, or offset of \$10 or more of these taxes is reportable on Form 1099-G. In the case of the dividends tax and the capital gains tax, if you determine that the recipient did not itemize deductions, as explained above, you are not required to furnish a statement to the recipient. However, in the case of the tax on unincorporated businesses, you must furnish a statement to the recipient in all cases, as this is a tax that applies exclusively to income from a trade or business. See the instructions for Box 8 and Rev. Rul. 86-140, 1986-48 I.R.B. 7.

Box 3.—No entry is required in Box 3 if the refund, credit, etc., is for the 1986 tax year. If it is for any other tax year, enter the year for which the refund, credit, etc., was made in this box. Also, if the refunds, credits, etc., are for more than one tax year, report the amount for each year on a separate Form 1099-G. "YYYY" is preprinted to show the format for making an entry in this box. For example, enter 1985, not '85. If you wish, you may make your entry over "YYYY."

Box 4.—Amounts for backup withholding. For example, persons who have not furnished their taxpayer identification number to you become subject to withholding at a 20% rate on payments required to be reported in Boxes 6 or 7 on this form.

Box 5.—Any amount in excess of \$600 that was owed to the Federal Government and that has been declared uncollectible as a result of a defaulted obligation, not in dispute, and either:

- (1) A Federal statute expiration for collection of the debt has occurred, or
- (2) A formal compromise agreement has been entered into.

If an amount less than the amount owed is accepted as payment in full, enter the difference between the amount of the debt and the settlement amount in Box 5. The discharge or forgiveness of indebtedness is taxable income to the person originally liable for that amount.

Do not include any obligation discharged in a Title 11 bankruptcy case, for a debtor known to be insolvent, or for a qualified business indebtedness.

Box 6.—Any amount of a taxable grant administered by a Federal, state, or local program to provide subsidized energy financing or grants for projects designed to conserve or produce energy, but only with respect to section 38 property or a dwelling unit located in the U.S. Also report amounts of other taxable grants of \$600 or more. A Federal grant is ordinarily taxable unless stated otherwise in the legislation authorizing the grant.

Box 7.—U.S.D.A. agricultural subsidy payments made to recipients during the year. Since the Department of Agriculture reports these payments on magnetic media, this box will ordinarily be used by persons receiving subsidy payments as nominees for another person. Nominees must file Form 1099-G to report the actual owner of the payments.

Box 8.—If the amount in Box 2 is a refund, credit, or offset attributable to an income tax that applies exclusively to income from a trade or business and is not a tax of a general application, please enter an "X" in this box.

Form 1099-INT

File Form 1099-INT, Statement for Recipients of Interest Income, for each person (1) to whom you paid amounts reportable in Boxes 1 and 3 of at least \$10 (except for the \$600 limit described in the instructions below in Box 1), (2) for whom you withheld and paid foreign tax on interest if the recipient can claim credit for the tax on his or her income tax return, or (3) for each person from whom you withheld any Federal income tax under the backup withholding rules regardless of the amount of the payment.

Give a copy of the official form, or a substitute form containing substantially similar language, to each recipient. If you have furnished Forms 1099-INT to a recipient for amounts received during the year on a transactional basis, for example, window transactions, do not include these same amounts in a Form 1099-INT furnished to the same recipient for other payments during the year.

Only report interest payments made in the course of your trade or business (including Federal, state, and local government agencies and activities deemed nonprofit), or for which you were a nominee/middleman, or from which you withheld Federal income tax or foreign tax.

Note: Do not report tax-exempt or tax-deferred interest, such as interest on municipal bonds or interest that is earned but not distributed from an individual retirement arrangement (IRA).

An exempt-interest dividend from a regulated investment company retains its tax-exempt status and is not reported on Form 1099-DIV or 1099-INT.

IRS intends to issue regulations in 1987 explaining the reporting requirements for real estate mortgage investment conduits (REMICs).

Report in:

Payer's RTN (optional).—If you are a financial institution that wishes to participate in the program for direct deposit of refunds of electronic filers, you may enter your routing and transit number (RTN).

Box 1.—Amounts, whether or not designated as interest, that are paid or credited to any person's account by savings and loan associations, mutual savings banks not having capital stock represented by shares, building and loan associations, cooperative banks, homestead associations, credit unions, or similar organizations. Include interest on bank deposits, accumulated dividends paid by a life insurance company, indebtedness (including bonds, debentures, notes and certificates other than those of the U.S. Treasury) issued in registered form or of a type offered to the public, or from which you withheld Federal income tax or foreign tax. Also include interest paid in the course of your trade or business not meeting these criteria, such as interest on delayed death benefits paid by a life insurance company, if the interest totals \$600 or more for any person.

Also show original issue discount on short-term obligations of one year or less and interest on all bearer certificates of deposit.

Do not include in Box 1 interest on tax-free covenant bonds, which is reportable on Form 1042S, or dividends from money market funds, which are reportable on Form 1099-DIV. Also, do not include any description in Box 1. If you wish to show a description, use the blank box above Box 1.

Box 2.—Amounts of interest or principal forfeited because of an early withdrawal of time deposits, such as an early withdrawal from a CD, that are deductible from gross income by the recipient. Do not reduce the amount reported in Box 1 by the amount of the forfeiture. For detailed instructions for determining the amount of forfeiture deductible by the depositor, see Rev. Ruls.

75-20, 1975-1 C.B. 29, and 75-21, 1975-1 C.B. 367.

Box 3.—Interest on U.S. Savings Bonds, Treasury bills, Treasury notes, and Treasury bonds. Do not include this amount in Box 1.

If you make payment on a U.S. Savings Bond or other U.S. obligation on which interest is reportable, enter your name, address, and Federal identification number on Forms 1099-INT and 1096, not those of the U.S. Treasury Department or the Bureau of Public Debt.

Box 4.—Amounts for backup withholding. For example, persons who have not furnished their taxpayer identification number to you in the manner required become subject to withholding at a 20% rate on payments required to be reported in Box 1 (which may be reduced by the amount reported in Box 2) and Box 3 on this form.

Box 5.—Foreign tax withheld and paid on interest. Report this amount in U.S. dollars.

Box 6.—The name of the foreign country or U.S. possession to which the withheld tax applies.

Form 1099-MISC

File Form 1099-MISC, Statement for Recipients of Miscellaneous Income, for each person, other than corporations (Boxes 6 and 8 must be reported to corporations), to whom you have paid at least \$600 (unless a different amount is indicated below) in rents, royalties, payments for services, including payment for parts or materials, and other payments reportable on the form, or from whom you have withheld any Federal income tax under the backup withholding rules regardless of the amount of the payment. Report only payments made in the course of your trade or business (including Federal, state, or local government agencies and activities deemed nonprofit), or for which you were a nominee/middleman, or from which you withheld Federal income tax. If you are a broker, you must also report payments received as described in Box 8.

For information about the requirement of furnishing a statement to each recipient, see part H under *General Instructions*.

DO NOT use this form to report PS 58 costs or an employee's travel or auto allowance. Report PS 58 costs on either a Form W-2P or a separate Form 1099-R. Report an employee's travel or auto allowance on Form W-2.

Report in:

Box 1.—Amounts paid to recipients for all types of rents, such as real estate rentals paid for office space, machine rentals (for example, hiring a bulldozer to level your parking lot), and pasture rentals (for example, farmers paying for the use of grazing land). If the machine rental is a part of a contract that includes both the use of the machine and the operator, the rental should be prorated between the rent of the machine (reported in Box 1) and the operator's charge (reported as nonemployee compensation in Box 7).

Box 2.—Gross royalty payments of \$10 or more before reduction for severance and other taxes that may have been withheld and paid. Include in this box royalties paid

by a publisher directly to an author or literary agent or paid by a literary agent to an author. Do not include surface royalties. They should be reported in Box 1. Do not report oil or gas payments for a working interest in Box 2; report working interests in Box 7.

Box 3.—Prizes and awards that are not for services rendered. Prizes or awards for services rendered by employees should be reported on Form W-2. Prizes and awards for services rendered by nonemployees, such as an award for the top commission salesperson, are reported in Box 7. Include the fair market value of merchandise won on game shows.

Prizes and awards received in recognition of past accomplishments in religious, charitable, scientific, artistic, educational, literary, or civic fields are not reportable if (1) the winners are chosen without action on their part, (2) the winners are not expected to perform future services, AND (3) the payer transfers the prize or award to a charitable organization or governmental unit.

Box 4.—Amounts for backup withholding. For example, persons who have not furnished their taxpayer identification number to you become subject to withholding at a 20% rate on payments required to be reported in Boxes 1, 2 (net of severance taxes), 3, 5 (to the extent paid in cash), 6, 7, and 8 on this form.

Box 5.—The share of all proceeds from the sale of a catch or the fair market value of a distribution in kind to each crew member of fishing boats with normally fewer than 10 crew members.

Box 6.—Payments by medical and health care insurers to each physician or other supplier or provider of services under health, accident, and sickness insurance programs. In the case of a corporation, list the corporation as the recipient rather than the individual providing the services. (See Rev. Ruls. 69-595, 1969-2 C.B. 242, and 70-608, 1970-2 C.B. 286.)

The exemption for issuing Form 1099-MISC to a corporation does not apply to payments for medical or health care services provided by corporations, including professional corporations.

Box 7.—Nonemployee compensation. Include fees, commissions, prizes and awards for services rendered, or other forms of compensation for services rendered for your trade or business by an individual who is not your employee. Also include expenses incurred for the use of an entertainment facility that you treat as compensation to a nonemployee. Do not report in Box 7, nor elsewhere on Form 1099-MISC, PS 58 costs or an employee's travel or auto allowance.

Examples of payments to be reported in Box 7 are:

- (1) Attorneys' and accountants' fees for professional services.
- (2) Fees paid by one professional to another, such as fee-splitting or referral fees.
- (3) Payments by attorneys to witnesses or experts in legal adjudication.
- (4) Payment for services, including payment for parts or materials used to render the services, unless the person rendering services is in the business of selling parts and materials. For

example, report the total insurance company payments to an auto repair shop under a repair contract indicating an amount for labor and another amount for parts, as long as the repair shop does not hold itself out as a parts dealer.

- (5) Commissions paid to nonemployee salespersons, subject to repayment but not repaid during the calendar year.
- (6) A fee paid to a nonemployee and travel reimbursement for which the nonemployee did not account to the payer if the fee and reimbursement aggregate at least \$600.
- (7) Payments to nonemployee entertainers for services.
- (8) Exchanges of services between individuals in the course of their trades or businesses. For example, an attorney represents a painter for nonpayment of business debts in exchange for the painting of the attorney's law offices. The amount reportable by each on Form 1099-MISC is the fair market value of his or her own services rendered. However, if the attorney represents the painter in a divorce proceeding, the attorney must report on Form 1099-MISC the value of his or her services, but the painter need not report. The payment by the painter is not made in the course of the painter's trade or business, even though the painting services are of the type normally performed in the course of the painter's trade or business.
- (9) Crop insurance proceeds paid to farmers by insurance companies, unless the farmer has informed the insurance company that expenses have been capitalized under section 278, 263A, or 447. (Also enter an "X" in Box 10.)
- (10) Taxable fringe benefits for nonemployees. For information on valuation of fringe benefits, see Publication 535, *Business Expenses*.
- (11) Oil or gas payments for a working interest.

Note: In order to qualify for relief under section 530 of the Revenue Act of 1978 as extended by Pub. L. 97-248, relating to the employment tax status of independent contractors and employees, employers may file Form 1099-MISC. Additional requirements for relief are discussed in Rev. Proc. 85-18, 1985-1 C.B. 518. Also see Notice 87-19, 1987-6 I.R.B. 17, for special rules that may apply to certain skilled workers, such as engineers, designers, drafters, computer programmers, and systems analysts.

Golden Parachute Payments.—In Box 7 report any excess golden parachute payments paid to a nonemployee. Enter the letters "EPP" next to this amount. Also enter the total compensation, including any golden parachute payments. Your entry should be in the following format:

300000EPP
40000

Box 8.—Aggregate payments of at least \$10 received by a broker on behalf of a customer in lieu of dividends or tax-exempt interest as a result of the transfer of a customer's securities for use in a short sale.

Form 1099-MISC must be filed with IRS and furnished to the customer on whose behalf you received the payment. However, for substitute payments in lieu of dividends, do not file Form 1099-MISC nor furnish it to your customer if your customer is an individual, unless you have reason to know on the record date of the dividend payment that such substitute dividend payment is in lieu of: (1) an exempt-interest dividend, (2) a capital gain dividend, (3) a return of capital, or (4) a dividend subject to a foreign tax credit. Form 1099-MISC is required to be filed for and furnished to an individual on whose behalf you received a payment in lieu of tax-exempt interest. If you are not required to make a report on Form 1099-MISC for substitute dividends of at least \$10, you must report the substitute dividends on Form 1099-DIV.

Substitute payment means a payment in lieu of: (1) tax-exempt interest to the extent that interest (including OID) has accrued while the short sale was open, and (2) a dividend, if the ex-dividend date is after the transfer of stock for use in a short sale and before the closing of the short sale.

Box 9.—Sales by you of \$5,000 or more of consumer products to a person on a buy-sell, deposit-commission, or other commission basis for resale (by the buyer or any other person) anywhere other than in a permanent retail establishment. Enter an "X" in the checkbox in Box 9. No dollar amount is needed.

If you are reporting an amount in Box 7, you may also check Box 9 on the same Form 1099-MISC.

The report required to be given to the recipient for these direct sales need not be made on the official form. It may be in the form of a letter showing this information along with commissions, prizes, awards, etc.

Box 10.—If the amount in Box 7 is crop insurance proceeds, please enter an "X" in this box.

Form 1099-OID

File Form 1099-OID, Statement for Recipients of Original Issue Discount, if the original issue discount (OID) includible in gross income is at least \$10 and you are any of the following: (1) an issuer with any bond outstanding or other evidence of indebtedness in registered or bearer form issued with OID; (2) an issuer of certificates of deposit made, purchased, or renewed after 1970 if the term of the obligation or deposit is more than one year; (3) a financial institution having other deposit arrangements, such as time deposits or bonus-savings plans having a term in excess of one year provided the payment of interest is deferred until maturity; or (4) a broker or other middleman holding an OID obligation, including certificates of deposit (CDs), as nominee for the actual owner.

Issuers that do not use actual dates of ownership by holders in computing the discount are permitted to prepare a Form 1099-OID only for each person who is a holder of record of the obligations on the semiannual record date, if any, used by the corporation or its agent for the payment of stated interest or, if there is no such date, on June 30 and December 31. On each Form 1099-OID, you should treat each holder as holding the obligation on every

day it was outstanding during the calendar year. However, for time deposits and face-amount certificates use the actual date of deposit to compute OID.

If you are a broker or middleman who holds a bank CD as nominee, whether or not you sold the CD to the owner, you must determine the amount of OID includible in the income of the owner, if any, and report it on Form 1099-OID. (IRS intends to amend regulations under section 6049 to provide that a broker or middleman holding a debt instrument as a nominee may waive its status as an exempt recipient and request that the issuer of the debt instrument provide a written statement of the OID.)

Also, file Form 1099-OID in any case in which you are required to deduct and withhold taxes even if the amount of the OID is less than \$10. Original issue discount on obligations with a term of one year or less should be reported on Form 1099-INT.

Give a copy of the official form, or a substitute form containing substantially similar language, to each recipient.

Original issue discount means the difference between the stated redemption price at maturity and the issue price of a debt instrument. In the case of a stripped bond or coupon, OID is the difference between the stated redemption price at maturity and the acquisition price. A discount of less than one-fourth of 1% of the stated redemption price at maturity, multiplied by the number of full years from the date of issue to maturity, is considered to be zero.

Ordinarily, you will file only one Form 1099-OID for the depositor or holder of a particular obligation for the calendar year. If a person holds more than one discount obligation, issue separate Forms 1099-OID for each obligation. However, if a person holds more than one certificate of the same issue for the same period of time during the calendar year, and if Form 1099-OID amounts are proportional, you may treat all such certificates as one discount obligation and file a single Form 1099-OID.

For time deposits and face-amount certificates, use the actual date of deposit and compute OID on a straight line, monthly prorated basis for obligations issued before July 2, 1982, and on a daily economic accrual basis for obligations issued after July 1, 1982.

Publication 1212, List of Original Issue Discount Instruments, contains information on certain outstanding publicly traded discount obligations.

Issuers of certain publicly offered debt instruments having OID must file Form 8281, Information Return for Publicly Offered Original Issue Discount Instruments, within 30 days of the date of issuance. The information provided on that form will enable IRS to update Publication 1212. See Form 8281 for details.

IRS intends to issue regulations in 1987 explaining the reporting requirements for real estate mortgage investment conduits (REMICs).

Report in:

Box 1.—The total OID for the calendar year that is reportable on the obligation.

Box 2.—Any interest other than OID paid or credited on this obligation during the year.

Some OID instruments pay regular interest, in addition to the OID, at certain intervals during the life of the instrument. However, if OID is the only interest on this obligation, leave this box blank. Interest reported here must not be reported on Form 1099-INT.

Box 3.—Amounts of interest or principal forfeited because of an early withdrawal, such as an early withdrawal from a CD, that are deductible from gross income by the recipient. Do not reduce the amounts in Boxes 1 and 2 by the amount of the forfeiture. For detailed instructions for determining the amount of forfeiture deductible by the holder, see Rev. Ruls. 75-20, 1975-1 C.B. 29, and 75-21, 1975-1 C.B. 367.

Box 4.—Amounts for backup withholding. For example, persons who have not furnished their taxpayer identification number to you in the manner required become subject to withholding at a 20% rate on amounts required to be reported in Boxes 1 and 2 (which may be reduced by the amount reported in Box 3) limited to the cash paid on these obligations.

Box 5.—The CUSIP number, if any; if there is no CUSIP number, the abbreviation for the stock exchange, the abbreviation for the issuer used by the stock exchange, the coupon rate, and the year of maturity (e.g., NYSE XZY 12½ 87). If the issuer of the obligation is other than the payer, show the name of the issuer.

Form 1099-PATR

File Form 1099-PATR, Statement for Recipients (Patrons) of Taxable Distributions Received From Cooperatives, for each person to whom the cooperative has paid at least \$10 in patronage dividends and other distributions described in section 6044(b), or from whom you withheld any Federal income tax under the backup withholding rules regardless of the amount of the payment. A cooperative determined to be primarily engaged in the retail sale of goods or services that are generally for personal, living, or family use of the members may ask for and receive exemption from certain IRS reporting requirements. See Form 3491, Consumer Cooperative Exemption Application, for information about how to apply for this exemption.

Give a copy of the official Form 1099-PATR, or a substitute form containing substantially similar language, to each recipient.

Report dividends paid on cooperatives' capital stock on Form 1099-DIV.

Report in:

Box 1.—The total patronage dividends paid in cash (qualified or "consent" checks), qualified written notices of allocation (face amount), and other property.

Box 2.—The total nonpatronage distributions paid in cash (qualified or "consent" checks), qualified written notices of allocation (face amount), and other property. This box is applicable only to farmers' cooperatives exempt from tax under section 521.

Box 3.—The total per-unit retain allocations paid in cash, qualified per-unit retain certificates (face amount), and other property.

Box 4.—Amounts for backup withholding. For example, persons who have not furnished their taxpayer identification number to you in the manner required become subject to withholding at a 20% rate on payments required to be reported in Boxes 1, 2, 3, and 5 to the extent such payments are in cash or qualified check. See A-10 of section 35a.9999-3 of the Temporary Employment Tax Regulations for more information on backup withholding by cooperatives.

Box 5.—All redemptions of nonqualified written notices of allocation issued as patronage dividends, nonqualified written notices of allocation issued as nonpatronage allocations (applicable only to farmers' cooperatives qualifying under section 521), and nonqualified per-unit retain certificates, issued with respect to marketing.

Pass-Through Credits.—Report in the appropriate boxes the patron's share of unused credits that the cooperative is passing through to this patron:

Box 6.—Investment credit.

Box 7.—Energy investment credit.

Box 8.—Jobs credit.

Form 1099-R

File a Form 1099-R, Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc., for each person to whom you have made any designated distribution (as defined in section 3405(d)) that is a total distribution from profit-sharing or retirement plans, whether or not you withheld Federal income tax. This rule applies even if the designated distribution is less than \$600. Total distributions from an individual retirement arrangement (IRA) or simplified employee pension (SEP) must be reported in Box 8 regardless of the amount. But see the instructions for Boxes 8 and 9 for how to report the withdrawal of excess contributions.

DECs.—If you are reporting a total distribution from a plan that includes a distribution of deductible voluntary employee contributions (DECs), file two Forms 1099-R—one to report the distribution of DECs, the other to report the distribution from the other part of the plan. Report the distribution of DECs in Boxes 1 and 3 on the separate Form 1099-R.

For information about the requirement of furnishing a statement to each recipient, see part H under General Instructions.

The payer or plan administrator must file Form 1099-R using the same name and employer identification number used to deposit any tax withheld and to file a quarterly withholding tax return (Form 941 or 941E).

Do not report direct transfers between trustees (or issuers) that involve no payment or distribution of funds to the participant (including the direct transfer to an IRA for a spouse due to a divorce), except exchanges of insurance contracts (including a tax-free exchange under section 1035) under which any designated distribution may be made.

A total distribution is one in which the entire balance of the account is distributed. Payments that are not total distributions

Page 12

should be reported on Form W-2P, Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments.

Report on Form 1099-R total payments of matured or redeemed annuity, endowment, and life insurance contracts. For loans treated as distributions, see section 72(p). Do not report payments subject to social security (FICA) tax withholding on this form.

For payments to beneficiaries, prepare Form 1099-R using the name and taxpayer identification number of the beneficiary, not those of the decedent.

The plan administrator must, when making an eligible rollover distribution, provide a written explanation to the recipient of the rollover provisions of the law and, if applicable, of the capital gain and 5-year/10-year averaging provisions. See section 402(f). This notice must also include an explanation of the provisions of section 1124 of the Tax Reform Act of 1986, if applicable.

If you made a lump-sum distribution in 1987 before March 16, 1987, because the employee separated from service in 1986, the employee may elect to include such distribution in his or her 1986 income (see section 1124 of the Tax Reform Act of 1986). You must issue a 1987 Form 1099-R. To avoid unnecessary correspondence from IRS for 1987, an employee who makes the election should report the gross distribution shown on the 1987 Form 1099-R on the line on his or her 1987 Federal income tax return for total pensions and annuities received and zero on the line for the taxable amount. Please furnish this information to employees who receive such distributions at the same time you give them a 1987 Form 1099-R, or similar statement.

Report in:

Box 1.—The amount includible as income. Enter the total of amounts in Boxes 2 and 3. But do not include excludable or tax-deferred amounts reportable in Boxes 5, 6, or 9. Also, include premiums paid by a trustee or custodian for current life or other insurance protection (PS 58 costs) that were not reported on Form W-2P. However, do not report PS 58 costs and a total distribution on the same Form 1099-R. Use a separate Form 1099-R for each. Enter code 9 in Box 7 for PS 58 costs. See Regulations section 1.72-16(b), and Rev. Ruls. 55-747, 1955-2 C.B. 228, and 66-110, 1966-1 C.B. 12, for information on the cost of premiums paid by an employees'

trust under a qualified plan for current life insurance protection taxable to plan participants or their beneficiaries.

Do not include IRA or SEP distributions in this box. Report them in Box 8. But do include DEC distributions in this box.

Box 2.—Capital gain (for lump-sum distributions only). See example below.

Box 3.—Ordinary income. See example below.

To compute the months of an employee's active participation before 1974, count as 12 months any part of a calendar year in which an employee actively participated under the plan; for active participation after 1973, count as one month any part of a month in which the employee actively participated under the plan.

Active participation begins with the first month in which an employee became a participant under the plan and ends with the earliest of:

- The month in which the employee received a lump-sum distribution under the plan;
- In the case of an employee, other than a self-employed person or owner-employee, the month in which the employee separates from service;
- The month in which the employee dies; or
- For a self-employed person or owner-employee, the first month in which the employee becomes disabled (within the meaning of section 72(m)(7)).

For survivor-beneficiaries of deceased employees, the entries in Boxes 1, 2, and 3 should be without regard to the survivor's death benefit exclusion under section 101(b). However, enter the applicable code in Box 7 if the death benefit exclusion applies.

Box 4.—Federal income tax withheld. See Publication 493, Alternative Tax Withholding Methods and Tables, for the special tables for qualified total distributions. If a payee fails to furnish his or her correct taxpayer identification number (TIN) to you in the manner required, or if IRS notifies you before any distribution that the TIN furnished is incorrect, you must withhold at a rate of 10% for nonperiodic distributions that are not qualified total distributions. For qualified total distributions, see Publication 493. Backup withholding does not apply.

Box 5.—Employees' contributions to a profit-sharing or retirement plan, or insurance premiums. Enter the amount (a) actually contributed by the employee over

Example

Step I: Total Taxable Amounts

Total Distribution			XXXXXX
Less: 1. Current actuarial value of any annuity		XXXXX	
2. Employee contributions (minus any amounts previously distributed that were not includible in the employee's gross income)		XXXXXX	
3. Net unrealized appreciation in the value of any employer securities that were a part of the lump-sum distribution		XXXXXX	XXXXXX
Total Taxable Amount			XXXXXX

Step II: Capital Gain

$$\text{Total Taxable Amount (from Step I)} \times \frac{\text{Months of Active Participation Before 1974}}{\text{Total Months of Active Participation}} = \text{Capital Gain}$$

Step III: Ordinary Income

$$\text{Total Taxable Amount (from Step I)} \times \frac{\text{Months of Active Participation After 1973}}{\text{Total Months of Active Participation}} = \text{Ordinary Income}$$

the years under the retirement or profit-sharing plans, plus (b) any employer-contributed amounts considered to have been contributed by the employee under section 72(f), (c) the accumulated cost of premiums paid for life insurance protection, taxable to the employee in previous years and in the current year under Regulations section 1.72-16, and (d) premiums paid on commercial annuities. Do not include contributions to IRAs, SEPs, or DEC's in this box.

Box 6.—Net unrealized appreciation in employer's securities. See Regulations section 1.402(a)-1(b) for determination of the net unrealized appreciation. Use this box if a distribution includes securities of the employer corporation (or a subsidiary or parent corporation) and you can compute the net unrealized appreciation in the employer's securities.

Box 7.—The appropriate code(s) from the list below, that shows the type of distribution being made. When applicable, you may enter a numeric and an alpha code. No numerical code is needed for normal distributions you report in Box 1, but code A, B, or C might apply. IRS suggests that anyone using code P advise payees, at the time the distribution is made, that the earnings are taxable in the year in which the contribution was made. The codes are as follows: 1—Premature distribution (other than codes 2, 3, 4, 5, 8, or P); 2—Rollovers; 3—Disability; 4—Death (includes payments to a beneficiary); 5—Prohibited transactions; 6—Other; 7—Normal IRA or SEP distributions; 8—Excess contributions refunded plus earnings on such excess contributions; 9—PS 58 costs; P—Excess contributions refunded plus earnings on such excess contributions taxable in 1986; A—Qualifies for 5-year/10-year averaging; B—Qualifies for death benefit exclusion; C—Qualifies for both A and B.

Box 8.—The amount distributed from an IRA or SEP. The amount shown in this box is generally includible in the recipient's current income. In the case of a distribution by a trust representing CDs redeemed early, report the net amount distributed. Do not include any amounts paid for IRA insurance protection in the total for Box 8. Do not include DEC distributions in Box 8. For a distribution of excess contributions plus earnings, report only the earnings in Box 8. Report the gross distribution in Box 9. Otherwise, you are not required to report whether the IRA distribution is taxable or nontaxable.

Box 9.—Other. This space is for payers whose distribution includes items not covered by the above and who want to provide that information to employees or beneficiaries (for example, the current actuarial value of an annuity contract that is a part of a lump-sum distribution or the value of U.S. retirement bonds that you may distribute to employees or beneficiaries). Identify any amounts shown in this box by including any applicable code in Box 7.

To determine the value of an annuity contract (reportable in Box 9), show the value as an amount equal to the current actuarial value of the annuity contract, reduced by an amount equal to the excess of the employee's contributions over the cash and other property (not including the annuity contract) distributed.

If an annuity contract is part of a multiple recipient lump-sum distribution, enter in Box 9, along with the current actuarial value, the percentage of the total annuity contract each Form 1099-R represents.

For a section 1035 exchange, show the total value of the contract in Box 9; show the total premiums paid in Box 5; and enter code 2 in Box 7.

Report here any death benefit payments not made as part of a pension, profit-sharing, or retirement plan. Do not show amounts reportable in Box 1. Enter code 4 in Box 7.

For a distribution of excess contributions plus earnings, report the gross distribution (the excess contribution withdrawn plus earnings) in Box 9.

Nontaxable Distributions.—Report nontaxable distributions in Box 9 and show any applicable, code in Box 7 to identify them.

State Tax Information.—These boxes and additional copies are provided for your convenience only and need not be completed for IRS. If state income tax has been withheld on this total distribution, you may want to enter it in Box 10 and complete the "Payer's state number." The state number is the payer's identification number assigned by the individual state. You may designate the applicable state in either box. Copy 1 of the form may be used to provide information to the state, and Copy 2 may be used as the recipient's copy for use in filing a state income tax return.

Form 5498

File Form 5498, Individual Retirement Arrangement Information, with the IRS on or before May 31, 1988, for each person for whom you maintained an individual retirement arrangement (IRA) or simplified employee pension (SEP) during 1987. For a SEP, complete only Box 4 for the value of the account; do not report employer SEP contributions on Form 5498. For an IRA, complete all applicable boxes. If no IRA contributions were made for 1987, complete only Box 4.

For contributions made between January 1 and April 15, 1988, trustees and issuers should obtain the participant's designation of the year for which the contributions are made.

For reporting purposes, contributions and rollovers do not include direct transfers between trustees (or issuers) that involve no payment or distribution of funds to the participant.

Trustees or issuers of IRAs or SEPs must provide participants with a statement of the value of the participant's account by February 1, 1988, in any written format. Trustees or issuers of IRAs must provide participants with contribution information by May 31. You are not required to provide information to IRS or to participants as to whether a contribution is deductible or nondeductible.

Distributions from IRAs and SEPs will continue to be reported on Form 1099-R or W-2P. For a distribution of excess contributions plus earnings, report the distribution on Form W-2P or 1099-R, whichever is applicable, using the applicable code.

Report in:

Box 1.—Regular contributions to an IRA made in 1987 and through April 15, 1988, designated for 1987. Also include employee contributions to a SEP. Report gross contributions, including the amount allocable to the cost of life insurance (see Box 3) and including any excess contributions, even if the excess contributions were withdrawn.

Box 2.—Rollover contributions made to an IRA received by you during 1987.

Box 3.—For endowment contracts only, the amount included in Box 1 allocable to the cost of life insurance.

Box 4.—The fair market value of the IRA or SEP account on December 31, 1987.

Form W-2G

The requirements for filing Form W-2G, Statement for Recipients of Certain Gambling Winnings, depend on the type of gambling and are listed separately following these general instructions.

Withholding Requirements.—A payer of certain gambling winnings (other than winnings from keno, bingo, and slot machines) is required to withhold 20% from such winnings and report this amount on Form W-2G. This is referred to as regular gambling withholding. It applies to gambling winnings of more than (1) \$1,000 from a sweepstakes, wagering pool, or nonstate-conducted lottery, (2) \$5,000 from a state-conducted lottery, and (3) \$1,000 from other wagering transactions if the betting odds are 300 to 1 or higher. Regular gambling withholding applies to the amount of gross proceeds (the amount of winnings less the amount wagered) and not merely to the amounts in excess of \$1,000 or \$5,000. **Backup Withholding.**—If a recipient fails to furnish a payer of reportable gambling winnings with a correct taxpayer identification number (TIN), the payer is required to withhold 20% of the proceeds and report this amount on Form W-2G unless the winnings are already subject to regular withholding as explained above. This is referred to as backup withholding. Backup withholding applies to the amount of the winnings reduced, at the option of the payer, by the amount wagered and not merely to the amounts of such reportable payments in excess of \$600, \$1,200, or \$1,500. See the instructions for each type of gambling for detailed rules for backup withholding.

A recipient may use Form W-9, Payer's Request for Taxpayer Identification Number and Certification, to report his or her taxpayer identification number to the payer.

Payments of gambling winnings to a nonresident alien individual or a foreign corporation are not subject to reporting or withholding on Form W-2G or Form 5754, Statement by Person(s) Receiving Gambling Winnings, since such payments are subject to withholding under sections 1441(a) and 1442(a) and are reportable on Forms 1042 and 1042S.

State Tax Information.—If state income tax withholding is required on gambling winnings in your state, you may want to complete Boxes 13 and 14 on Form W-2G. Copy 1 of the form may be used to provide information to the state and Copy 2 may be

used as the winner's copy for use in filing a state income tax return. The state identification number is assigned by the individual state.

Instructions for Payers of Gambling Winnings From Horse Racing, Dog Racing, Jai Alai, and Other Wagering Transactions Not Discussed Later

File Form W-2G for every person to whom you pay \$600 or more in gambling winnings if such winnings are at least 300 times the amount of the single wager. You must withhold Federal income tax, at the rate of 20%, from the amount of winnings less the amount wagered if such winnings less the wager exceed \$1,000. In addition, if the recipient of reportable gambling winnings does not provide a TIN, you must impose backup withholding at the rate of 20% on any such winnings that are not subject to regular gambling withholding under the preceding sentence. That is, if the winnings are at least \$600 but not more than \$1,000, backup withholding applies to the amount of the winnings reduced, at the option of the payer, by the amount wagered. If more than one person shares in the winnings from a single wager, the aggregate amount of the winnings will determine the amount of the proceeds for purposes of reporting and backup withholding.

In the case of multiple wagers sold on one ticket, such as the \$12 box bet on a Big Triple or Trifecta, the wager will be considered to be six \$2 bets and not one \$12 bet for purposes of computing the amount to be reported or withheld. Winnings on a \$12 box bet must be reported if they are \$600 or more, and Federal income tax must be withheld if the proceeds amount to more than \$1,000 or, in the event the proceeds do not exceed \$1,000, if the recipient fails to provide a TIN.

Identical wagers (for example, two \$2 bets on a particular horse to win the same race) are aggregated for purposes of the reporting and withholding requirements. Also, identical wagers that are not part of the payment for which the W-2G is being prepared are aggregated for purposes of withholding to determine if the total amount of proceeds from identical wagers is more than \$1,000. If the person presenting the ticket for payment is the sole owner of the ticket, Form W-2G should be completed showing the name, address, and identification number of the winner. If Federal income tax is to be withheld, the winner then signs the W-2G, under penalties of perjury, stating that he or she is the sole owner and that the information listed on the form is correct. In this case, Form 5754 is not used.

Report in:

- Box 1.—Payments of \$600 or more if the payment is at least 300 times the amount of a single wager.
- Box 2.—The amount of Federal income tax withheld, whether regular withholding or backup withholding.
- Box 3.—The type of wager if other than a regular race bet, for example, Daily Double or Big Triple.

Page 14

Box 4.—The date of the winning event. This is not the date the money was paid if paid after the date of the race (or game).

Box 5.—Not applicable.

Box 6.—The race (or game) applicable to the winning ticket.

Box 7.—The amount of additional winnings from identical wagers.

Box 8 or 10.—The cashier and/or window number making the winning payment.

Boxes 11 and 12.—The identification numbers of the person receiving the winnings.

Box 13.—(optional) The abbreviated name of the state and your state identification number.

Box 14.—(optional) The amount of state income tax withheld.

Instructions for Payers of Gambling Winnings From State-Conducted Lotteries

File Form W-2G for every person to whom you pay winnings of \$600 or more from a state-conducted lottery if such winnings are at least 300 times the amount of the single wager. You must withhold Federal income tax, at the rate of 20%, from the amount of winnings less the price of the winning ticket if such winnings less the price of the winning ticket exceed \$5,000. In addition, if the recipient of the reportable lottery winnings does not provide a TIN, you must impose backup withholding at the rate of 20% on any such winnings that are not subject to regular gambling withholding under the terms of the preceding sentence. That is, if the amount of the lottery winnings is at least \$600 but not more than \$5,000, backup withholding applies to the amount of the winnings reduced, at the option of the payer, by the amount wagered.

Installment payments of \$5,000 or less are subject to regular 20% gambling withholding if the aggregate proceeds from such wager will exceed \$5,000.

If payments are to be made for the life of a person (or for the lives of more than one person), and it is actuarially determined that the aggregate proceeds from such wager are expected to exceed \$5,000, such payments are subject to regular 20% gambling withholding.

The price of the wager must be deducted from the total winnings to determine whether reporting or withholding is required. The deduction for the cost of the wager should be made at the time of the first payment.

Noncash payments, such as an automobile, are to be taken into account at their fair market value for purposes of reporting and withholding. If the fair market value exceeds \$5,000, after deducting the price of the wager, it is subject to regular gambling withholding. In such a case, the tax that must be withheld is computed as follows: (1) if payment of the withholding tax is made by the winner to the payer of winnings, 20% of the noncash payment less the amount of the wager is subject to withholding; (2) if the payer of winnings also pays the withholding tax, 25% of the noncash payment (less the wager) is subject to withholding. The sum of the noncash payment and withholding tax is still entered in Box 1. See Regulations section 31.3402(q)-1 for more information.

A payment of winnings is considered made when it is paid, either actually or constructively, to the winner. Winnings are constructively paid when they are credited to, or set apart for, that person without any substantial limitation or restriction on the time, manner, or condition of payment.

When a person other than a state lottery employee or agent makes the payments, as in the case of an insurance company handling the winnings as an annuity, that other person must deduct and withhold as originally required of the state lottery payer.

Report in:

Box 1.—Payments of \$600 or more.

Box 2.—The amount of Federal income tax withheld, whether backup withholding or regular gambling withholding.

Box 3.—The name of the lottery (Instant, Big 50, Baker's Dozen, etc.) and the price of the ticket (50¢, \$1, etc.).

Box 4.—The date of the drawing of the winning number. This may not be the date the winnings are paid.

Box 5.—The ticket number or other identifying number.

Boxes 6 through 8 and 10 through 12.—Not applicable to lottery winnings.

Box 13.—(optional) The abbreviated name of the state and your state identification number.

Box 14.—(optional) The amount of state income tax withheld.

Instructions for Payers of Gambling Winnings From Keno, Bingo, and Slot Machines

File Form W-2G for every person to whom you pay \$1,200 or more in gambling winnings from bingo or slot machines, or \$1,500 or more from keno, after the price of the wager is deducted. If the winnings are of a noncash nature, the fair market value of the item won is to be considered the amount of the winnings. Total all winnings from each bingo or keno game. Winnings and losses from other wagering transactions are not to be taken into account in arriving at the \$1,200 or \$1,500 figure. If the recipient of reportable gambling winnings from bingo, keno, or slot machines does not provide a TIN, you must impose backup withholding at the rate of 20% on any such winnings. Backup withholding applies to the amount of the winnings reduced, at the option of the payer, by the amount wagered. Regular gambling withholding does not apply to winnings from bingo, keno, or slot machines.

Report in:

Box 1.—Payments of \$1,200 or more from bingo or slot machines or payments of \$1,500 or more from keno.

Box 2.—The amount of any backup withholding.

Box 3.—The type of wager, such as bingo, keno, and slot machines, and the amount of the wager.

Box 4.—The date of the winning transaction.

Box 5.—The ticket number, card number (and color, if applicable), machine serial number, or any other information that will help identify the winning transaction.

Boxes 6 and 7.—Not applicable.

- Box 8.**—The initials of the person paying the winnings.
- Box 10.**—The location of the person paying the winnings, if applicable.
- Boxes 11 and 12.**—The identification numbers of the person receiving the winnings.
- Box 13.**—(optional) The abbreviated name of the state and your state identification number.
- Box 14.**—(optional) The amount of state income tax withheld.

Instructions for Sweepstakes, Wagering Pools, and Certain Lotteries

File Form W-2G for each person to whom you pay \$600 or more in gambling winnings from any wager placed in a sweepstakes, wagering pool, or lottery (other than state-conducted lotteries). You must withhold Federal income tax, at the rate of 20%, from the amount of winnings less the amount wagered if such winnings less the wager exceed \$1,000. If the recipient of such reportable gambling winnings does not provide a TIN, you must impose backup withholding at the rate of 20% on any such winnings that are not subject to regular gambling withholding under the terms of the preceding sentence. That is, if the winnings are at least \$600 but not more

than \$1,000, backup withholding applies to the amount of the winnings reduced, at the option of the payer, by the amount wagered. These requirements apply to church raffles, charity drawings, etc.

Report in:

- Box 1.**—All payments of \$600 or more.
- Box 2.**—The amount of Federal income tax withheld, whether regular gambling withholding or backup withholding.
- Box 3.**—The type of wager, such as a raffle or a 50-50 drawing.
- Box 4.**—The date of the winning transaction.
- Boxes 5 through 8 and 10.**—Not applicable.
- Boxes 11 and 12.**—The identification numbers of the person receiving the winnings.
- Box 13.**—(optional) The abbreviated name of the state and your state identification number.
- Box 14.**—(optional) The amount of state income tax withheld.

Form 5754

Form 5754, Statement by Person(s) Receiving Gambling Winnings, is used only in preparing Form W-2G when the person receiving the winnings is not the actual winner or is a member of a group of two or more winners on the same winning ticket.

The person receiving the winnings must furnish all the information required by Form 5754. However, a recipient of winnings from state-conducted lotteries need not provide identification other than his or her taxpayer identification number. Part I lists the identification of the person to whom the winnings are paid, and Part II lists the actual winners, their respective shares of the winnings, and any additional winnings from identical wagers. If the person receiving the winnings is also one of the winners, the first name listed in Part II should be the same as the name in Part I. In this case, the "Amount won" box and (if applicable) the "Winnings from identical wagers" box must be completed for that person, but the other boxes may be marked "Same as above."

In Part II, the person receiving the winnings must provide the name, address, identification number, respective share of the winnings, and additional winnings from identical wagers for each of the winners. In addition, if Federal income tax is to be withheld, the form must be signed, under penalties of perjury, and dated by the person receiving the winnings. The form must be returned to the payer for preparation of Form W-2G for each of the persons listed as winners. Forms W-2G may be issued immediately or by January 31 following the year of the payment. Do not file Form 5754 with IRS.

Guide to Information Returns

Form Number	Title	What To Report	Amounts To Report	Due Date	
				To IRS	To Recipient (unless indicated otherwise)
1042S	Foreign Person's U.S. Source Income Subject to Withholding	Payments subject to withholding under Chapter 3 of the Code, including interest, dividends, royalties, pensions and annuities, and compensation for personal services.	All amounts	March 15	March 15
1098	Mortgage Interest Statement	Mortgage interest you received in the course of your trade or business from individuals.	\$600 or more	February 28	(To Payer/Borrower) January 31
1099-A	Information Return for Acquisition or Abandonment of Secured Property	Information about the acquisition or abandonment of property that is security for a debt for which you are the lender.	All amounts	February 28	(To Borrower) January 31
1099-B	Statement for Recipients of Proceeds From Real Estate, Broker, and Barter Exchange Transactions	Sales or redemptions of securities, futures transactions, commodities, real estate transactions, and bartering exchange transactions.	All amounts	February 28	January 31
1099-DIV	Statement for Recipients of Dividends and Distributions	Distributions, such as dividends, capital gains, or nontaxable distributions, that were paid on stock, and distributions in liquidation.	\$10 or more, except \$600 or more for liquidations	February 28	January 31
1099-G	Statement for Recipients of Certain Government Payments	Unemployment compensation, state and local income tax refunds, agricultural payments, taxable grants, and discharge of indebtedness.	\$10 or more for unemployment and tax refunds; \$600 or more for all others	February 28	January 31
1099-INT	Statement for Recipients of Interest Income	Interest payments not including interest on an IRA.	\$10 or more (\$600 or more in some cases)	February 28	January 31
1099-MISC	Statement for Recipients of Miscellaneous Income (Also, use this form to report the occurrence of direct sales of \$5,000 or more of consumer goods for resale.)	Rent or royalty payments; prizes and awards that are not for services, such as winnings on TV or radio shows. Payments to crew members by owners or operators of fishing boats. Report payments of proceeds from sale of catch. Payments to a physician, physicians' corporation, or other supplier of health and medical services. Issued mainly by medical assistance programs or health and accident insurance plans.	\$600 or more, except \$10 or more for royalties All payments \$600 or more	February 28	January 31

Guide to Information Returns (Continued)

Form Number	Title	What To Report	Amounts To Report	Due Date	
				To IRS	To Recipient (unless indicated otherwise)
		Payments for services performed for a trade or business by people not treated as its employees. Examples: fees to subcontractors or directors, expenses incurred for use of an entertainment facility treated as compensation to a nonemployee, and golden parachute payments. Substitute dividend and interest payments reportable by brokers.	\$600 or more \$10 or more	February 28	January 31
1099-OID	Statement for Recipients of Original Issue Discount	Original issue discount.	\$10 or more	February 28	January 31
1099-PATR	Statement for Recipients (Patrons) of Taxable Distributions Received From Cooperatives	Distributions from cooperatives to their patrons.	\$10 or more	February 28	January 31
1099-R	Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.	Distributions from retirement or profit-sharing plans or from individual retirement arrangements (IRAs). Use Form 1099-R only if the distribution closed the payee's account.	All amounts	February 28	January 31
4789	Currency Transaction Report	Each deposit, withdrawal, exchange of currency, or other payment or transfer by, through, or to financial institutions (other than casinos) that involves a transaction in currency of more than \$10,000.	Over \$10,000	Within 15 days after the date of the transaction	Not required
5498	Individual Retirement Arrangement Information	Contributions (including rollover contributions) to an individual retirement arrangement (IRA), and the value of an IRA or simplified employee pension (SEP) account.	All amounts	May 31	(To Participant) January 31 (for value of account) May 31 (for contributions)
8027	Employer's Annual Information Return of Tip Income and Allocated Tips	Receipts from food or beverage operations, tips reported by employees, and allocated tips.	See separate instructions.	February 28	Allocated tips are shown on Form W-2, due January 31
8300	Report of Cash Payments Over \$10,000 Received in a Trade or Business	Payments in cash or foreign currency received in one transaction, or two or more related transactions, in the course of a trade or business. Does not apply to banks and financial institutions filing Form 4789, Currency Transaction Report, and casinos that are required to report such transactions on Form 8362, Currency Transaction Report by Casinos, or, generally, to transactions outside the United States.	Over \$10,000	Within 15 days after the date of the transaction	(To Payer) January 31
8308	Report of a Sale or Exchange of Certain Partnership Interests	Sales or exchanges of a partnership interest involving unrealized receivables or substantially appreciated inventory items.	(Transaction only)	(Attach to Form 1065)	(To Transferor and Transferees) January 31
8362	Currency Transaction Report by Casinos	Each deposit, withdrawal, exchange of currency or gambling tokens or chips, or other payment or transfer by, through, or to a casino (with gross annual gaming revenue in excess of \$1,000,000) that involves a transaction in cash.	Over \$10,000	Within 15 days after the date of the transaction	Not required
W-2G	Statement for Recipients of Certain Gambling Winnings	Gambling winnings from horse racing, dog racing, jai alai, lotteries, raffles, drawings, bingo, slot machines, and keno.	Generally, \$600 or more (\$1,200 or more from bingo or slot machines; \$1,500 or more from keno)	February 28	January 31
W-2	Wage and Tax Statement	Wages, tips, other compensation, withheld income and FICA taxes, and advance earned income credit (EIC) payments. Include bonuses, vacation allowances, severance pay, moving expense payments, some kinds of travel allowances and third-party payments of sick pay.	See separate instructions.	To SSA February 28	To Recipient January 31
W-2P	Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments	Retirement payments other than total distributions.	See separate instructions.	February 28	January 31

Form 1096. Annual Summary and Transmittal of U.S. Information.

DO NOT STAPLE

6969

CORRECTED

Form 1096 Department of the Treasury Internal Revenue Service	Annual Summary and Transmittal of U.S. Information Returns	OMB No 1545-0108 1987
[Type or machine print FILER'S name (or attach label) Street address City, state, and ZIP code		Paperwork Reduction Act Notice We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.
Enter in Box 1 or 2 below the identification number you used as the filer on the attached information returns. Do not fill in both Boxes 1 and 2.		For Official Use Only [] [] [] [] [] []
1 Employer identification number	2 Social security number	3 Total number of documents
4 Federal income tax withheld \$	5 Total amount reported with this Form 1096 \$	
Check only one box below to indicate the type of forms attached.		
W-2G 32 <input type="checkbox"/>	1098 81 <input type="checkbox"/>	1099-A 80 <input type="checkbox"/>
1099-B 79 <input type="checkbox"/>	1099-DIV 91 <input type="checkbox"/>	1099-G 86 <input type="checkbox"/>
1099-INT 92 <input type="checkbox"/>	1099-MISC 95 <input type="checkbox"/>	1099-OID 96 <input type="checkbox"/>
1099-PATR 97 <input type="checkbox"/>	1099-R 98 <input type="checkbox"/>	5498 28 <input type="checkbox"/>

Under penalties of perjury, I declare that I have examined this return and accompanying documents and, to the best of my knowledge and belief, they are true, correct, and complete. In the case of documents without recipients' identification numbers, I have complied with the requirements of the law in attempting to secure such numbers from the recipients.

Signature _____ Title _____ Date _____

Please return this entire page to the Internal Revenue Service. Photocopies are NOT acceptable.

Instructions

Changes You Should Note.—Form 1096 has been reformatted. Please take care in making entries in the proper boxes. A new Box 5, "Total amount reported with this Form 1096," has been added. No entry is required if you are filing Form 1099-A or 1099-G. For all other forms, enter in Box 5 of Form 1096 the total of the amounts from the specific boxes of the forms listed below:

- | | |
|----------------|-------------------------------|
| Form W-2G | Box 1 |
| Form 1098 | Box 1 |
| Form 1099-B | Boxes 1b, 2a, 3, and 6 |
| Form 1099-DIV | Boxes 1, 8, and 9 |
| Form 1099-INT | Boxes 1 and 3 |
| Form 1099-MISC | Boxes 1, 2, 3, 5, 6, 7, and 8 |
| Form 1099-OID | Boxes 1 and 2 |
| Form 1099-PATR | Boxes 1, 2, 3, and 5 |
| Form 1099-R | Boxes 1, 8, and 9 |
| Form 5498 | Boxes 1 and 2 |

Purpose of Form.—Use this form to transmit Forms W-2G, 1098, 1099, and 5498 to the Internal Revenue Service.

Completing Form 1096.—If you have received a preprinted label from IRS, place it in the name and address area of the form using the brackets as indicators. Make any necessary corrections to your name and address on the label. However, do not use the label if the taxpayer identification number shown is incorrect. If you are not using a preprinted label, enter the filer's name, address, and taxpayer identification number (TIN) in the spaces provided on the

form. A filer includes a payer, a recipient of mortgage interest payments, a broker, a barter exchange, a trustee or issuer of an individual retirement arrangement (including an IRA or SEP), and a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned. Individuals not in a trade or business should enter their social security number in Box 2; sole proprietors and all others should enter their employer identification number in Box 1. However, sole proprietors who are not required to have an employer identification number should enter their social security number in Box 2.

Group the forms by form number and submit each group with a separate Form 1096. For example, if you must file both Forms 1099-DIV and Forms 1099-INT, complete one Form 1096 to transmit your Forms 1099-DIV and another Form 1096 to transmit your Forms 1099-INT.

In Box 3, enter the number of forms you are transmitting with this Form 1096. Do not include blank or voided forms in your total. Enter the number of correctly completed forms, not the number of pages, being transmitted. For example, if you send one page of three-to-a-page Forms 5498 with a Form 1096 and you have correctly completed two Forms 5498 on that page, enter 2 in Box 3 of Form 1096. Check the appropriate box to indicate the type of form you are transmitting.

If you are filing a Form 1096 for corrected information returns, enter an "X" in the CORRECTED box at the top of this form.

For more information about filing, see the separate Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form 1096. Annual Summary and Transmittal of U.S. Information. (cont'd)

Form 1096 (1987)

Page 2

Where To File.—Send all information returns filed on magnetic media to: Magnetic Media Reporting, Internal Revenue Service, National Computer Center, P.O. Box 1359, Martinsburg, WV 25401-1359. Send all information returns filed on paper to the following:

If your principal business, office or agency, or legal residence in the case of an individual, is located in

Use the following Internal Revenue Service Center address

Alabama, Florida, Georgia, Mississippi, South Carolina	Atlanta, GA 31101
New Jersey, New York (New York City and counties of Nassau, Rockland, Suffolk, and Westchester)	Holtsville, NY 00501
New York (all other counties), Connecticut, Maine, Massachusetts, Minnesota, New Hampshire, Rhode Island, Vermont	Andover, MA 05501
Illinois, Iowa, Missouri, Wisconsin	Kansas City, MO 64999
Delaware, District of Columbia, Maryland, Pennsylvania	Philadelphia, PA 19255

Kentucky, Michigan, Ohio, West Virginia
Cincinnati, OH 45999

Kansas, Louisiana, New Mexico, Oklahoma, Texas
Austin, TX 73301

Alaska, Arizona, California (counties of Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Mendocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo, and Yuba), Colorado, Idaho, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming
Ogden, UT 84201

California (all other counties), Hawaii
Fresno, CA 93888

Arkansas, Indiana, North Carolina, Tennessee, Virginia
Memphis, TN 37501

If you have no legal residence or principal place of business in any Internal Revenue district, file with the Internal Revenue Service Center, Philadelphia, PA 19255.

RIA Caution: IRS will not accept a photocopy of copy A, see p. 732,008.

Form 1098. Mortgage Interest Statement.

Instructions for Payer/Borrower

A person (including a financial institution, a governmental unit, and a cooperative housing corporation) who is engaged in a trade or business, and, in the course of such trade or business, received from you at least \$600 of mortgage interest on any one mortgage in the calendar year must furnish this statement to you.

If you received this statement as the payer of record on a mortgage on which there are other borrowers entitled to a deduction for this interest, please furnish each of the other borrowers with information about the proper distribution of the amounts shown on this form. Each borrower is entitled to deduct only the amount he or she paid that represents his or her share of the amount allowable as a mortgage interest deduction.

If your mortgage payments were subsidized by a government agency, you may not be able to deduct the amount of the subsidy.

For information about interest deductions, see Publication 545, Interest Expense.

Box 1.—Shows the total interest received by the mortgage holder on your mortgage during the year. This amount does not include points and other prepaid interest, government subsidy payments, or seller payments on a "buy-down" mortgage. Such amounts are deductible by you only in certain circumstances. If you can claim the mortgage interest credit, see Form 8396, Mortgage Interest Credit. If the interest was paid on a loan secured by your personal residence, it may be subject to a deduction limitation, and you may be required to complete Form 8598 to compute your proper deduction on Form 1040. See your Form 1040 instructions.

Box 2.—This box is for use by the interest recipient to furnish other information to you, such as real estate taxes or insurance paid from escrow.

8181		<input type="checkbox"/> VOID	<input type="checkbox"/> CORRECTED	For Official Use Only	OMB No. 1545-0901 1987	Mortgage Interest Statement
RECIPIENT'S/LENDER'S name, street address, city, state, and ZIP code						
RECIPIENT'S Federal identification no.	PAYER'S social security number	1 Mortgage interest received from payer(s)/borrower(s)		Copy A For Internal Revenue Service Center For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.		
Type or machine print PAYER'S/BORROWER'S name (first, middle, last)		2				
Street address						
City, state, and ZIP code						
Account number (optional)						

Form 1098

Do NOT Cut or Separate Forms on This Page

Department of the Treasury - Internal Revenue Service

RIA Caution: IRS will not accept a photocopy of copy A, see p. 732.008 under "Paper Document Reporting". The official form, available at IRS District Offices, must be used.

Form 1098, Mortgage Interest Statement, (cont'd)

CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, street address, city, state, and ZIP code		OMB No. 1545-0901 1987	Mortgage Interest Statement
RECIPIENT'S Federal identification no.	PAYER'S social security number		
PAYER'S/BORROWER'S name (first, middle, last)		1 Mortgage interest received from payer(s)/borrower(s) \$	Copy B For Payer The amount in Box 1 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if the IRS determines that an underpayment of tax results because you failed to properly show this amount on your return.
Street address		2	
City, state, and ZIP code		* The amount shown may not be fully deductible by you on your Federal income tax return. Limitations based on the cost and value of the secured property may apply. In addition, you may only deduct an amount of mortgage interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person.	
Account number (optional)			

Form 1098

Department of the Treasury - Internal Revenue Service

VOID CORRECTED

RECIPIENT'S/LENDER'S name, street address, city, state, and ZIP code		OMB No. 1545-0901 1987	Mortgage Interest Statement
RECIPIENT'S Federal identification no.	PAYER'S social security number		
PAYER'S/BORROWER'S name (first, middle, last)		1 Mortgage interest received from payer(s)/borrower(s) \$	Copy C For Recipient For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
Street address		2	
City, state, and ZIP code			
Account number (optional)			

Form 1098

Department of the Treasury - Internal Revenue Service

Form 1099-A. Acquisition or Abandonment of Secured Property.

Instructions for Borrower

Certain lenders who acquire an interest in property that was security for a loan, or who have reason to know that such property has been abandoned, must provide you with this statement. You may have reportable income or loss because of such acquisition or abandonment. Gain or loss from an acquisition generally is measured by the difference between your adjusted basis in the property and the amount of your debt cancelled in exchange for the property, or, if greater, the sale proceeds. If you abandoned the property, you may have income from the discharge of indebtedness in the amount of the unpaid balance of your cancelled debt. You may also have a loss from abandonment up to the adjusted basis of the property at the time of abandonment. Losses on acquisitions or abandonments of property held for personal use are not deductible. See Publication 544, Sales and Other Dispositions of Assets, for information about foreclosures and abandonments.

Property means real property, such as a personal residence, intangible property, or tangible personal property held for investment or used in a trade or business.

If you borrowed money on this property with someone else, each of you should receive this statement.

Box 1.—For a lender's acquisition of property that is security for a loan, the date shown is generally the earlier of the date title is

transferred to the lender or the date possession and the burdens and benefits of ownership are transferred to the lender. This may be the date of a foreclosure or execution sale or the date your right of redemption expires. For an abandonment, the date shown is the date on which the lender first knew or had reason to know that the property was abandoned.

Box 2.—This is the amount of the debt owed to the lender on the loan at the time the interest in the property was acquired by the lender or on the date the lender first knew or had reason to know that the property was abandoned.

Box 3.—This is the amount of the loan you no longer owe as a result of the acquisition or abandonment.

Box 4.—If you were personally liable for repayment of the loan, this box shows the fair market value of the property when acquired by the lender or when abandoned by you. If the property was sold in a foreclosure or execution sale, this amount may be the proceeds of sale.

Box 5.—This box indicates whether you were personally liable for repayment of the loan.

Box 6.—The description identifies the property acquired by the lender or abandoned by you. If "CCC" is shown, the form indicates the amount of any Commodity Credit Corporation loan outstanding when you forfeited your commodity.

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VOID

CORRECTED

For Official Use Only

Type or machine print LENDER'S name, street address, city, state, and ZIP code		OMB No 1545-0877 1987 Information Return for		Copy A For Internal Revenue Service Center For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
LENDER'S Federal identification number	BORROWER'S identification number	1 Date of lender's acquisition or knowledge of abandonment MMDDYY	2 Amount of debt outstanding \$	
Type or machine print BORROWER'S name (first, middle, last)		3 Amount of debt satisfied \$	4 Fair market value of property at acquisition or abandonment \$	
Street address		5 Is borrower personally liable for repayment of the debt? <input type="checkbox"/> Yes <input type="checkbox"/> No		
City, state, and ZIP code		6 Description of property		
Account number (optional)				

Form 1099-A

Do NOT Cut or Separate Forms on This Page

Department of the Treasury - Internal Revenue Service

RIA Caution: IRS will not accept a photocopy of copy A, see p. 732,008 under "Paper Document Reporting". The official form, available at IRS District Offices, must be used.

Form 1099-A. Acquisition or Abandonment of Secured Property. (cont'd)

CORRECTED (if checked)

LENDER'S name, street address, city, state, and ZIP code			OMB No. 1545-0877	1987 Information Return for	Acquisition or Abandonment of Secured Property
LENDER'S Federal identification number	BORROWER'S identification number		1 Date of lender's acquisition or knowledge of abandonment		
BORROWER'S name (first, middle, last)		3 Amount of debt satisfied \$	4 Fair market value of property at acquisition or abandonment \$		
Street address		5 Is borrower personally liable for repayment of the debt? <input type="checkbox"/> Yes <input type="checkbox"/> No			
City, state, and ZIP code		6 Description of property			
Account number (optional)					

Form 1099-A

Department of the Treasury - Internal Revenue Service

VOID CORRECTED

LENDER'S name, street address, city, state, and ZIP code			OMB No. 1545-0877	1987 Information Return for	Acquisition or Abandonment of Secured Property
LENDER'S Federal identification number	BORROWER'S identification number		1 Date of lender's acquisition or knowledge of abandonment		
BORROWER'S name (first, middle, last)		3 Amount of debt satisfied \$	4 Fair market value of property at acquisition or abandonment \$		
Street address		5 Is borrower personally liable for repayment of the debt? <input type="checkbox"/> Yes <input type="checkbox"/> No			
City, state, and ZIP code		6 Description of property			
Account number (optional)					

Form 1099-A

Department of the Treasury - Internal Revenue Service

Form 1099-B. Proceeds from Broker and Barter Exchange Transactions.

Instructions for Recipient

Brokers, including real estate brokers, and barter exchanges must report proceeds from transactions to the Internal Revenue Service. This form is used to report these proceeds. Report amounts from your Forms 1099-B in the applicable parts of Schedule D (Form 1040) or Form 6781.

Box 1a.—Ordinarily, this date will be the trade or exchange date of the transaction. However, if an "S" is shown immediately before the date, the broker is using the settlement date and not the trade date. For aggregate reporting, no entry will be present.

For real estate transactions, the date of closing is shown.

Box 1b.—Shows the proceeds from a real estate transaction. If the real estate was your principal residence, file Form 2119, Sale or Exchange of Principal Residence, for any gain.

Box 2a.—Shows the proceeds from transactions involving stocks, bonds, other debt obligations, commodities, or forward contracts. Losses on forward contracts are shown in parentheses. This box does not include proceeds from regulated futures contracts. The broker must indicate whether gross proceeds or gross proceeds less commissions and option premiums were reported to IRS. State and local transfer taxes cannot be subtracted. You may deduct these taxes only as an itemized deduction on your tax return.

Box 2b.—For broker transactions, may show the CUSIP (Committee on Uniform Security Identification Procedures) number of the item reported.

Box 3.—Shows the fair market value of any trade credits or scrip credited to your account for exchanges of property or services as well as cash received. See the instructions for your tax return on how to report this amount.

Box 4.—Any amount listed in this box represents backup withholding. For example, persons not furnishing their taxpayer identification number to the payer become subject to backup withholding at a 20% rate on certain payments. See Form W-9, Payer's Request for Taxpayer Identification Number and Certification, for information on backup withholding. Include this on your income tax return as tax withheld.

Box 5.—Shows a brief description of the item or service for which the proceeds are being reported. For regulated futures contracts and forward contracts, "RFC" or other appropriate description, and any amount subject to backup withholding, may be shown.

Box 6.—Shows the profit or (loss) realized on regulated futures or foreign currency contracts closed during 1987.

Box 7.—Shows any year-end adjustment to the profit or (loss) shown in Box 6 due to open contracts on December 31, 1986.

Box 8.—Shows the unrealized profit or (loss) on open contracts held in your account on December 31, 1987. These are considered sold as of that date. This will become an adjustment reported in Box 7 in 1988.

Box 9.—Boxes 6, 7, and 8 are used to figure the aggregate profit or (loss) on regulated futures or foreign currency contracts for the year. Include this figure on your 1987 Form 6781, Gains and Losses From Section 1256 Contracts and Straddles.

7979

VOID

CORRECTED

For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code		1a Date of sale/closing MMDDYY	OMB No. 1545-0715 1987 Statement for Recipients of	Proceeds From Real Estate, Broker, and Barter Exchange Transactions
		1b Real estate \$		
		2a Stocks, bonds, etc. \$	<input type="checkbox"/> Gross proceeds <input type="checkbox"/> Gross proceeds less commissions and option premiums	2b CUSIP no.
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Bartering \$	4 Federal income tax withheld \$	Copy A For Internal Revenue Service Center For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
Type or machine print RECIPIENT'S name (first, middle, last)		5 Description	<input type="checkbox"/> Principal residence <input type="checkbox"/> Other real estate	
Street address		Regulated Futures Contracts		
City, state, and ZIP code		6 Profit or (loss) realized in 1987 \$	7 Unrealized profit or (loss) on open contracts—12/31/86 \$	
Account number (optional)		8 Unrealized profit or (loss) on open contracts—12/31/87 \$	9 Aggregate profit or (loss) \$	

Form 1099-B

Do NOT Cut or Separate Forms on This Page

Department of the Treasury - Internal Revenue Service

RIA Caution: IRS will not accept a photocopy of copy A, see p. 732,008 under "Paper Document Reporting". The official form, available at IRS District Offices, must be used.

Form 1099-B. Proceeds from Broker and Barter Exchange Transactions. (cont'd)

CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code		1a Date of sale/closing	OMB No 1545-0715	Proceeds From Real Estate, Broker, and Barter Exchange Transactions
		1b Real estate \$	1987 Statement for Recipients of	
PAYER'S Federal identification number		2a Stocks, bonds, etc. \$	<input type="checkbox"/> Gross proceeds <input type="checkbox"/> Gross proceeds less commissions and option premiums	2b CUSIP no.
		3 Bartering \$	4 Federal income tax withheld \$	Copy B For Recipient This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S identification number		5 Description <input type="checkbox"/> Principal residence <input type="checkbox"/> Other real estate		
RECIPIENT'S name (first, middle, last)		Regulated Futures Contracts		
Street address		6 Profit or (loss) realized in 1987 \$	7 Unrealized profit or (loss) on open contracts—12/31/86 \$	
City, state, and ZIP code		8 Unrealized profit or (loss) on open contracts—12/31/87 \$	9 Aggregate profit or (loss) \$	
Account number (optional)				

Form 1099-B

Department of the Treasury - Internal Revenue Service

VOID CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1a Date of sale/closing	OMB No 1545-0715	Proceeds From Real Estate, Broker, and Barter Exchange Transactions
		1b Real estate \$	1987 Statement for Recipients of	
PAYER'S Federal identification number		2a Stocks, bonds, etc. \$	<input type="checkbox"/> Gross proceeds <input type="checkbox"/> Gross proceeds less commissions and option premiums	2b CUSIP no.
		3 Bartering \$	4 Federal income tax withheld \$	Copy C For Payer For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
RECIPIENT'S identification number		5 Description <input type="checkbox"/> Principal residence <input type="checkbox"/> Other real estate		
RECIPIENT'S name (first, middle, last)		Regulated Futures Contracts		
Street address		6 Profit or (loss) realized in 1987 \$	7 Unrealized profit or (loss) on open contracts—12/31/86 \$	
City, state, and ZIP code		8 Unrealized profit or (loss) on open contracts—12/31/87 \$	9 Aggregate profit or (loss) \$	
Account number (optional)				

Form 1099-B

Department of the Treasury - Internal Revenue Service

Form 1099-DIV. Dividends and Distributions.

Instructions for Recipient

Report the amount shown in Box 1 on the "Dividends" line of your income tax return or, if required, list your dividends on the separate schedule of your tax return. See the instructions for your income tax return for more information on how to report the income.

The amount shown in Box 1 may be a distribution from an employee stock ownership plan (ESOP). Although you should report the ESOP distribution as a dividend on your income tax return, treat it as a plan distribution, not as investment income, for any other purpose.

The amount in Box 2 is your share of the expenses of a regulated investment company, including a mutual fund, which is included in Box 1. The full amount shown in Box 1 must be reported as income on your tax return. The expenses shown in Box 2 are deductible as a "Miscellaneous Deduction" only if you itemize your deductions, and they are subject to the 2% limit. Generally, the actual amount you should have received or had credited to you is the amount in Box 1 less the amount in Box 2.

Any amount shown in Box 4 represents backup withholding. For example, persons not furnishing their taxpayer identification number to the payer become subject to backup withholding at a

20% rate on certain payments. See Form W-9, Payer's Request for Taxpayer Identification Number and Certification, for information on backup withholding. Include this amount on your income tax return as tax withheld.

Amounts listed in Box 5 as nontaxable distributions are usually a return of capital. Once you have received an amount equal to your cost, or other basis, these distributions are taxable to you as a capital gain even if the payer lists them as nontaxable. For more information, see Publication 550, Investment Income and Expenses.

If your Federal identification number is shown on this form, and two or more recipients are shown or the form includes amounts belonging to another person, you are considered a nominee recipient. You must file Form 1099-DIV for each of the other owners showing the income allocable to each. File Form(s) 1099-DIV with Form 1096, Annual Summary and Transmittal of U.S. Information Returns, at the Internal Revenue Service Center for your area. On Forms 1099-DIV and 1096, you should be listed as the "payer." On Form 1099-DIV, the other owner(s) should be listed as the "recipient." A husband or wife is not required to file a nominee return to show payments for the other.

9191

VOID

CORRECTED

For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code		OMB No. 1545-0110		1987 Statement for Recipients of	Dividends and Distributions
		1 Gross dividends and other distributions on stock \$			
PAYER'S Federal identification number	RECIPIENT'S identification number	2 Investment expenses included in Box 1 \$		3 Capital gain distributions \$	
Type or machine print RECIPIENT'S name (first, middle, last)		4 Federal income tax withheld \$		5 Nontaxable distributions (if determinable) \$	
Street address		6 Foreign tax paid \$		7 Foreign country or U.S. possession	
City, state, and ZIP code		Liquidation Distributions			
Account number (optional)		8 Cash \$		9 Noncash (Fair market value) \$	

**Copy A
For Internal Revenue Service Center
For Paperwork Reduction Act
Notice and instructions for completing this form, see
Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.**

Form 1099-DIV

Do NOT Cut or Separate Forms on This Page

Department of the Treasury - Internal Revenue Service

RIA Caution: IRS will not accept a photocopy of copy A, see p. 732,008 under "Paper Document Reporting". The official form, available at IRS District Offices, must be used.

CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code		OMB No. 1545-0110		1987 Statement for Recipients of	Dividends and Distributions
		1 Gross dividends and other distributions on stock			
PAYER'S Federal identification number		RECIPIENT'S identification number		2 Investment expenses included in Box 1	3 Capital gain distributions
RECIPIENT'S name (first, middle, last)		4 Federal income tax withheld		5 Nontaxable distributions (if determinable)	
Street address		6 Foreign tax paid		7 Foreign country or U.S. possession	
City, state, and ZIP code		Liquidation Distributions			
Account number (optional)		8 Cash		9 Noncash (Fair market value)	
		\$		\$	

Copy B For Recipient

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this dividend income is taxable and the IRS determines that it has not been reported.

Form 1099-DIV

Department of the Treasury - Internal Revenue Service

VOID CORRECTED

PAYER'S name, street address, city, state, and ZIP code		OMB No. 1545-0110		1987 Statement for Recipients of	Dividends and Distributions
		1 Gross dividends and other distributions on stock			
PAYER'S Federal identification number		RECIPIENT'S identification number		2 Investment expenses included in Box 1	3 Capital gain distributions
RECIPIENT'S name (first, middle, last)		4 Federal income tax withheld		5 Nontaxable distributions (if determinable)	
Street address		6 Foreign tax paid		7 Foreign country or U.S. possession	
City, state, and ZIP code		Liquidation Distributions			
Account number (optional)		8 Cash		9 Noncash (Fair market value)	
		\$		\$	

Copy C For Payer

For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.

Form 1099-DIV

Department of the Treasury - Internal Revenue Service

Form 1099-INT. Interest Income.

Instructions for Recipient

Box 1.—Interest paid to you during the calendar year by the payer, except interest included in Box 3.

If you receive a Form 1099-INT for interest paid on a tax-exempt obligation, please see the instructions for your income tax return.

Box 2.—Interest or principal forfeited because of early withdrawal of time savings. You may deduct this on your Federal income tax return only on the specific line of Form 1040 under "Adjustments to Income."

Box 3.—Interest on U.S. Savings Bonds, Treasury bills, Treasury bonds, and Treasury notes. This may or may not be all taxable. See Publication 550, Investment Income and Expenses. This interest is exempt from state or local income taxes.

Box 4.—Backup withholding. For example, persons not furnishing their taxpayer identification number to the payer

become subject to backup withholding at a 20% rate. See Form W-9, Payer's Request for Taxpayer Identification Number and Certification, for information on backup withholding. Include this amount on your income tax return as tax withheld.

If your Federal identification number is shown on this form, and two or more recipients are shown or the form includes amounts belonging to another person, you are considered a nominee recipient. You must file Form 1099-INT for each of the other owners showing the income allocable to each. File Form(s) 1099-INT with Form 1096, Annual Summary and Transmittal of U.S. Information Returns, with the Internal Revenue Service Center for your area. On Forms 1099-INT and 1096, you should be listed as the "payer." On Form 1099-INT, the other owner(s) should be listed as the "recipient." A husband or wife is not required to file a nominee return to show payments for the other.

9292

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For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code		Payer's RTN (optional)	OMB No. 1545-0112	1987 Interest Income Statement for Recipients of
PAYER'S Federal identification number		RECIPIENT'S identification number		
Type or machine print RECIPIENT'S name (first, middle, last)		1 Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc. \$	3 U.S. Savings Bonds, etc. \$	Copy A For Internal Revenue Service Center For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
Street address		2 Early withdrawal penalty \$	4 Federal income tax withheld \$	
City, state, and ZIP code		5 Foreign tax paid (if eligible for foreign tax credit)	6 Foreign country or U.S. possession	
Account number (optional)				
		\$		

Form 1099-INT

Do NOT Cut or Separate Forms on This Page

Department of the Treasury - Internal Revenue Service

RIA Caution: IRS will not accept a photocopy of copy A, see p. 732,008 under "Paper Document Reporting". The official form, available at IRS District Offices, must be used.

Form 1099-INT. Interest Income. (cont'd)

CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code		Payer's RTN (optional)	OMB No. 1545-0112	1987 Interest Income Statement for Recipients of
PAYER'S Federal identification number	RECIPIENT'S identification number	1 Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc.		Copy B For Recipient This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S name (first, middle, last)		2 Early withdrawal penalty	3 U.S. Savings Bonds, etc.	
Street address		\$	\$	
City, state, and ZIP code		4 Federal income tax withheld		
Account number (optional)		5 Foreign tax paid (if eligible for foreign tax credit)	6 Foreign country or U.S. possession	
		\$	\$	

Form 1099-INT

Department of the Treasury - Internal Revenue Service

VOID CORRECTED

PAYER'S name, street address, city, state, and ZIP code		Payer's RTN (optional)	OMB No. 1545-0112	1987 Interest Income Statement for Recipients of
PAYER'S Federal identification number	RECIPIENT'S identification number	1 Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc.		Copy C For Payer For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
RECIPIENT'S name (first, middle, last)		2 Early withdrawal penalty	3 U.S. Savings Bonds, etc.	
Street address		\$	\$	
City, state, and ZIP code		4 Federal income tax withheld		
Account number (optional)		5 Foreign tax paid (if eligible for foreign tax credit)	6 Foreign country or U.S. possession	
		\$	\$	

Form 1099-INT

Department of the Treasury - Internal Revenue Service

Form 1099-MISC. Miscellaneous Income.

Instructions for Recipient

The amount(s) shown on this form may or may not be taxable to you. If the amount(s) is taxable and you are an individual, report it on your tax return as explained below. (Other taxpayers, such as fiduciaries, report the amount(s) on corresponding lines of your tax return.)

Boxes 1 and 2.—On Schedule E (Form 1040); or Schedule C if you provide services that are primarily for your customer's convenience, such as regular cleaning, changing linen, or maid service.

Box 3.—On the line for "Other income" on Form 1040. If it is trade or business income, report this amount on Schedule C or F (Form 1040).

Box 4.—Any amount listed in this box represents backup withholding. For example, persons not furnishing their taxpayer identification number to the payer become subject to backup withholding at a 20% rate on certain payments. See Form W-9, Payer's Request for Taxpayer Identification Number and Certification, for information on backup withholding. Include this on your income tax return as tax withheld.

Box 5.—An amount in this box means the fishing boat operator considers you self-employed. Report this amount on Schedule C (Form 1040). See Publication 595, Tax Guide for Commercial Fishermen.

Box 6.—On Schedule C (Form 1040).

Box 7.—Generally, these amounts are considered income from self-employment. Report them as part of your trade or business income on Schedule C or F (Form 1040). If you are not self-employed, amounts paid

to you for services rendered are generally reported on Form 1040 on the line for "Wages, salaries, tips, etc."

If there are two amounts shown in this box, one may be labeled "EPP." This represents excess golden parachute payments. You must pay a 20% excise tax on this amount. See your Form 1040 instructions under "Other Taxes." The unlabeled amount is your total compensation.

Box 8.—As "Other income" on your tax return. The amount shown is substitute payments in lieu of dividends or tax-exempt interest received by your broker on your behalf after transfer of your securities for use in a short sale.

Box 9.—An entry in the checkbox means sales to you of consumer products on a buy-sell, deposit-commission, or any other basis for resale, have amounted to \$5,000 or more. The person filing this return does not have to show a dollar amount in this box. Any income from your sale of these products should generally be reported on Schedule C (Form 1040).

Box 10.—An entry in this checkbox means the amount reported in Box 7 is crop insurance proceeds.

The amounts shown on this form (except Boxes 4 and 8) may be subject to self-employment (social security) tax computed on Schedule SE (Form 1040). See Publication 533, Self-Employment Tax, for more information on amounts considered self-employment income. Since no income or social security taxes will be withheld by the payer, you may be required to make estimated tax payments. See Form 1040-ES, Estimated Tax for Individuals.

9595

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Type or machine print PAYER'S name, street address, city, state, and ZIP code		1 Rents	OMB No. 1545-0115 1987 Statement for Recipients of	Miscellaneous Income
		\$		
PAYER'S Federal identification number RECIPIENT'S identification number		2 Royalties	3 Prizes and awards	4 Federal income tax withheld
		\$		\$
Type or machine print RECIPIENT'S name (first, middle, last)		5 Fishing boat proceeds	6 Medical and health care payments	Copy A For Internal Revenue Service Center For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
		\$	\$	
Street address		7 Nonemployee compensation	8 Substitute payments in lieu of dividends or interest	
		\$	\$	
City, state, and ZIP code		9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>		
Account number (optional)		10 The amount in Box 7 is crop insurance proceeds <input type="checkbox"/>		

Form 1099-MISC

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Department of the Treasury - Internal Revenue Service

RIA Caution: IRS will not accept a photocopy of copy A, see p. 732,008 under "Paper Document Reporting". The official form, available at IRS District Offices, must be used.

Form 1099-MISC. Miscellaneous Income. (cont'd)

CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code		1 Rents	OMB No. 1545-0115 1987 Statement for Recipients of	Miscellaneous Income
		\$		
PAYER'S Federal identification number		2 Royalties		
		\$		
RECIPIENT'S identification number		3 Prizes and awards	4 Federal income tax withheld	Copy B For Recipient This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S name (first, middle, last)		5 Fishing boat proceeds	6 Medical and health care payments	
Street address		7 Nonemployee compensation	8 Substitute payments in lieu of dividends or interest	
City, state, and ZIP code		9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>		
Account number (optional)		10 The amount in Box 7 is crop insurance proceeds . . . <input type="checkbox"/>		

Form 1099-MISC

Department of the Treasury - Internal Revenue Service

VOID CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1 Rents	OMB No. 1545-0115 1987 Statement for Recipients of	Miscellaneous Income
		\$		
PAYER'S Federal identification number		2 Royalties		
		\$		
RECIPIENT'S identification number		3 Prizes and awards	4 Federal income tax withheld	Copy C For Payer For Paperwork Reduction Act Notice and instructions for completing this form, see instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
RECIPIENT'S name (first, middle, last)		5 Fishing boat proceeds	6 Medical and health care payments	
Street address		7 Nonemployee compensation	8 Substitute payments in lieu of dividends or interest	
City, state, and ZIP code		9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>		
Account number (optional)		10 The amount in Box 7 is crop insurance proceeds . . . <input type="checkbox"/>		

Form 1099-MISC

Department of the Treasury - Internal Revenue Service

Form 1099-OID. Original Issue Discount.

Instructions for Recipient

Original issue discount (OID) means the difference between the stated redemption price at maturity and the issue price of a bond, debenture, note, or other evidence of indebtedness, or the acquisition price of a stripped bond or coupon. This also applies to certificates of deposit, time deposits, bonus savings plans, and other deposit arrangements having a term of more than one year, provided the payment of interest is deferred until maturity.

Original issue discount is taxable over the life of the obligation. If you are the holder of one of these obligations, you must include a part of the original issue discount in your gross income each year you hold the obligation.

If, as the record holder, you receive Form 1099-OID showing OID or other periodic interest belonging to another person, you are considered a nominee recipient. You must file another Form 1099-OID showing the actual owner as "recipient" and you as the "payer." Show the OID for the entire year, even if the actual owner did not own the obligation for the entire year. Complete Form 1099-OID and Form 1096, Annual Summary and Transmittal of U. S. Information Returns, and file both forms with the Internal Revenue Service Center for your area. Also give a copy of the form you are filing with IRS to the actual owner. A husband or wife is not required to file a nominee return to show payments for the other. If you are not a nominee, and you did not hold the OID obligation for the entire year, you are not required to issue nor file Form 1099-OID showing the portion of OID or stated interest allocable to the purchaser/seller of the obligation.

Box 1.—Shows the total OID on the obligation for the calendar year. If you bought the obligation at original issue and you held the obligation for

the entire year or for the part of the year it was outstanding, report the entire amount in Box 1 as interest income on your income tax return. If you did not buy the obligation at original issue or if you disposed of the obligation during the year, or if the obligation is a stripped bond or stripped coupon, you must compute your share of the amount in Box 1. See Publication 1212, List of Original Issue Discount Instruments, for help in making this computation.

Box 2.—Shows other interest on this obligation for the year, which is an amount separate from the OID. If you held the obligation the entire year, report this amount as interest income on your tax return. If you disposed of the obligation or acquired it from another holder during the year, see Publication 550, Investment Income and Expenses, for reporting instructions.

Box 3.—Shows the amount of interest or principal forfeited by you if you withdrew the money before the maturity date of the obligation. You may deduct this on your Federal income tax return only on the specific line of Form 1040 under "Adjustments to Income."

Box 4.—Shows the amount withheld for backup withholding. For example, persons not furnishing their taxpayer identification number to the payer become subject to backup withholding at a 20% rate on certain payments shown on the form. See Form W-9, Payer's Request for Taxpayer Identification Number and Certification, for information on backup withholding and the furnishing of your taxpayer identification number to the payer. Include this amount on your income tax return as tax withheld.

Box 5.—Shows the identification number (CUSIP number) or description of the obligation. The description may include the stock exchange, issuer, coupon rate, and year of maturity.

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For Official Use Only

Type or machine print PAYER'S name, street address, city, state, and ZIP code		1 Total original issue discount for 1987	OMB No. 1545-0117 1987 Statement for Recipients of	Original Issue Discount
		\$		
PAYER'S Federal identification number		2 Other periodic interest	1987	Original Issue Discount
		\$		
RECIPIENT'S identification number		3 Early withdrawal penalty	4 Federal income tax withheld	Copy A For Internal Revenue Service Center For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
Type or machine print RECIPIENT'S name (first, middle, last)		5 Description	\$	
Street address				
City, state, and ZIP code				
Account number (optional)				

Form 1099-OID

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Department of the Treasury - Internal Revenue Service

RIA Caution: IRS will not accept a photocopy of copy A, see p. 732,008 under "Paper Document Reporting". The official form, available at IRS District Offices, must be used.

Form 1099-OID. Original Issue Discount. (cont'd)

CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code		1 Total original issue discount for 1987*	OMB No. 1545-0117 1987 Statement for Recipients of	Original Issue Discount
		\$		
PAYER'S Federal identification number RECIPIENT'S identification number		2 Other periodic interest	3 Early withdrawal penalty	4 Federal income tax withheld
		\$		
RECIPIENT'S name (first, middle, last)		5 Description		Copy B For Recipient This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address				
City, state, and ZIP code				
Account number (optional)				
		* This may not be the correct figure to be reported on your income tax return. See instructions.		

Form 1099-OID

Department of the Treasury - Internal Revenue Service

VOID CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1 Total original issue discount for 1987	OMB No. 1545-0117 1987 Statement for Recipients of	Original Issue Discount
		\$		
PAYER'S Federal identification number RECIPIENT'S identification number		2 Other periodic interest	3 Early withdrawal penalty	4 Federal income tax withheld
		\$		
RECIPIENT'S name (first, middle, last)		5 Description		Copy C For Payer For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, 1096, and W-2G.
Street address				
City, state, and ZIP code				
Account number (optional)				

Form 1099-OID

Department of the Treasury - Internal Revenue Service

Form W-8. Certificate of Foreign Status.

Form **W-8**
(Rev. September 1985)
Department of the Treasury
Internal Revenue Service

Certificate of Foreign Status

Use to notify payers, middlemen, brokers, and barter exchanges not to withhold or report on payments of interest, broker transactions, or barter exchanges.

Give this Form to the
Payer, Middleman,
Broker or Barter
Exchange

Please print or type	Name as shown on account (if joint account also give joint owner's name)	U.S. taxpayer identification number (if any)
	Address	
	City, state, and ZIP code (or country)	

List account number(s) here (see instructions) ▶

Part I Qualifications for Exemption.—Check Applicable Box(es)

Interest Payments.—If this form was sent to you because you are receiving interest payments and if you are not a U.S. citizen or resident (or if you are a foreign corporation, partnership, estate or trust), check here

Broker Transactions or Barter Exchanges.—If your broker or barter exchange sent you this form and if you are an "exempt foreign person" (see the instructions below for definition), check here

Part II Notice of Change in Status—To notify the payer, broker, or barter exchange that you no longer qualify for exemption, check here.

If you check this box, reporting will begin on the account(s) listed.

Please
Sign
Here

Certification.—Under the penalties of perjury, I certify that, to the best of my knowledge and belief, I qualify as a foreign person as indicated in the box(es) checked above.

Signature

Date

Instructions

(Section references are to the Internal Revenue Code, unless otherwise stated.)

Purpose of Form.—Use this form to tell the payer, middleman, broker or barter exchange that you are a nonresident alien or foreign entity that is not subject to certain U.S. information return reporting or to backup withholding rules. Payers of interest (including original issue discount), brokers, and barter exchanges may have to withhold 20% of each payment or transaction if, among other reasons, payees do not give the payer or broker their correct taxpayer identification number. This is referred to as "backup withholding." (The taxpayer identification number is a number assigned by the Social Security Administration or the IRS, for individuals, or an employer identification number assigned by IRS for other entities.) Also, the law requires that:

- payments of interest;
 - sales of securities, commodities, regulated futures contracts and forward contracts through a broker; and
 - exchanges of property or services through a barter exchange
- must generally be reported to the Internal Revenue Service.

Nonresident aliens (individuals who are neither citizens nor residents of the United States) and foreign partnerships, corporations, estates and trusts are not generally required to have a U.S. taxpayer identification number, nor are they subject to any backup withholding because they do not furnish such a number to a payer or broker. Also, subject to substantiation of foreign status, payments to these account holders are generally not subject to U.S. reporting requirements.

Interest Payments.—Bank interest paid to you is not subject to the withholding or reporting requirements if you are not a U.S. citizen or resident, or if you are a foreign corporation, partnership, estate or trust. Use this form to notify the payer of your foreign status.

Repeal of 30% Withholding on Portfolio Interest.—Generally, for publicly offered long-term commercial obligations ("portfolio debt investments") issued after July 18, 1984, no withholding is required on interest paid to nonresident aliens or to foreign partnerships or corporations.

For interest on registered obligations not targeted to foreign markets to qualify as portfolio interest and not be subject to 30% withholding, you must give the U.S. payer a Form W-8.

For interest on registered obligations targeted to foreign markets to qualify as portfolio interest and not be subject to 30% withholding, you must give the U.S. payer a Form W-8 in some cases. Therefore, give the payer a Form W-8 if one is requested. For bearer obligations targeted to foreign markets, you need not give the payer a Form W-8.

Broker Transactions and Barter Exchanges.—You are exempt from U.S. withholding and reporting requirements and may use Form W-8 to notify the broker or barter exchange if you meet the following definition of an "exempt foreign person" for the calendar year in which the transaction occurs:

- Individuals.**—
- You are not a citizen or resident of the United States;
 - You have not been present in the United States for 183 days or more during the calendar year, and don't plan to be (or

your country has a tax treaty with the United States that exempts your transactions from U.S. taxes); and

- The gains from your transactions with the broker or barter exchange are not effectively connected (related) to any U.S. trade or business you are engaged in or plan to engage in during the year, or your country has a tax treaty with the United States that exempts your transactions from U.S. taxes.

Nonresident Alien Married to a U.S. Citizen or Resident.—If you are married to a U.S. citizen or resident and have made an election under section 6013(g) or (h), you are treated as a U.S. resident and may not file Form W-8.

Corporations, Partnerships, Estates and Trusts.—

- You are not a U.S. corporation, partnership, estate or trust; and
- The gains from your transactions with the broker or barter exchange are not effectively connected (related) to any U.S. trade or business you are engaged in or plan to engage in during the year, or your country has a tax treaty with the United States that exempts your transactions from U.S. taxes.

When to File.—File this certificate with the payer (or broker or barter exchange) in the calendar year in which the payment is made or collected (or for brokerage sales or barter exchanges, the year the transaction took place), unless you have already done this in either of the two preceding calendar years.

(Continued on back.)

Form W-8 (Rev. 9-85)

Form W-8. Certificate of Foreign Status. (cont'd)

Form W-8 (Rev. 9-85)

Page 2

Address.—

If you are—	Then show the address of—
An individual . . .	Your permanent residence
A partnership or corporation . . .	Principal office
An estate or trust . . .	Permanent residence or principal office of any fiduciary

Notice of Change in Status.—If you become a U.S. citizen or resident after you have filed Form W-8, or if you cease to be an "exempt foreign person," you must notify the payer within 30 days of your change in status. To notify the payer, you may check the box in Part II of this form, or use the method prescribed by the payer. Reporting will then begin on the account(s) listed, and backup withholding may also begin unless

you certify to the payer that (1) the taxpayer identification number you have given is correct, and (2) the Internal Revenue Service has not notified you that you are subject to backup withholding because you failed to report certain interest or dividend income. You may use Form W-9, Payer's Request for Taxpayer Identification Number and Certification, to make these certifications.

If an account is no longer active, you do not have to notify a payer or broker of your change in status unless you also have another account with the same payer that is still active.

If you file a false certificate when you are not entitled to the exemption from withholding or reporting, you may be subject to penalties and/or imprisonment under U.S. perjury laws.

More Than One Payer.—If you receive interest from more than one payer or have dealings with more than one broker or barter exchange, file a certificate with each. **More Than One Account With the Same Payer.—**If you have more than one account with the same payer (for example, a savings account and a certificate of deposit at the same bank), the payer may require you to file a separate certificate for each account.

How Often You Must File.—This certificate generally remains in effect for three calendar years. A payer, broker, or barter exchange, however, may require that a new certificate be filed each time a payment is made.

Signature.—On joint accounts in which each joint-owner is a foreign person each must provide a Form W-8.

- (1) A corporation.
- (2) An organization exempt from tax under section 501(a), or an individual retirement plan (IRA).
- (3) The United States or any agency or instrumentality thereof.
- (4) A state, the District of Columbia, a possession of the United States, or any subdivision or instrumentality thereof.
- (5) A foreign government, a political subdivision of a foreign government, or any agency or instrumentality thereof.
- (6) An international organization or any agency or instrumentality thereof.
- (7) A foreign central bank of issue.
- (8) A dealer in securities or commodities required to register in the U.S. or a possession of the U.S.
- (9) A futures commission merchant registered with the Commodity Futures Trading Commission.
- (10) A real estate investment trust.
- (11) An entity registered at all times during the tax year under the Investment Company Act of 1940.
- (12) A common trust fund operated by a bank under section 584(a).
- (13) A financial institution.
- (14) A middleman known in the investment community as a nominee or listed in the most recent publication of the American Society of Corporate Secretaries, Inc., Nominee List.

Payments of dividends and patronage dividends generally not subject to backup withholding include the following:

- Payments to nonresident aliens subject to withholding under section 1441.
- Payments to partnerships not engaged in a trade or business in the U.S. and that have at least one nonresident partner.
- Payments of patronage dividends not paid in money.
- Payments made by certain foreign organizations.

Payments of interest generally not subject to backup withholding include the following:

- Payments of interest on obligations issued by individuals. Note: You may be subject to backup withholding if this interest is \$600 or more and is paid in the course of the payer's trade or business and you have not provided your correct TIN to the payer.
- Payments of tax-exempt interest (including exempt-interest dividends under section 852).
- Payments described in section 6049(b)(5) to nonresident aliens.
- Payments on tax-free covenant bonds under section 1451.
- Payments made by certain foreign organizations.

Payments that are not subject to information reporting are also not subject to backup withholding. For details, see the regulations under sections 6041, 6041A(a), 6042, 6044, 6045, 6049, and 6050A.

Penalties

Failure to Furnish TIN.—If you fail to furnish your correct TIN to a payer, you are subject to a penalty of \$50 for each such failure unless your failure is due to reasonable cause and not to willful neglect.

Failure to Include in Income Dividend and Interest Payments.—If you fail to include any portion of an includible payment of interest, dividends, or patronage dividends in gross income, and the payment was reported to you by the payer, such failure will be treated as being due to negligence, and you will be subject to a penalty of 5% on any portion of an underpayment attributable to that failure unless there is clear and convincing evidence to the contrary.

Civil Penalty for False Information With Respect to Withholding.—If you make a false statement with no reasonable basis which results in no imposition of backup withholding, you are subject to a penalty of \$500.

Criminal Penalty for Falsifying Information.—Willfully falsifying certifications or affirmations may subject you to criminal penalties including fines and/or imprisonment.

Specific Instructions

Name.—Be sure to enter your correct name. If you are an individual and your name has changed, for example, because of marriage, contact the Social Security Administration to report your new name.

Certification.—

(1) **Interest, Dividend, and Barter Exchange Accounts Opened Before 1984 and Broker Accounts That Were Considered Active During 1983.**—You are not required to sign the certification, however, you may do so. You are required to provide your correct TIN.

(2) **Interest, Dividend, Broker and Barter Exchange Accounts Opened After 1983 and Broker Accounts That Were Considered Inactive During 1983.**—You must sign the certification or backup withholding will apply. If you are subject to backup withholding and you are merely providing your correct TIN to the payer, you must cross out item (2) in the certification before signing the form.

(3) **Other Payments.**—You are required to furnish your correct TIN, but you are not required to sign the certification. Other payments include payments made in the course of the payer's trade or business for rents, royalties, goods (other than bills for merchandise), medical and health care services, payments to a nonemployee for services (including attorney and accounting fees), and payments to certain fishing boat crew members.

(4) **Exempt Payees and Payments.**—If you are exempt from backup withholding, you should complete this form to avoid possible erroneous backup withholding. Enter your correct TIN in Part I, write "EXEMPT" in the block in Part II, cross out item (2) of the certification, sign and date the form. If you are a nonresident alien or foreign entity not subject to backup withholding, give the payer a completed Form W-8, Certificate of Foreign Status.

(5) **TIN "Applied For."**—Follow the instructions under *How to Obtain a TIN*, sign and date this form.

Signature.—For a joint account, only the person whose TIN is shown in Part I should sign the form.

Privacy Act Notice.—Section 6109 requires most recipients of dividend, interest, or other payments to give taxpayer identification numbers to payers who must report the payments to IRS. IRS uses the numbers for identification purposes. Payers must be given the numbers whether or not recipients are required to file tax returns. Payers must generally withhold 20% of taxable interest, dividend, and certain other payments to a payee who does not furnish a taxpayer identification number to a payer. Certain penalties may also apply.

What Number to Give the Payer

For this type of account:	Give the SOCIAL SECURITY number of:
1. Individual	The individual
2. Two or more individuals (joint account)	The actual owner of the account or, if combined funds, the first individual on the account ¹
3. Custodian account of a minor (Uniform Gift to Minors Act)	The minor ²
4. a. The usual revocable savings trust (grantor is also trustee)	The grantor-trustee ¹
b. So-called trust account that is not a legal or valid trust under state law	The actual owner ¹
5. Sole proprietorship	The owner ³
For this type of account:	Give the EMPLOYER IDENTIFICATION number of:
6. A valid trust, estate, or pension trust	Legal entity (Do not furnish the identification number of the personal representative or trustee unless the legal entity itself is not designated in the account title.) ⁴
7. Corporate	The corporation
8. Association, club, religious, charitable, educational, or other tax-exempt organization	The organization
9. Partnership	The partnership
10. A broker or registered nominee	The broker or nominee
11. Account with the Department of Agriculture in the name of a public entity (such as a state or local government, school district, or prison) that receives agricultural program payments	The public entity

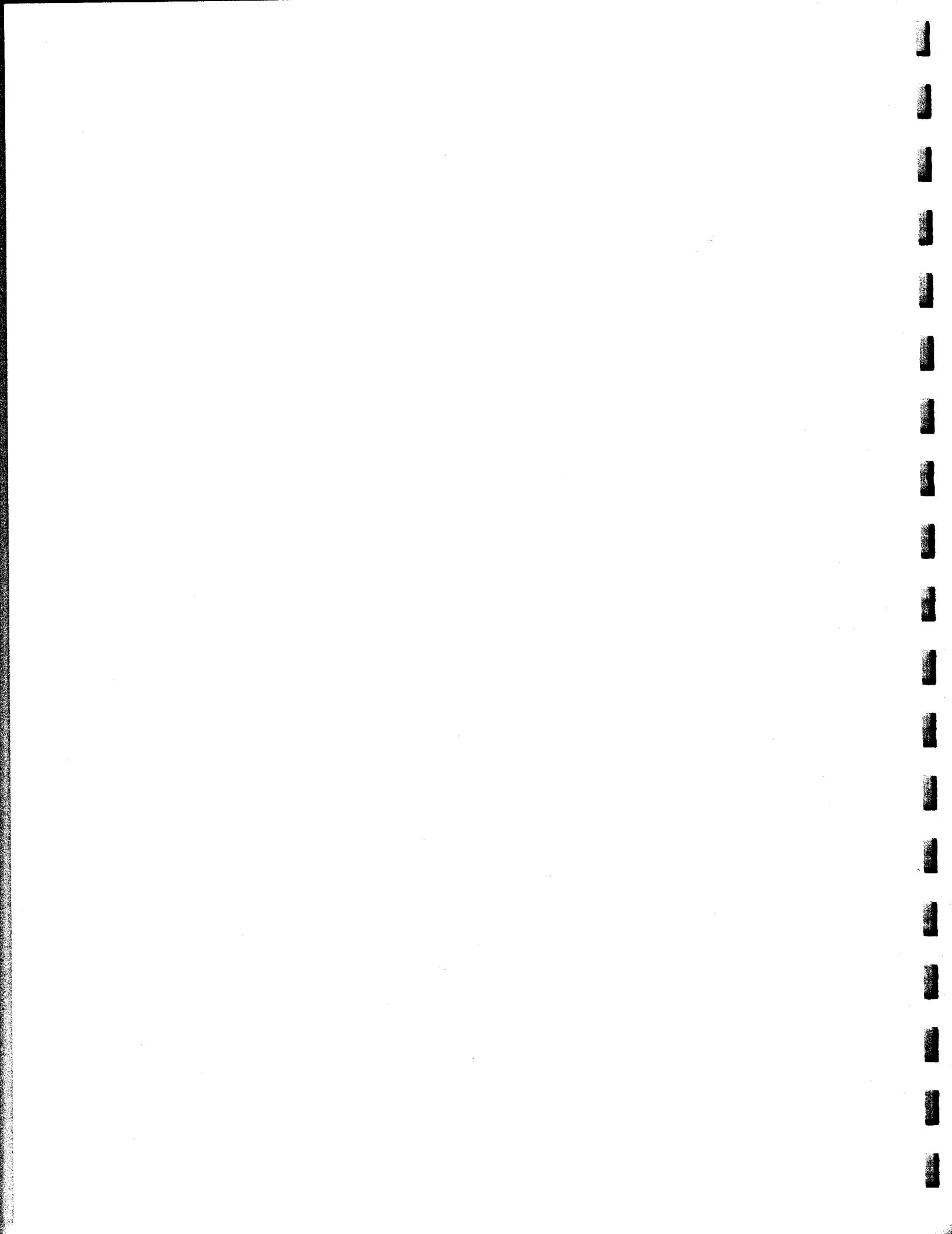
¹ List first and circle the name of the person whose number you furnish.

² Circle the minor's name and furnish the minor's social security number.

³ Show the name of the owner.

⁴ List first and circle the name of the legal trust, estate, or pension trust.

Note: If no name is circled when there is more than one name, the number will be considered to be that of the first name listed.



Form W-9. Payer's Request for Taxpayer Identification Number.

Form **W-9**
(Rev. December 1987)
Department of the Treasury
Internal Revenue Service

**Request for Taxpayer
Identification Number and Certification**

Give this form
to the requester. Do
NOT send to IRS.

Please print or type

Name (If joint names, list first and circle the name of the person or entity whose number you enter in Part I below. See instructions if your name has changed.)

Address

City, state, and ZIP code

List account number(s)
here (optional) ▶

Part I Taxpayer Identification Number

Enter your taxpayer identification number in the appropriate box. For individuals and sole proprietors, this is your social security number. For other entities, it is your employer identification number. If you do not have a number, see *How To Obtain a TIN*, below.

Social security number

			+		+				
--	--	--	---	--	---	--	--	--	--

OR

Employer identification number

	+								
--	---	--	--	--	--	--	--	--	--

Note: If the account is in more than one name, see the chart on page 2 for guidelines on whose number to enter.

Part II For Payees Exempt From Backup Withholding (See Instructions)

Requester's name and address (optional)

Certification.—Under penalties of perjury, I certify that:

- (1) The number shown on this form is my correct taxpayer identification number (or I am waiting for a number to be issued to me), and
- (2) I am not subject to backup withholding either because I have not been notified by the Internal Revenue Service (IRS) that I am subject to backup withholding as a result of a failure to report all interest or dividends, or the IRS has notified me that I am no longer subject to backup withholding (does not apply to real estate transactions, mortgage interest paid, the acquisition or abandonment of secured property, contributions to an individual retirement arrangement (IRA), and payments other than interest and dividends).

Certification Instructions.—You must cross out item (2) above if you have been notified by IRS that you are currently subject to backup withholding because of underreporting interest or dividends on your tax return. (Also see *Signing the Certification under Specific Instructions*, later.)

Please Sign Here	Signature ▶	Date ▶
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Instructions

(Section references are to the Internal Revenue Code.)

Purpose of Form.—A person who is required to file an information return with IRS must obtain your correct taxpayer identification number (TIN) to report income paid to you, real estate transactions, mortgage interest you paid, the acquisition or abandonment of secured property, or contributions you made to an individual retirement arrangement (IRA). Use Form W-9 to furnish your correct TIN to the requester (the person asking you to furnish your TIN), and, when applicable, (1) to certify that the TIN you are furnishing is correct, (2) to certify that you are not subject to backup withholding, and (3) to claim exemption from backup withholding if you are an exempt payee. Furnishing your correct TIN and making the appropriate certifications will prevent certain payments from being subject to the 20% backup withholding.

Note: If a requester gives you a form other than a W-9 to request your TIN, you must use the requester's form.

How To Obtain a TIN.—If you do not have a TIN, you should apply for one immediately. To apply for the number, obtain Form SS-5, Application for a Social Security Number Card (for individuals), or Form SS-4, Application for Employer Identification Number (for businesses and all other entities), at your local office of the Social Security Administration or the Internal Revenue Service. Complete and file the appropriate form according to its instructions.

To complete Form W-9 if you do not have a TIN, write "Applied For" in the space for the TIN in Part I, sign and date the form, and give it to the requester. For payments that could be subject to backup withholding, you will then have 60 days to obtain a TIN and furnish it to the requester.

During the 60-day period, the payments you receive will not be subject to the 20% backup withholding, unless you make a withdrawal. However, if the requester does not receive your TIN from you within 60 days, backup withholding, if applicable, will begin and continue until you furnish your TIN to the requester.

Note: Writing "Applied For" on the form means that you have already applied for a TIN OR that you intend to apply for one in the near future.

As soon as you receive your TIN, complete another Form W-9, include your new TIN, sign and date the form, and give it to the requester.

What Is Backup Withholding?—Persons making certain payments to you are required to withhold and pay to IRS 20% of such payments under certain conditions. This is called "backup withholding." Payments that could be subject to backup withholding include interest, dividends, broker and barter exchange transactions, rents, royalties, nonemployee compensation, and certain payments from fishing boat operators, but do not include real estate transactions.

If you give the requester your correct TIN, make the appropriate certifications, and report all your taxable interest and dividends on your tax return, your payments will not be subject to backup withholding. Payments you receive will be subject to backup withholding if:

- (1) You do not furnish your TIN to the requester, or
- (2) IRS notifies the requester that you furnished an incorrect TIN, or
- (3) You are notified by IRS that you are subject to backup withholding because you failed to report all your interest and dividends on your tax return (for interest and dividend accounts only), or
- (4) You fail to certify to the requester that you are not subject to backup withholding under (3) above (for interest and dividend accounts opened after 1983 only), or

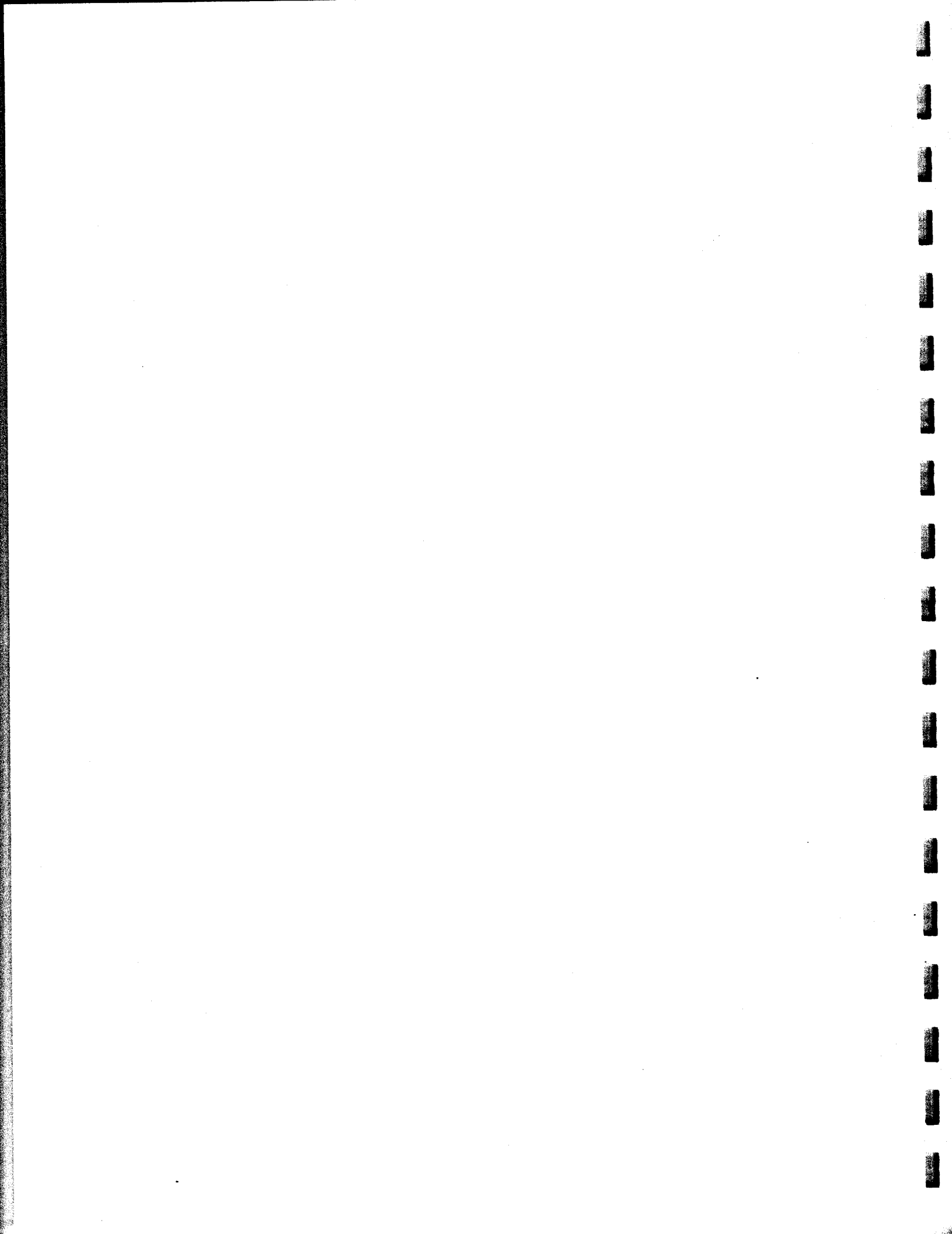
(5) You fail to certify your TIN. This applies only to interest, dividend, broker, or barter exchange accounts opened after 1983, or broker accounts considered inactive in 1983.

For other payments, you are subject to backup withholding only if (1) or (2) above applies.

Certain payees and payments are exempt from backup withholding and information reporting. See *Payees and Payments Exempt From Backup Withholding*, below, and *Exempt Payees and Payments under Specific Instructions*, on page 2, if you are an exempt payee.

Payees and Payments Exempt From Backup Withholding.—The following lists payees that are exempt from backup withholding and information reporting. For interest and dividends, all listed payees are exempt except item (9). For broker transactions, payees listed in (1) through (13), and a person registered under the Investment Advisers Act of 1940 who regularly acts as a broker are exempt. Payments subject to reporting under sections 6041 and 6041A are generally exempt from backup withholding only if made to payees described in items (1) through (7), except that a corporation that provides medical and health care services or bills and collects payments for such services is not exempt from backup withholding or information reporting. Only payees described in items (2) through (6) are exempt from backup withholding for barter exchange transactions, patronage dividends, and payments by certain fishing boat operators.

- (1) A corporation.
- (2) An organization exempt from tax under section 501(a), or an individual retirement plan (IRA), or a custodial account under 403(b)(7).
- (3) The United States or any agency or instrumentality thereof.



IRS COMPLIANCE
(FORECLOSURE, INTEREST, AND BROKER REPORTING)

A. FORECLOSURES, TRANSFERS AND ABANDONMENTS OF SECURITY

I. Information Returns - Form 1099-A

Anyone engaged in a trade or business or government unit that lends money, which is secured by property, must report the following to the IRS:

- a. Any acquisition of an interest in such property in full or partial satisfaction of the debt, occurring after 1984, or
- b. Any abandonment of such property, occurring after 1984, of which it has a reason to know.

II. Due Date of Returns

Form 1099-A must be filed by February 28 of the year following the calendar year in which the transactions occurs.

The lender must also furnish a statement to the borrower no later than January 31.

III. Property to Which Return Applies

All tangible personal property used by a borrower in his trade or business and all realty is subject to the reporting rules. (Does not apply, however, to consumer goods or pawned goods).

B. MORTGAGE INTEREST RECEIVED

I. Information Return Form 1098

Any person who is engaged in any trade or business and who receives \$600 or more in mortgage interest from an individual is required to report that interest to the IRS on Form 1098. When a person collects such interest for another, the first person who receives the interest is required to make the report. "Mortgage" includes any obligation secured by real property.

II. Due Dates

Form 1098 must be filed by February 28 of the year following the calendar year in which the transaction occurs.

In addition, the recipient of the interest is required to furnish the individual making such payments with a similar statement no later than January 31.

C. REAL ESTATE TRANSACTION REPORTING

I. Introduction

The Tax Reform Act of 1986 provides for the requirement to file information return Form 1099-B for post-1986 real estate transactions. The person responsible for preparing this document is the defined "broker" in the transaction.

II. Broker Defined

In general, the person designated as the broker is the one responsible for closing the transaction. Depending on the parties involved, the term "broker" could include the attorneys for the buyer or the seller, the title or escrow company, the mortgage lender, or the buyer himself. The definition is in no way limited to persons licensed as real estate brokers.

III. Broker Status

If a uniform settlement statement (closing statement) is prepared, the person listed as settlement agent is responsible for preparing the Form 1099-B.

Absent the above, the next person responsible for filing the information return is the buyer's attorney and next the seller's attorney.

If there is no attorney, then the disbursing title or escrow company is the broker.

If we have none of the above, the regulations list the following persons as being responsible for the reporting requirements.

- (1) Seller's Broker
- (2) Buyer's Broker
- (3) Mortgage Lender
- (4) Transferer (Buyer)

IV. Sales or Exchanges Affected

Under the temporary regulations, the reporting requirements will initially be limited to the following:

- (1) Single Family Homes
- (2) Townhomes
- (3) Duplexes
- (4) Apartment buildings of up to four units
- (5) Condominium Units
- (6) Stock in Coop Housing Corporations

Note: The sale of a residence includes land and all attachments or structures included in the sale, including any outbuildings (i.e. detached garage, storage sheds, etc.)

V. Contents and Filing of Returns

Form 1099-B must include the following information:

1. Name, address, and taxpayer identification number (TIN) of the seller.
2. Name, address, and TIN of the broker.
3. A general description of the real estate (not necessarily the legal description).
4. Date of closing of the transaction.
5. Gross cash proceeds without reduction for commissions or similar expenses, and not including the value of any property other than cash.
6. Description of other property or services the seller is to receive.
7. Real estate broker's name, address and TIN.
8. Any other information required by the Form 1099-B or its instructions.

The information returns must be filed on magnetic media if the number of returns is more than 500 for 1987 (250 in later years). To file on magnetic media you must request permission from the IRS for instructions on how to file. They are due no later than February 28 following the calendar year in which the transaction is closed.

Note: The Seller must also be supplied with a statement regarding the transaction. The Seller's information may be contained in a copy of the closing statement provided at or after the closing. It is recommended this statement include a notification that this information will be reported to the IRS on Form 1099-B and that the Seller should retain this important information for income tax purposes.

VI. Multiple Sellers

Where the property is held in joint or common tenancy, the broker must make a separate return for each seller, and make an allocation of the gross proceeds based upon information provided by the sellers. If the broker does not receive appropriate allocation information, he must report the entire gross proceeds on each information return.

D. PENALTIES (CODE SECTION 6652)

I. Failure to File or Delinquent Filing

The penalty for failure to file or delinquent filing of an information return is \$50 for each return, up to a maximum of \$100,000 per person failing to file. In addition, there is a \$50 penalty for failure to furnish a statement to the Seller or Borrower. There are other penalties which apply for failure to include the seller's or borrower's tax identification number.

II. Reasonable Cause

The penalties may be abated if the failure to file is excused by reasonable cause and is not due to willful neglect. If the return is filed late, a Form 4571, Explanation for Filing Return Late, should be attached to avoid the penalty.

III. Intentional Disregard of Rules

Where the failure to file any of the above information returns is due to intentional disregard of the filing requirements, the \$100,000 limit does not apply.

In addition, where there is intentional disregard, the penalty imposed on brokers (Form 1099-B) cannot be less than five percent of the gross proceeds required to be reported, and the penalty on failure to file Forms 1099-A and Forms 1098 cannot be less than 10 percent of the aggregate amount of the items required to be reported.

CREDITORS' RIGHTS UNDER CHAPTER 12

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SECTION G

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CREDITORS' RIGHTS UNDER CHAPTER 12

TABLE OF CONTENTS

	Page
I. Introduction	G-1
II. Summary Of The Content Of Chapter 12	G-2
III. Practical Suggestions For The Creditor	G-6
A. Beginning Before the Beginning: Perfection of Security	G-6
B. Valuation	G-7
C. Re-Evaluation of the Farmer-Borrower	G-8
IV. After A Chapter 12 Filing: The Best Defense Is Offense	G-9
A. Attacking Eligibility Requirements	G-9
B. Feasibility	G-10
C. Adequate Protection	G-12
D. Protect Your Cash Collateral	G-17
E. Information and Investigation	G-18
F. Assumption and Rejection of Leases	G-20
G. The Nondischargeability Lawsuit	G-21
V. Conclusion	G-22



I. INTRODUCTION

This paper is concerned with creditors' rights under Chapter 12 of the United States Bankruptcy Code, which came into being as "The Family Farmer Bankruptcy Act of 1986," a new debtor remedy which at this writing has already been invoked by almost 250 small farmers in the Commonwealth of Kentucky. Given the eligibility limits of the new law (\$1.5 million in total debts per farmer petitioner), this new and extraordinary form of reorganization relief has, by definition, already put at risk over a quarter of a billion dollars in creditor investments in Kentucky farms. And the law is only fifteen months old.

All forms of bankruptcy relief present serious perils to the lending community, but under no other chapter of the Code is the danger as grave as it is in the Chapter 12 proceeding, which mandates a written-down debt while effectively depriving the secured creditor of its rights of possession in its collateral.

Our discussion of Chapter 12 is written as much for bankers as for lawyers. It will presuppose a primary working knowledge of the bankruptcy process and only a passing familiarity with the basic provisions of this short (13 pages) but important new extension of debtors' relief.

Based upon the foregoing assumptions and in the interest of easy comprehension, this paper will delete all but the most important citations of statutory and case law authority; as a practical matter, the law is too new to have

generated a substantial body of case law, and that is particularly true in the Commonwealth of Kentucky. Unless otherwise indicated, all references to statutory sections and subsections will be to Title 11 of the United States Code, otherwise known as the Bankruptcy Code.

For its organizational content, this monograph draws heavily upon Deitz and Ames, "A New Chapter in Bankruptcy Law: Chapter 12 and the Family Farmer", 209 pp. (Professional Education Systems Inc. 1987). Credit for informal insights into the practical, procedural operation of Chapter 12 in its first full year must be given to United States Bankruptcy Judges G. William Brown of the Western District and the Hon. Joe Lee of the Eastern District of Kentucky, as well as to numerous clients of the undersigned who have unwittingly and sometimes involuntarily contributed to a tentative understanding of the new law.

Finally, and most important, the text which follows will emphasize practical approaches to self-protection by the secured creditor confronted with a Chapter 12 potential loss.

II. SUMMARY OF THE CONTENT OF CHAPTER 12

Chapter 12 is grammatically structured along chronological lines, beginning with a series of definitions which establish eligibility for the law's treatment: describing the extent of protections accorded to the debtor and his co-makers; defining the duties of the Chapter 12 trustee as well as those of the debtor himself; providing for the forms of "adequate protection" which may be available to creditors

before confirmation; mandating the contents of a Chapter 12 plan; describing the essential elements of confirmation of that plan, and generally describing the remedies which are available to both debtor and creditors after a Chapter 12 plan is confirmed.

As a general rule, a farmer (defined as including a husband and wife) may qualify for Chapter 12 relief only if his total debts of all types do not exceed \$1.5 million, 80% of which must be derived from the farming operation, and only if more than 50% of his taxable income from the preceding year was realized from the farming operation. Corporations and partnerships are also eligible for Chapter 12 relief, along substantially similar guidelines, and in an important but largely overlooked eligibility requirement, the law extends only to family farmers "whose annual income is sufficiently stable and regular to enable...payments under a plan under Chapter 12".

Chapter 12 imposes a stay upon creditor actions against not only the farmer, but also against co-debtors on strictly consumer debts (as opposed to farm-related debts), and requires the appointment of a trustee to assume responsibility for collecting and distributing to creditors the funds committed to the Chapter 12 plan. The "standing trustee" administers all cases in the Federal District, and plays a central role in recommending to the Court the confirmation and continuation of Chapter 12 cases.

As in Chapter 11, the debtor in possession is permitted to retain control of the farm, and may be removed only upon a showing of fraud or gross mismanagement. Unlike Chapter 11, only the farmer may submit a Chapter 12 plan, and only the farmer may move to convert the case to a liquidation proceeding (except upon a showing of fraud) or to convert the case to one under another chapter.

The debtor is armed with the customary powers to set aside fraudulent conveyances and preferential transfers, much as a trustee may do in a Chapter 7 case, and may buy and sell property with the approval of the Court.

Creditors may move for dismissal of a Chapter 12 proceeding upon the grounds expressly delineated in §1208, which includes a non-exclusive list of nine grounds for dismissal. The most important reasons justifying dismissal, and those most frequently used by creditors, are (1) unreasonable delay or gross mismanagement prejudicial to creditors, (2) failure to make timely payments, (3) material default under a confirmed plan, and (4) continuing loss or diminution of the estate with a resulting inability to effectively reorganize.

A Chapter 12 plan must specifically describe the classification of claims and the treatment to be accorded to each; must provide for full payment of all priority claims; and must provide for the dedication of all future earnings or other future income to the plan for its full term, which may be at least three but not more than five years.

Confirmation of a plan has the effect of revesting all property in the debtor, although a discharge is not extended to the debtor until successful completion of all obligations required under the plan. Confirmation may be extended only upon a showing of compliance with a series of conditions precedent, listed in §1225 and including most importantly (a) a showing of feasibility and (b) a showing that all creditors will receive at least as much as they would have received in a liquidation case. Long-term mortgage creditors must realize in their future stream of payments at least the present value of the secured property, and, if a single creditor objects to the proposed plan, the debtor must commit all of his projected net disposable income for a three-year period to future payments under the plan.

The discharge, extended only after substantial consummation of the plan, has the effect of eliminating all unsecured debt. A confirmed plan may be modified on the motion of either the debtor or creditors for the purpose of decreasing or increasing plan payments upon a showing of substantial change of post-confirmation circumstances of the debtor.

Many creditor protections which are available under Chapter 11 were intentionally omitted by Congress in writing Chapter 12. Creditors are not entitled to vote in a Chapter 12 proceeding. They are not given the option of electing to be treated as fully secured, as they are in Chapter 11. Nor are they protected by the "absolute priority rule", which

provides that dissenting creditors must be paid in full before the debtor can keep his property. The absence of these vital protections only underscores the need for aggressive exploration of those avenues of defense which remain open in Chapter 12.

III. PRACTICAL SUGGESTIONS FOR THE CREDITOR

A. BEGINNING BEFORE THE BEGINNING: PERFECTION OF SECURITY.

Viewed in its most simple terms, what distinguishes Chapter 12 from other forms of bankruptcy relief is that it permits a farmer/debtor to write down his secured debt, repay it on more permissive terms, and to virtually eradicate his unsecured debt, all the while retaining ownership and control of the farm property under the protection of the Bankruptcy Court. It is fair to say that only the secured creditor has any possibility of minimizing, to any material extent, the amount of his potential losses in Chapter 12.

It therefore behooves the farm lender to review at frequent intervals the portfolio of individual farm borrowers, to determine whether any of them are at or near the point of default and thus potential candidates for Chapter 12 relief.

Because of the extraordinary powers of avoidance enjoyed by a debtor in possession, including the ability to treat as completely unsecured any obligation which has not been perfected in exact accordance with controlling state law, it is essential to the farm lender to make certain that

all relevant security agreements and financing statements are properly executed, properly describe the collateral for the loan, and are properly lodged to record in the appropriate county courthouse. Failure of compliance can result in the entire obligation being treated as unsecured, in which event the lender will realize little or nothing in Chapter 12.

B. VALUATION.

The clear central purpose of Chapter 12 is to permit a farmer to write down the amount of his secured indebtedness to the present market value of the secured property; retain that property as part his farm reorganization; pay the reduced secured indebtedness over a long term of years at a lower rate of interest; and virtually eradicate the unsecured portion of the debt. In this regard Chapter 12 is most extraordinary. Such relief is available to no other economic class of debtor, and the congressional intent obviously was to correct the imbalance in farmland values created by the inflationary excesses of the 1970's. It therefore follows that the determination of value of secured properties becomes, under Chapter 12, the most important single exercise of the bankruptcy power.

Because this is true, there is no more important self-protective instrument to the farm-lender than a current, credible, impartial appraisal of the borrower's farmland, machinery and equipment.

Most Chapter 12 farmers have an appraisal done of their farm properties before they even file a Chapter 12

petition. It thus becomes necessary for the farm lending institution to be able to quickly produce an appraisal of its own, valuing the farm properties at a realistic level. Given the cost of such appraisals, it is unlikely that lenders will be able to prepare them in advance in all cases; however, a qualified and impartial expert should be kept on call for the development of an appropriate appraisal on short notice. The resulting work product should include a valuation of the secured assets on a dual basis; (a) fair market value, and (b) liquidation value. Both methods of valuation will become an issue in the Bankruptcy Court.

C. RE-EVALUATION OF THE FARMER-BORROWER.

The existence of Chapter 12 has worked a change in debtor-creditor relations in farming communities. It is safe to say that Chapter 12 has brought agricultural lenders and borrowers back to the negotiating table, where the borrower may avoid the community embarrassment of a bankruptcy, and the lender may minimize its losses to a far greater extent than would be possible in a Chapter 12 restructuring.

The Farm Credit System has recently adopted loan restructuring guidelines which are designed to accomplish basically the same purpose as a Chapter 12 proceeding, which, because they result in consensual agreements in the absence of bankruptcy, permit the lender to enjoy continued powers of loan policing and repossession which would be denied the lender by a Chapter 12 court.

Those same policies are adaptable to smaller banks as well. Farm lenders would be well advised to measure the benefits of a voluntarily renegotiated loan against the probable effects of adverse court determinations on such key questions as property valuation, interest rates and loan repayment terms. In a significant number of cases, a bank's long-term best interests and continued community good will would be better served by a voluntary workout than by having to live with a judicially-coerced loan agreement of dubious prospects and less attractive terms.

Of course, before even approaching the bargaining table, the bank should satisfy itself that the borrower is a "good farmer" -- that is, that his farming and husbandry practices, accounting procedures, maintenance of books and records, and commitment to his creditors are such that he is a sound credit risk. In making a straightforward analysis of this sort, the bank would be doing exactly what the Bankruptcy Court would do in a "feasibility test", which is to measure the prospects of success of the individual farmer.

IV. AFTER A CHAPTER 12 FILING: THE BEST DEFENSE IS OFFENSE

A. ATTACKING ELIGIBILITY REQUIREMENTS.

With the assistance of a qualified professional, the lender should always carefully review a Chapter 12 petition to determine whether the farmer meets the minimal eligibility standards. For example, the \$1.5 million debt limitation in Chapter 12 applies to total debt of all types,

and includes accrued but unpaid interest as of the petition date. Many petitioners fail to realize this and recite as their total debt only the original principal amount of such debt; in many cases, the addition of accrued but unpaid interest as of the petition date will push a petitioner over the \$1.5 million debt limit and thus disqualify him for Chapter 12 relief.

Chapter 12 also requires that a qualifying farmer must have received more than 50% of his gross taxable income during the preceding taxable year from the farming operation. Many are categorically disqualified on this single ground. A lender should carefully review the sources of income as reported by a Chapter 12 petition, and through the use of discovery devices known to bankruptcy lawyers, particularly the so-called "Rule 2004 Examination", a lender may be able to determine that the major part of last year's income was derived from non-farming sources. A Chapter 12 petition would be summarily dismissed upon such a showing.

B. FEASIBILITY.

The lender should keep in mind that only those farmers qualify for Chapter 12 who have a "sufficiently stable" projected future income from which they will be able to make the proposed Chapter 12 payments. This issue, the feasibility question, has a profound significance in the farming context because of the numerous uncertainties of weather and the market place which make the American farm a high risk enterprise at its very best. The farm lender

should have at its disposal a qualified farm analyst whose duty it is to thoroughly review all of a Chapter 12 farmer's operating history and his pro-forma projections of the future, in order to point out the weaknesses which are inherent in any such computations.

For example, a Chapter 12 plan which projects a crop yield greater than the prevailing county averages should be inherently suspect, as would one based on unrealistically high crop prices. Likewise, a farm operating statement which proposes the continued use of antiquated equipment in poor condition is open to attack. Continued dependence on high levels of government price-support programs should raise a strong question of feasibility in the mind of the bankruptcy judge.

It has been the experience of Chapter 12 practitioners that most Chapter 12 farmers, even with a significantly written-down secured debt load, and with the elimination of unsecured claims and relaxed debt service at low interest rates over the long term, are marginal at best. At the hands of a qualified expert for the lender, these facts of life should be not only pointed out the Bankruptcy Court, but repeated and reiterated at each and every opportunity. A recent decision of the United States Supreme Court strongly suggests this approach, and that opinion will be discussed later in this paper.

C. ADEQUATE PROTECTION

In no other area of bankruptcy law have creditors' rights been diluted so much by Chapter 12 as in the area known as "adequate protection," a heretofore time-honored doctrine which has been all but eliminated by the new chapter. Before explaining the changes in the law, it is first necessary to explain the concept, what it has meant under prior law, and what it now means under Chapter 12.

"Adequate protection" is a concept of constitutional origin. The Fifth Amendment to the Constitution of the United States guarantees that no person may be deprived of property without due process of law, and of course, secured creditors have property rights in their collateral. For that reason, a line of cases from the Supreme Court and lower courts dating back to the Great Depression of the 1930's established the principle that in order for a debtor to use secured property as part of a reorganization plan, he must first provide the affected creditor with "adequate protection". The required degree of protection was thought to be absolute; nothing short of the "indubitable equivalent" of the value of the secured property would suffice, according to the early cases.

The case law came to be incorporated into the statutes, and over the years it has come to be accepted in reorganization cases under other chapters of the Code that "indubitable equivalence" could take the form of a cash payment, periodic cash payments, or replacement liens on collateral of equal value.

Here it must be kept in mind that adequate protection is a pre-confirmation remedy, designed to protect the creditor's property until such time as the Court is satisfied that the debtor's plan will pay out its present value with interest over a term of years. Adequate protection arguments take the form of a motion for relief from the §362 automatic stay, which, if granted, permits the creditor to remove himself from Bankruptcy Court and pursue the full range of his nonbankruptcy remedies. In most cases, obviously, relief from the stay when granted to the larger secured creditors means the end of the reorganization effort.

Chapter 12 changed the adequate protection rules to a significant degree, and a 1988 opinion of the United States Supreme Court does further damage to the concept. These developments will be discussed in order.

In a respectable line of cases from the federal appellate courts, the view emerged that a Chapter 11 creditor was entitled to adequate protection in the form of "lost opportunity costs," an economist's way of saying that the secured lender should be compensated for the lost opportunity, caused by the bankruptcy, to reinvest the liquidated value of the collateral. In the farm Chapter 11 cases, therefore, it became standard practice for bankruptcy courts to require payment by the farmer-debtor of interest on the value of the collateral through the pendency of the proceeding, before confirmation, in order to keep the property and work toward a reorganization.

In the case of farmland, that protection no longer exists under Chapter 12. §1205 of the new law specifically permits adequate protection payments "for the use of farmland, the reasonable rent customary in the community where the property is located, based upon the rental value, net income, and earning capacity of the property."

Given the comparatively low rental values of farm properties in this jurisdiction, it is almost universally true that rent payments do not equate in the least to the amount which could be realized upon a reinvestment of the value of the farm property. It is the view of most experts that at least in the case of mortgaged farmland, the new Chapter 12 has all but erased the concept of adequate protection from the lawbooks.

Further sounding a retreat from the doctrine of adequate protection is the Supreme Court's recent decision in In re Timbers of Inwood, decided in January, 1988, which vigorously denounced and rejected the "lost opportunity cost" approach to adequate protection. In that case, the aggrieved lender, a Texas savings and loan association precluded indefinitely from foreclosing on its collateral valued at \$4.2 million, appealed through the federal court system on the theory that it had been deprived of its property without due process. In a strongly-worded opinion for a unanimous court, Justice Scalia declared an end to the practice of court-approved interim payments to undersecured lenders, as adequate protection, a practice which had been prevalent in

most bankruptcy courts, including those in Kentucky. Timbers of Inwood is generally taken for the proposition that undersecured creditors are no longer entitled to periodic preconfirmation payments equivalent to interest on the value of their collateral.

The opinion is, facially at least, very much a debtor-oriented pronouncement. It does not tell us what adequate protection is; rather it informs us what adequate protection is not. When read at the superficial level, Timbers of Inwood leaves bankruptcy courts without guidance and undersecured creditors without hope.

However, the opinion does contain language from which the attentive creditor may draw some comfort. In discussing a subsection of the Bankruptcy Code which was not really at issue, Justice Scalia suggested that it is the duty of every debtor in every reorganization case to prove not only that the property in question is necessary to a reorganization, but is necessary to a reorganization which may be accomplished in a reasonable length of time. That language in the opinion all but recommends that (a) a reorganization case should be substantially consummated within a year, and (b) to the extent that a debtor is not able to prove the ability to reorganize within that time, the secured creditor should be excused from the bankruptcy proceeding and permitted to foreclose. The "reasonable time" requirement of Timbers of Inwood should be less important in Chapter 12 than in other types of reorganization cases. Chapter 12 requires

that a reorganization plan be filed within 90 days of the petition, and the plan confirmed within 45 days thereafter. Total time elapsing from the date of filing to the confirmation would therefore seem to be a maximum of 135 days. However, as a practical matter, bankruptcy courts have not been able to conclude Chapter 12 cases within that short time period.

The time issue notwithstanding, however, it is likely that in future Chapter 12 cases, secured creditors will vigorously argue the feasibility question from the outset of a case, thereby shifting to the debtor-farmer the burden of proving that he does in fact have a reasonable prospect of reorganizing within a reasonable time. It likewise follows that bankruptcy courts will heed the mandate of our nation's highest court and appraise the farmer's prospects for success with a considerably more jaundiced eye.

It is important here to keep in mind that Timbers of Inwood eliminates the "lost opportunity cost" doctrine not only with respect to land, but also as to farm machinery and equipment, or any other form of collateral.

So now, the undersecured creditor, being unable to successfully contend for periodic payments equivalent to interest on the value of its collateral, must seek alternative methods of computing the lost property rights for which it should be justly compensated.

For example, a strong argument could be made that a secured creditor should be permitted to receive as adequate

protection payments the amounts by which its collateral could reasonably be expected to depreciate during the reorganization period. In the case of farm machinery and equipment, that can be no little sum. With farm equipment generally depreciating on a five-year schedule, the creditor could realistically argue for periodic payments totaling 20% of the fully depreciated value of the equipment, for a one-year period of reorganization. Inventive counsel may be able to come up with a number of other ways to restore meaning to the faltering adequate protection requirement.

D. PROTECT YOUR CASH COLLATERAL.

Closely related to the adequate protection doctrine is the concept of cash collateral, which under all chapters of the Bankruptcy Code requires a debtor to obtain creditor consent or prior court approval before using secured property or its proceeds, known as "cash collateral".

The farm cases uniquely lend themselves to opportunities for conversion, either innocent or intentional. As the creditor's crop-lien collateral changes form through the growing season, from crops in the ground to grain in the bin to cash in the bank, there are opportunities for dissipation of value at every stage of the metamorphosis.

Creditors should protect their collateral at an early stage in the Chapter 12 proceeding by filing a motion to sequester cash collateral, which will have the effect of preventing the debtor's further use of the property without prior court approval.

Even if the Bankruptcy Court should be inclined to permit the farmer to continue to use the cash collateral as part of his reorganization, the creditor has a right to demand a replacement lien on assets of similar value. In re Martin and other cases permit a farmer to use the proceeds of a secured crop, provided a replacement lien of equal amount is given on other crops growing in the field. Such "soft" collateral does little to protect the lender.

The creditor should take care to distinguish between "soft" collateral and "hard" collateral in order to protect itself to the fullest extent. For example, if a farmer has sold his crops and has cash in the bank, negotiable securities or government entitlement certificates, the creditor should vigorously contend that such secured assets may be used only if they are replaced by other collateral similar in form. Don't settle for a lien on the current year's growing crop, for example, if the collateral sought to be used is cash in the bank. Hold out for a replacement lien on hard assets subject to fewer liquidation risks.

And remember -- a vigorously demanding creditor, even if it does not get it asks for in the short term, may be able to pressure the debtor into extending more favorable long-term treatment under the Chapter 12 plan than the farmer otherwise would have been willing to propose.

E. INFORMATION AND INVESTIGATION

The Chapter 12 farmer is required to file monthly operating statements with the Bankruptcy Court through the

pendency of his proceeding, sufficiently detailed to inform the Court of the farm's cash flow for the period and changes in financial condition from month to month. Such reports normally are filed only with the Court and the Chapter 12 trustee. File a request with the Court that your firm name be put on the mailing list to receive such reports, and review them in detail in every month. Upon any change in circumstance that might present a danger to your collateral, notify the trustee or take formal action in court through your attorney.

The trustee has, in addition to the fiscal responsibilities imposed by the Code, investigatory powers which enable him to inquire into the status of the farming operation and its managements. The "grapevine" in rural communities operates with great efficiency, and a lender might informally learn that a particularly borrower is disposing of collateral or permitting the farming operation to decline. In such cases the creditor has every right to report such matters to the Chapter 12 trustee and request an inquiry, either formal or informal, into the farmer's operations and intentions. The creditor cannot take such actions unilaterally without Court approval because of the strictures of the §362 automatic stay, but if there is reasonable cause to believe that his property is being put at risk, he has every right to request such action of the trustee.

F. ASSUMPTION AND REJECTION OF LEASES.

Many farmers operate with leased equipment and do their farming on leased land. The creditors should always keep in mind that on land leases, the debtor in possession (whether under Chapter 12 or any other reorganization chapter) has 60 days within which to decide whether to assume or reject the outstanding land lease. If he makes no move whatsoever, the lease is "deemed rejected," and the farmer has lost his rights in the land. The vigilant creditor will know whether the farmer-debtor is sharecropping, and usually will know the landlord with whom he is dealing. If the farmer does not make the affirmative move to assume that lease within 60 days, creditors should immediately move to dismiss the Chapter 12 petition on the ground that the farmer has lost his lease and therefore the plan is not feasible.

If a creditor is leasing farm equipment and machinery to a debtor, that creditor should immediately file a motion with the Court to compel the debtor to either assume or reject the equipment lease. Unlike equipment mortgages, the equipment lease cannot be written down in Chapter 12 and must be performed in full according to contract terms, or the farmer must return the equipment to the lessor. In order to keep the property, the farmer must cure in full any outstanding default in rental payments, but he may be expected not to make any move to do so until forced by the lessor to make his decision. The proper procedural mode is to move under §365 to force the farmer to exercise his option.

G. THE NONDISCHARGEABILITY LAWSUIT

Section 523 of the Bankruptcy Code enumerates the specific types of obligations which may not be discharged in bankruptcy. Wilful and malicious injury to property (conversion), false financial statements in writing, and obtaining money, property or an extension of credit by false pretenses are the most common examples of nondischargeable debts.

When a creditor receives notice of a bankruptcy, it should immediately undertake a thorough review of the loan transactions with the debtor and the circumstances under which they were conducted, including personal consultation with the individual loan officers charged with that responsibility. It is a common occurrence for borrowers to overstate their assets and understate their liabilities in applying for a loan. The consequence could be a nondischargeable debt. Similarly, the "mysterious disappearance" or shortage of collateral, particularly in livestock and grain, occurs all too frequently in the agricultural cases, and the resulting losses to creditors can only be minimized, if at all, by bringing a nondischargeability lawsuit against the debtor.

Such actions must be brought shortly after the filing. The terminal date for such lawsuits will be recited in the notice of first meeting of creditors, received by all creditors listed in a bankruptcy petition, and must be scrupulously complied with. For this and other purposes, a

thorough review of the first meeting notice is essential in every case.

Nondischargeability actions are full-blown lawsuits, attended by all of the predictable attorneys fees and other costs of litigation, and for that reason should be undertaken only on a selective basis, involving the larger loans, and against only those farmer-defendants from whom actual recovery is a practical possibility.

* * * * *

V. CONCLUSION.

The foregoing text does not pretend to be a comprehensive discussion of creditors' rights under Chapter 12. It should be read with all of the caution accorded a roadmap without a scale, giving a general direction but without warning of the distance to be traveled or the hazards to be encountered.

As in any bankruptcy, the Chapter 12 landscape is littered with procedural barriers and substantive pitfalls against which the lonesome traveler has little chance of survival. But with a careful reading of each and every pleading and document generated by such a case, and with help along the way from a professional team of appraisers, farm analysts, junior loan officers and attorneys, the cautious creditor can emerge from the Chapter 12 process with losses less severe than it would have realized in a liquidation.

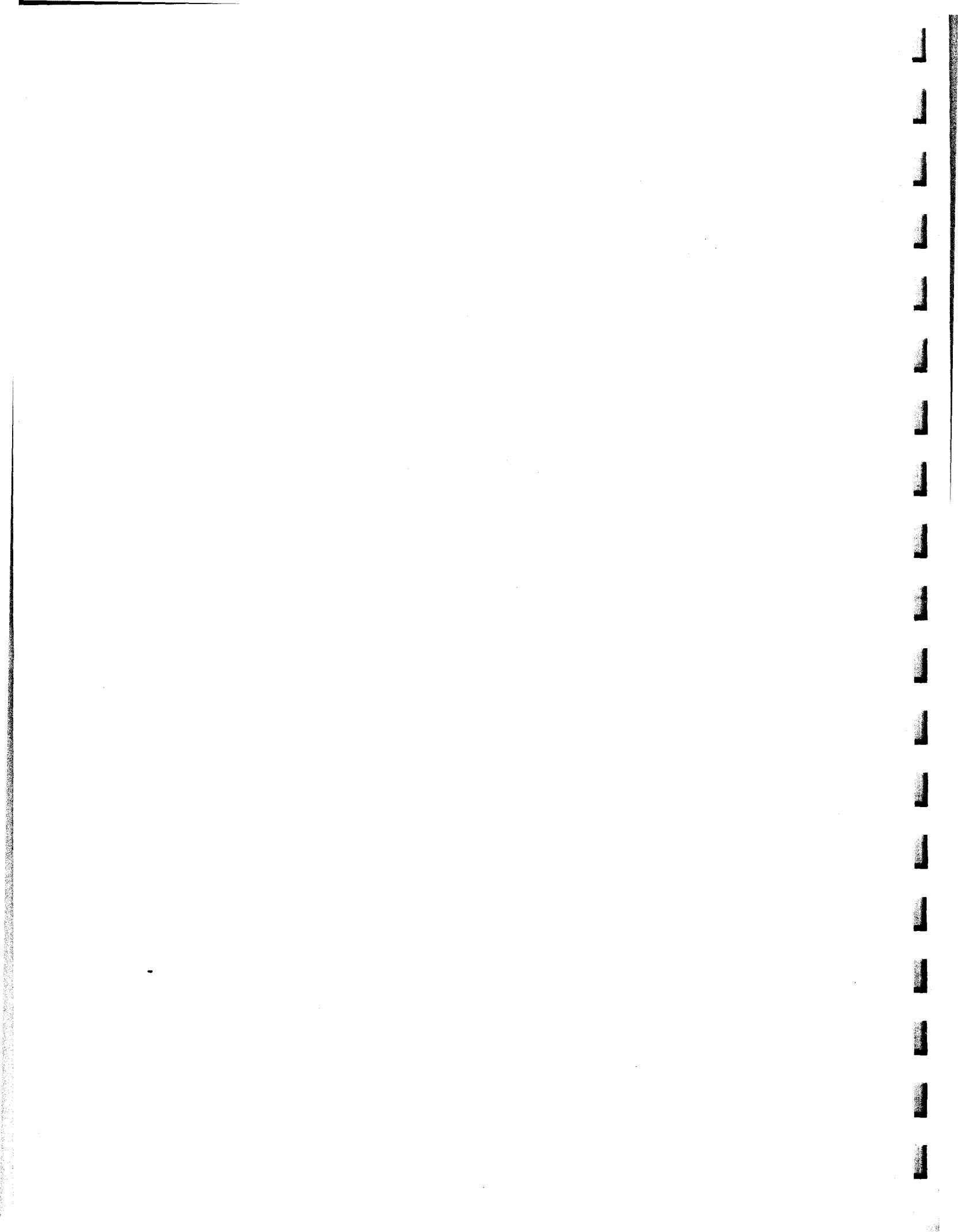

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G-22

CURRENT ISSUES FOR
DIRECTORS AND OFFICERS OF FINANCIAL INSTITUTIONS

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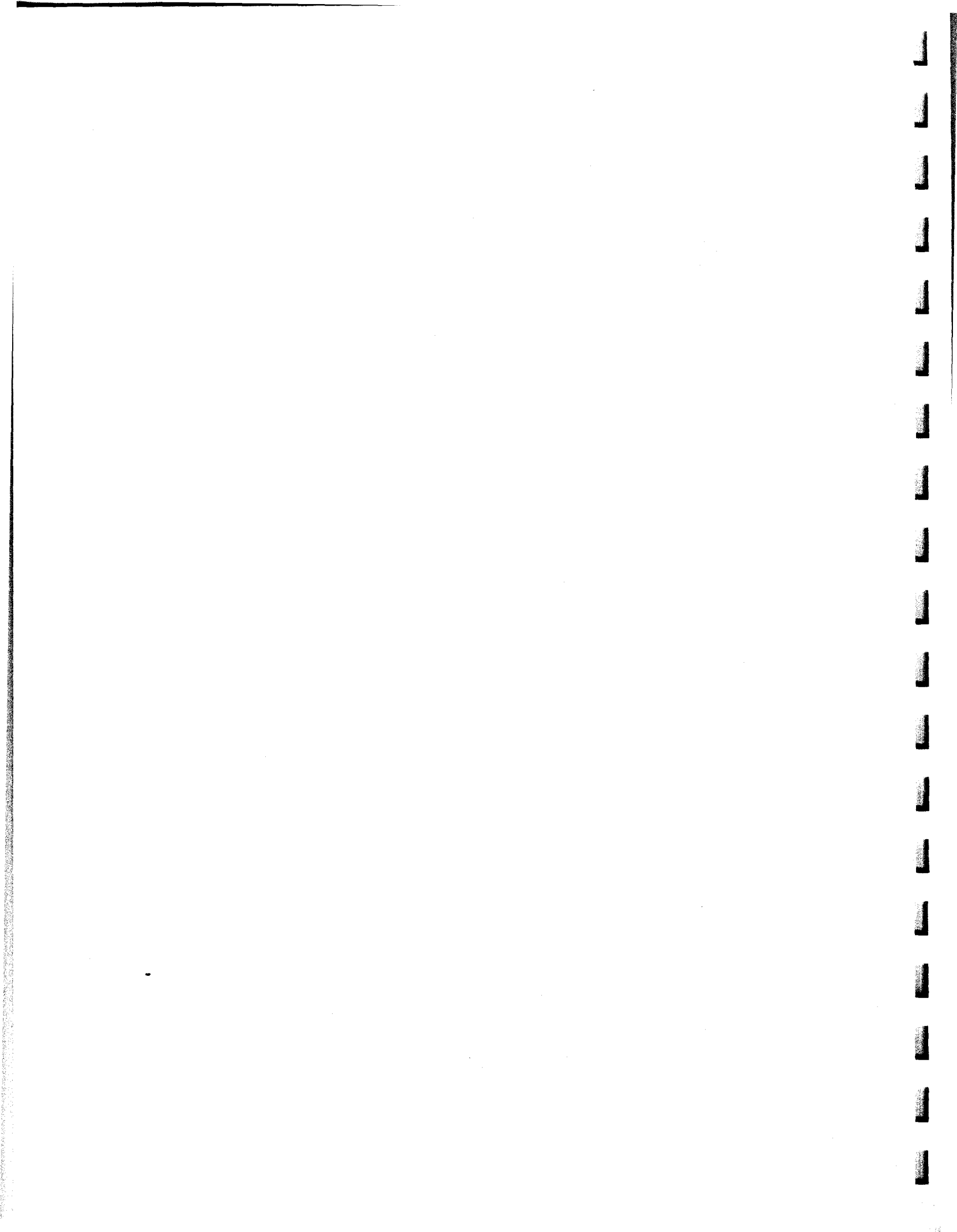
SECTION H



CURRENT ISSUES FOR
DIRECTORS AND OFFICERS OF FINANCIAL INSTITUTIONS

TABLE OF CONTENTS

	<u>Page</u>
*<u>BANK BRIBERY ACT</u>	
I. Background	H - 1
A. Amendment - generally	H - 1
B. Justice interpretation	H - 1
C. Congress broadened	H - 2
II. Guidelines For Compliance With the Federal Bank Bribery Law	H - 3
A. Bank Code of Conduct	H - 3
B. Other Considerations	H - 8
C. Disclosures and Reports	H - 8
**<u>MANAGEMENT SUPERVISION, ADMINISTRATION AND CONTROL</u> <u>OF BANKING OPERATIONS</u>	
I. Introduction	H - 10
II. Directors	H - 10
Selection and Qualification of Directors	H - 10
Powers Duties and Responsibilities of Directors	H - 11
Supervision By Directors	H - 13
Legal Liabilities of Directors	H - 14
Federal Banking Laws and Regulations Primarily pertaining to Bank Directors	H - 15
Indebtedness of Directors, Officers and their Interests	H - 16
Nonbanking Activities Conducted on Bank Premises	H - 17
Directors of "One Man Banks" and Advisory Directors	H - 17
III. Appraisal of Management	H - 18
Uniform Interagency Bank Rating System	H - 18
Meetings with Bank Directors	H - 18



Bank Bribery Act

I. BACKGROUND

A. Amendment - Generally

The Comprehensive Crime Control Act of 1984 (P.L. 98-473, title 11, October 12, 1984) amended the Federal bank bribery law, 18 U.S.C. section 215, to prohibit employees, officers, directors, agents and attorneys of financial institutions from seeking or accepting anything of value in connection with any transaction or business of their financial institution. The amended law also prohibited anyone from offering or giving anything of value to employees, officers, directors, agents or attorneys of financial institutions for or in connection with any transaction or business of the financial institution. Because of its broad scope, the 1984 Act raised concerns that it might have made what is acceptable conduct unlawful.

B. Justice Interpretation

In July 1985, the Department of Justice issued a Policy Concerning Prosecution Under the New Bank Bribery Statute. In that Policy, the Department of Justice discussed the basic elements of the prohibited conduct under section 215, and indicated that cases to be considered for prosecution under the new bribery law entail breaches of fiduciary duty or dishonest efforts to undermine financial institution transactions. Because the statute was intended to reach acts of corruption in the banking industry, the

Department of Justice expressed its intent not to prosecute insignificant gift giving or entertaining that does not involve a breach of fiduciary duty or dishonesty.

C. Congress Broadened

Congress decided that the broad scope of the statute provided too much prosecutorial discretion. Consequently, Congress adopted the Bank Bribery Amendments Act of 1985 (P.L. 99-370, August 4, 1986) to narrow the scope of 18 U.S.C. section 215 by adding a new element, namely an intent to corruptly influence or reward an officer in connection with financial institution business.

(a) Exception

The law now specifically excepts the payment of bona fide salary, wages, fees, or other compensation paid, or expenses paid or reimbursed, in the usual course of business. This exception is set forth in subsection 215(c).

(b) Penalty

The penalty for a violation remains the same as it was under the 1984 Act. If the value of the thing offered or received exceeds \$100, the offense is a felony punishable by up to five years imprisonment and a fine of \$5,000 or three times the value of the bribe or gratuity. If the value does not exceed \$100, the offense

is a misdemeanor punishable by up to one year imprisonment and a maximum fine of \$1,000.

(c) Publish Guidelines

The legislative history of the 1985 Act makes it clear that the guidelines would be relevant to, but not dispositive of, any prosecutorial decision the Department of Justice may make in any particular case. 132 Cong. Rec. 5944 (daily ed. Feb. 4, 1986). Therefore, the guidelines developed by the regulatory agencies are not a substitute for the legal standards set forth in the statute.

II. GUIDELINES FOR COMPLIANCE WITH THE FEDERAL BANK BRIBERY LAW

A. Bank Code of Conduct

The FDIC encourages all FDIC-insured state-chartered banks that are not members of the Federal Reserve System and all FDIC-insured state-licensed branches of foreign banks ("insured state nonmember banks") to adopt internal codes of conduct or written policies, or to amend their present codes of conduct, to include provisions that explain the general prohibitions of the bank bribery law. These guidelines relate only to the Federal bank bribery law and do not address other areas of conduct that an insured state nonmember bank would find advisable to cover in its code of ethics. Consistent with the intent of the statute to proscribe corrupt activity within:

(a) Generally

The bank's code of conduct should prohibit any employee, officer, director, agent or attorney of an insured state nonmember bank (hereinafter "Bank Official(s)") from (1) soliciting for themselves or for a third party (other than the bank itself) anything of value from anyone in return for any business, service or confidential information of the bank and (2) accepting anything of value (other than bona fide salary, wages and fees referred to in 18 U.S.C. § 215(c)) from anyone in connection with the business of the bank, either before or after a transaction is discussed or consummated.

(b) Knowledge

The insured state nonmember bank's code or policies should be designated to alert Bank Officials about the bank bribery statute, as well as to establish and enforce written policies on acceptable business practices.

(c) Written Exceptions

In its code of conduct, the insured state nonmember bank may, however, specify appropriate exceptions to the general prohibition of accepting something of value in connection with bank business. There are a number of instances where a Bank Official, without risk of corruption or breach of trust, may accept something

of value from one doing or seeking to do business with the insured state nonmember bank. The most common examples are the business luncheon or the special occasion gift from a customer. In general, there is no threat of a violation of the statute if the acceptance is based on a family or personal relationship existing independent of any business of the institution; if the benefit is available to the general public under the same conditions on which it is available to the Bank Official; or if the benefit would be paid for by the insured state nonmember bank as a reasonable business expense if not paid for by another party.

Other exceptions to the general prohibition regarding acceptance of things of value in connection with bank business may include:

(d) Other Exceptions

(i) Acceptance of gifts, gratuities, amenities or favors based on obvious family or personal relationships (such as those between the parents, children or spouse of a Bank Official) where the circumstances make it clear that it is those relationships rather than the business of the bank concerned which are the motivating factors;

(ii) Acceptance of meals, refreshments, entertainment, accommodations or travel arrangements, all of reasonable value, in the course of a meeting or other occasion, the

purpose of which is to hold bona fide business discussions or to foster better business relations, provided that the expense would be paid for by the bank as a reasonable business expense if not paid for by another party (the bank may establish a specific dollar limit for such an occasion);

(iii) Acceptance of loans from other banks or financial institutions on customary terms to finance proper and usual activities of Bank Officials, such as home mortgage loans, except where prohibited by law;

(iv) Acceptance of advertising or promotional material of reasonable value, such as pens, pencils, note pads, key chains, calendars and similar items;

(v) Acceptance of discounts or rebates on merchandise or services that do not exceed those available to other customers;

(vi) Acceptance of gifts of reasonable value that are related to commonly recognized events or occasions, such as a promotion, new job, wedding, retirement, holiday or birthday (the bank may establish a specific dollar limit for such an occasion); or

(vii) Acceptance of civic, charitable, educational, or religious organization awards for recognition of service and

accomplishment (the bank may establish a specific dollar limit for such an occasion).

By adopting a code of conduct with appropriate allowances for such circumstances, an insured state nonmember bank recognizes that acceptance of certain benefits by its Bank Officials does not amount to a corrupting influence on the bank's transactions. The policy or code may also provide that, on a case by case basis, an insured state nonmember bank may approve of other circumstances, not identified above, in which a Bank Official accepts something of value in connection with the bank business, provided that such approval is made in writing on the basis of a full written disclosure of all relevant facts and is consistent with the bank bribery statute.

In issuing guidance under the statute in the area of business purpose entertainment or gifts, it is not advisable for the FDIC to establish rules about what is reasonable or normal in fixed dollar terms. What is reasonable in one part of the country may appear lavish in another part of the country. An insured state nonmember bank should seek to embody the highest ethical standards in its code of conduct. In doing this, an insured state nonmember bank may establish in its own code of conduct a range of dollar values which covers the various benefits that its Bank Officials may receive from those doing or seeking to do business with the bank.

B. Other Considerations

(a) The code of conduct should provide that, if a Bank Official is offered or receives something of value from a customer beyond what is authorized in the bank's code of conduct or written policy, the Bank Official must disclose that fact to an appropriately designated official of the bank. The insured state nonmember bank should keep contemporaneous written reports of such disclosures.

(b) In this regard, an insured state nonmember bank's code of conduct or policy should require that its Bank Officials disclose all potential conflicts of interest, including those in which they have been inadvertently placed due to either business or personal relationships with customers, suppliers, business associates, or competitors of the bank.

C. Disclosures and Reports

To make effective use of these guidelines, the FDIC recommends the following additional procedures:

(c) The insured state nonmember bank should maintain a copy of any code of conduct or written policy it establishes for its Bank Officials, including any modification thereof;

(d) The insured state nonmember bank should require from its Bank Officials an initial written acknowledgment of its code or policy plus written acknowledgment of any subsequent material changes to the code or policy and the Bank Officials' agreement to a comply therewith; and

(e) The insured state nonmember bank should maintain contemporaneous written reports of any disclosures made by its Bank Officials in connection with a code of conduct or written policy.

MANAGEMENT SUPERVISION, ADMINISTRATION AND CONTROL

I. INTRODUCTION

The quality of management is probably the single most important element in the successful operation of a bank. For purposes of this section, "management" includes both the board of directors, which is elected by the shareholders, and executive officers, who are appointed to their positions by the board. In the complex, competitive and rapidly changing environment of financial institutions, it is extremely important for all members of bank management to be aware of the responsibilities entrusted to them and discharge those responsibilities in a manner which will ensure stability and soundness of the institution, so that it may continue to provide its community the financial services for which it was created.

The extreme importance of a bank director's position is clearly emphasized by the fact that bank directors can, in certain instances, be held personally liable. Also, Congress has placed great emphasis on the role of bank management by passing legislation which allows regulatory authorities to utilize "cease and desist" actions against individuals (instead of solely against the institution), to assess civil money penalties, and even remove an officer, director, or other person participating in the affairs of the bank when their gross negligence or disregard for safety and soundness considerations threatens the financial safety of the bank.

The board of directors is the source of all authority and responsibility. In the broadest sense, the board is responsible for formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare. On the other hand, the primary responsibility of executive management is implementation of the board's policies and objectives in the bank's day-to-day operations. While selection of competent executive management is critical to the successful operation of any bank, the continuing health, viability and vigor of the bank are dependent upon an interested, informed and vigilant board of directors. Therefore, the main thrust of this section is devoted to the powers, responsibilities and duties vested in bank directors.

II. DIRECTORS

Selection and Qualifications of Directors

Being selected to serve as a bank director is generally regarded as an honor, for it often denotes an individual's reputation as being successful in business or professional endeavors, public spirit-

ed, and entitled to public trust and confidence. It is this latter attribute and the public accountability implicit therein that distinguishes the office of bank director from directorships in most other corporate enterprises. Bank directors are not only responsible to the stockholders who elected them, but must also be concerned with safety of depositors' funds and the pervasive influence the bank exercises on the community it serves.

The importance of a director's position is emphasized by various laws governing the election of board members. Statutory or regulatory qualifications usually include taking of an oath of office, unencumbered ownership of a specific amount of the bank's capital stock, and residential and citizenship requirements. Other laws also pertain to qualification and selection of directors. There are, for example, certain restrictions, prohibitions, and penalties relating to: interlocking directorates; purchases of assets from or sales of assets to directors; commissions and gifts for procuring loans; and criminal activities such as embezzlement, abstraction, willful misapplication, making false entries, and improper political contributions. These qualifications and restrictions have no counterpart in general corporate law and both illustrate and emphasize the quasi-public nature of banking, the unique role of the bank director, and the grave responsibilities of that office. The position of bank director is one, therefore, not to be offered or entered into lightly.

Aside from the legal qualifications, each director should bring to the position particular skills and experience which will contribute to the composite judgment of the group. Directors should have ideas of their own and the courage to express them, sufficient time available to fulfill their responsibilities, and be free of financial difficulties which might tend to embarrass the bank. The one fundamental and essential attribute which all bank directors must possess without exception is personal integrity. Its presence usually gives assurance of a well-intentioned, interested and responsible director capable of assuming the important fiduciary responsibilities of the office and representing fairly and equitably the diverse interests of stockholders, depositors and the general public. Other desirable personal characteristics include: knowledge of the duties and responsibilities of the office; genuine interest in performing those duties and responsibilities to the best of their ability; capability of recognizing and avoiding potential conflicts of interest, or the appearance of same, which might impair their objectivity; sound business judgment and experience to facilitate understanding of banking and banking problems; familiarity with the community and trade area the bank serves and economic

conditions generally; and an independence in their approach to problem solving and decision making.

Powers, Duties and Responsibilities of Directors

The powers, duties and responsibilities of the board of directors are usually set forth in the applicable banking statutes and the bank's charter and bylaws. Generally speaking, the powers and responsibilities of bank directors include but are not limited to those discussed below.

Regulating the Manner in Which All Business of the Bank Is Conducted - Directors must provide a clear framework of objectives and policies within which executive officers must operate and administer the bank's affairs. These objectives and policies should, as a minimum, cover: investments; loans; asset, liability and funds management; profit planning and budgeting; capital planning; internal routine and controls; and personnel policies. Objectives and policies in most instances should be reduced to written form and reviewed on a periodic basis to determine that they remain applicable to the present operating environment. Examiners may encounter situations (often in smaller banks with control vested in one or a few individuals) where written policies have not been developed for these operational functions and management is reluctant to do so on the grounds that such written guidelines are unnecessary. To a considerable degree, the necessity for written policies may be inferred from the results achieved by management. That is, if the examiner's assessment of the bank reflects it is sound and healthy in virtually every important respect, it may be difficult to convince management of the need for formalized written policies. However, when deficiencies are noted in one or more aspects of a bank's operations, it is nearly always the case that absence of written and clearly defined objectives, goals, performance standards, and limits of authority is an important contributing factor. There are few better means of ensuring that directors are properly supervising the bank's affairs than by their direct participation in devising, enforcing, and modifying the institution's written guidelines on such matters as investments, loans, marketing, capital and profit planning. Moreover, it is recognized that the depth and detail of written policies may properly vary among banks, depending on the nature, scope and complexity of their operations. Therefore, it remains the Corporation's strongly held belief that all banks should have written policies which are readily understood by all affected parties, kept up-to-date, and relevant to the institution's needs and circumstances.

Corporate Planning - A vital part of the responsibilities of directors is to set the future direction of the bank. Planning, organizing, and controlling are three fundamental dimensions of management. Planning, however, has not been a priority concern for a large part of the banking industry. This may be due in part to the fact that the industry has historically been highly regulated and somewhat insulated from competitive pressures and sudden change. Dramatic changes in the structure, volatility and technology associated with the financial services market have altered this situation and have led to an emphasis on deregulating financial institutions. Increased competition and innovation have, consequently, produced an environment characterized by uncertainty.

Sound planning is indispensable in dealing with this uncertainty and rapid change. In order to be effective, planning must be dynamic, carefully attended to, and well-supported. Projections must be revised periodically as circumstances change and new strategies devised to meet stated objectives. An increasingly competitive marketplace suggests that an inadequate or illconceived planning process may be as much the cause of bank failure as poor loans.

An important examination function is the evaluation of the bank's planning process. A working knowledge of what constitutes an adequate planning process may be determined by considering such questions as: (1) How formal is the bank's planning process? (2) Who is involved? The board? Middle management? (3) Is the plan based on realistic assumptions regarding the bank's present and future market area(s) and nontraditional competitive factors? (4) Does the bank monitor actual performance against its plan? (5) Does the bank consider alternative plans in response to changing conditions?

Although the focus must be on an evaluation of the process, the plan itself cannot be ignored if in the examiner's judgment the plan is predicated on assumptions which are believed to be altogether inappropriate or unrealistic. This assessment must carefully take into account the personnel and financial resources and operating circumstances and conditions unique to the bank being examined. It is emphasized that plotting the future direction of the institution is, properly, the prerogative and responsibility of the board of directors and not examiners. However, when the goals and objectives chosen by directors are likely to result in significant financial harm to the bank, examiners would be remiss were they not to identify the deficiencies in the plan and attempt to effect necessary changes.

Absence of a satisfactory planning process or

glaring weaknesses in the plan itself are deficiencies which must be considered when appraising bank management. Where considered necessary, comments in the examination report may be in order.

Appointing, Dismissing at Pleasure, and Defining the Duties of Officers - It is a primary duty of a board of directors to select and appoint executive officers who are qualified to administer the bank's affairs effectively and soundly. It is also the responsibility of the board to dispense with the services of officers who prove unable to meet reasonable standards of executive ability and efficiency.

Honestly and Diligently Administering the Affairs of the Bank - The board of directors is charged with the responsibility of the conduct of the affairs of the bank. It is not expected to directly carry out details of the bank's business; these may be delegated to the bank's officers. But they may not be delegated and forgotten. The power to manage and administer carries with it the duty to supervise, therefore, directors must periodically examine the system of administration they have established to see that it functions properly. Should it become obsolete, it should be modernized, or should the bank's officers fail to function as intended, the cause(s) should be determined and corrections made.

Observance of Laws To Which the Bank is Subject - It is of utmost importance for directors to: ensure that executive management is cognizant of applicable laws and regulations; develop a system to effect and monitor compliance, which will likely include provisions for training and retraining personnel in these matters; and, when violations do occur, make correction as quickly as possible. Board members cannot be expected to be personally knowledgeable of all laws and regulations, but it is a duty inherent with their office to make certain that compliance with all laws and regulations receives high priority and violations are not knowingly committed by themselves or anyone in the bank's employ.

Avoiding Self-Serving Practices - Although somewhat independent from the responsibility to provide effective direction and supervision, the need for directors to avoid self-serving practices and conflicts of interest is of no less importance. Bank directors must act so as to place performance of their duties above personal concerns. Wherever there is a personal interest of a director which is adverse to that of the bank, the situation clearly calls for the utmost fairness and good faith in guarding the interests of the bank. Accordingly, directors must never abuse for personal advantage their influence with respect to

the bank's management, nor wrongfully employ confidential information concerning the bank's clients. The same principles with respect to self-serving practices and conflicts of interest apply to the executive management of the bank.

Paying Such Dividends as May Properly Be Paid -

The board of directors has the responsibility of maintaining an adequately capitalized bank and once this responsibility has been satisfied, the payment of dividends can and should receive consideration. Dividends represent the distribution of bank earnings to owners. Establishing the medium, rate, and date of payment must be based on the directors' overall assessment of the bank's financial condition.

Supervision by Directors

Supervision by directors does not necessarily indicate a board should be performing management tasks, but rather seeing that its policies are being implemented and adhered to and its objectives achieved. It is the failure to discharge these supervisory duties which has led to bank failures and personal liability of directors for losses incurred.

Directors' supervisory responsibilities can best be discharged by establishing procedures calculated to bring to their attention relevant and accurate information about the bank in a consistent format and at regular intervals. From this critical point, the remainder of a director's job unfolds. Directors who keep abreast of basic facts and statistics such as resource growth, capital growth, loan-to-deposit ratios, deposit mix, liquidity position, general portfolio composition, loan limits, loan losses and recoveries, delinquencies, etc., have taken a first, indispensable step in discharging their responsibilities. It is essential, therefore, that directors insist on receiving pertinent information about the bank in concise, meaningful and written form, and it is one of executive management's most important responsibilities to make certain directors are kept fully informed on all important matters and that the record clearly reflects this.

This critical need for and dependence on information involves a concern and responsibility for the integrity of not only the specific information furnished but the system that supplies it. Review of directors' reports should be undertaken during onsite examinations to ascertain the accuracy of the information being provided.

Directors' meetings which are conducted in a businesslike and orderly manner are a significant aid to fulfillment of the board's supervisory responsibilities. This requires, among other things, regularity in attendance. Physical presence is obviously necessary because absence without just cause is, like ignorance, not a valid defense. Moreover, a director's attendance should be an informed and intelligent one, and the record should show it. If directors dissent from the majority,

they should, for their own protection, insist upon their negative vote being recorded along with reasons for their action.

Careful and consistent preparation of an agenda for each directors' meeting not only assists in the conduct of such meetings, but also provides board members reasonable assurance that all important matters are brought to their attention. Agenda items will vary from bank to bank depending on asset size, type of business conducted, loan volume, trust activities and so forth. In general, the agenda should include: reports on income and expense; new, overdue, renewal, insider, charged-off and recovered loans; investment activity; personnel policies; and individual committee actions.

To carry out its functions, the board of directors may appoint and authorize committees to perform specific tasks and supervise certain phases of operations. In most instances, the name of the committee, such as loan, investment, examination, and if applicable, trust, identifies its duties. Of course, utilization of the committee process does not relieve the board of its fundamental responsibilities for actions taken by those groups. Review of the minutes of these committees should be a standard part of the board meeting agenda.

Communication of facts to a bank's board of directors is essential to sound and effective supervision. However, with the ever-broadening scope of modern banking and the increased complexity of banking operations, the ability of a board of directors to effectively supervise is becoming more difficult. Because of this, the use of outside personnel to provide management supervision is relatively common. While this does not release the board from its legal and implied responsibilities, it does provide an opportunity for management improvement through the use of these external sources. Since the early 1970's, the bank holding company has played a very large role in the supervision of its individual banks. Bank holding companies which control a number of banks may be able to provide individual bank boards with lending and investment counseling, audit and internal control programs or services, profit planning and forecasting, personnel efficiency reports, electronic data processing services, marketing strategy and asset appraisal reports. Banks which do not operate within a holding company organization are also able to obtain management assistance from various firms offering the above services. In the interest of quality supervision by a bank's board of directors, the use of outside advisors, while not releasing the board from its responsibilities, can be a valuable management tool.

Legal Liabilities of Directors

In general, directors and other corporate officers of a bank may be held personally liable for: a breach of trust; negligence which is the proximate cause of loss to the bank; ultra vires acts, or acts in excess of their powers; fraud; and misappropriation or conversion of the bank's assets. From the standpoint of imposing directors' liability where the facts evidence that fraud, misappropriation, conversion, breach of trust or commission of ultra vires acts is clearly shown, a relatively simple situation presents itself. Difficulties usually arise, however, in cases involving negligence (or breach of duty) which fall short of breach of trust or fraud.

Directors' liability for negligent acts is premised on common law principles for failure to exercise the degree of care prudent individuals would exercise under similar circumstances, and/or noncompliance with applicable statutory law, either or both of which proximately cause loss or injury to the bank. Statutory liability is reasonably well-defined and precise. Common law liability is somewhat imprecise since failure to exercise due care on the part of a director depends on the facts and circumstances of the particular case.

A director's duty to exercise due care and diligence extends to the management, administration and supervision of the affairs of the bank and to the use and preservation of its assets. Perhaps the most common dereliction of duty by bank directors is the failure to maintain reasonable supervision over the activities and affairs of the bank, its officers and employees. The actions and inactions listed below have been found to constitute negligence on the part of directors.

(1) An attitude of general indifference to the affairs of the bank, such as failing to hold meetings as required by the bylaws, obtain a statement of the financial condition of the bank, or examine and audit the books and records of the bank to determine its condition.

(2) Failure to heed warnings of mismanagement or defalcations by officers and employees and take appropriate action.

(3) Failure to adopt practices and follow procedures generally expected of bank directors.

(4) Turning over virtually unsupervised control of the bank to officers and employees in reliance upon their supposed fidelity and skill.

(5) Failure to acquaint themselves with examination reports showing the financial condition of a company to which excessive loans had been made.

(6) Assenting to loans in excess of applicable statutory limitations.

(7) Permitting large overdrafts in violation of bank's bylaws or permitting overdrafts to insiders in violation of law.

(8) Representing certain assets as good in a report of condition when such assets were called to the directors' attention as loss by the primary supervisor and directions were given for their immediate collection or removal from the bank.

In the final analysis, liability of bank directors for acts of negligence rests upon their betrayal of those who placed trust and confidence in them to perform honestly, diligently and carefully the duties of their office. While applicable principles involving directors' negligence (or breach of duty) are easy enough to state, their application to factual situations presents difficulties. In essence, the courts have judged the conduct of directors "not by the event, but by the circumstance under which they acted" (*Briggs v. Spaulding*, 141 U.S. 132, 155(1890), 35L.Ed. 662, 672). Courts also have generally followed what may be called the rule of reason in imposing liability on bank directors, "lest they should, by severity in their rulings, make directorships repulsive to the class of men whose services are most needed; or, by laxity in dealing with glaring negligences, render worthless the supervision of directors over . . . banks and leave these institutions a prey to dishonest executive officers" (*Robinson v. Hall*, 63 Fed. 222,225-226(4th Cir.1894)).

The following quotation represents a brief recapitulation of the law on the subject (*Rankin v. Cooper*, 149 Fed. 1010, 1013 (C.C.W.D. Ark. 1907):

"(1) Directors are charged with the duty of reasonable supervision over the affairs of the bank. It is their duty to use ordinary diligence in ascertaining the condition of its business, and to exercise reasonable control and supervision over its affairs (2) They are not insurers or guarantors of the fidelity and proper conduct of the executive officers of the bank, and they are not responsible for losses resulting from their wrongful acts or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors. (3) Ordinary care in this matter as in other departments of the law, means that degree of care which ordinarily prudent and diligent men would exercise under similar circumstances. (4) The degree of care required further depends upon the subject to which it is to be applied and in each case must be determined in view of all circumstances. (5) If nothing has come to the knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, upon the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would

awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible. Directors cannot, in justice to those who deal with the bank, shut their eyes to what is going on around them. (6) Directors are not expected to watch the routine of every day's business, but they ought to have a general knowledge of the manner in which the bank's business is conducted, and upon what securities its larger lines of credit are given, and generally to know of and give direction to the important and general affairs of the bank. (7) It is incumbent upon bank directors in the exercise of ordinary prudence, and as a part of their duty of general supervision, to cause an examination of the condition and resources of the bank to be made with reasonable frequency."

Federal Banking Laws and Regulations Primarily Pertaining to Bank Directors

Criminal Offense Involving Dishonesty or Breach of Trust - Section 19 of the Federal Deposit Insurance Act provides that, except with the written consent of the Corporation, no person shall serve as a director, officer, or employee of an insured bank who has been convicted of any criminal offense involving dishonesty or breach of trust. The Corporation does not view Section 19 as being punitive in intent. Rather, the essential criterion in assessing applications is whether the prospective director, officer or employee constitutes a significant threat or risk to the safety and soundness of the applicant bank. The FDIC's policy is to approve applications in which this risk is absent.

Part 349 of the Federal Deposit Insurance Corporation Rules and Regulations - Part 349 of the Rules and Regulations implements Title VIII of the Financial Institution Regulatory and Interest Rate Control Act of 1978 (FIRIRCA). Title VIII prohibits (1) preferential lending by a bank to executive officers, directors, principal shareholders of another bank, or any related interest of such person, when there is a correspondent account relationship between the banks; or (2) the opening of a correspondent account relationship between banks when there is a preferential extension of credit by one of the banks to an executive officer, director or principal shareholders of the other bank, or any related interest of such person. Title VIII also imposes reporting requirements with respect to certain insiders.

Section 22(h) of the Federal Reserve Act - Section 22(h) is incorporated into the Federal Deposit Insurance Act via Section 18(j)(2) and pertains to loans and extensions of credit by both member and nonmember banks to their executive officers,

directors, principal shareholders and their related interests (Section 18(j)(2) does not apply to any foreign bank in the United States but does apply to the insured branch itself). It is a very important statute in the examination and supervisory process because it is aimed at prevention and detection of insider abuse, a common characteristic of failed or failing banks.

Part 215 of Federal Reserve Regulation 0 implements Section 22(h) and requires that extensions of credit to executive officers, directors, principal shareholders or their related interests be made on substantially the same terms as those prevailing at the time for comparable transactions with persons not covered by the regulation. Aggregate lending limits are also imposed by Regulation 0 and apply to executive officers, principal shareholders and their related interests (but not to directors unless they are also principal shareholders or executive officers). Moreover, payment of overdrafts of directors or executive officers is prohibited unless part of a written, preauthorized interest-bearing, extension of credit plan. The requirements, prohibitions and restrictions of Regulation 0 are important and examiners should be fully familiar with them. The complete text of the regulation is contained in the Prentice-Hall volumes.

Section 337.3 of FDIC Rules and Regulations sets forth requirements for approval of extensions of credit to insiders. Specifically, prior approval of the bank's board of directors is necessary if an extension of credit or line of credit to any of the bank's executive officers, directors, principal shareholders, or to any related interest of any such person, exceeds the amount specified in the regulation when aggregated with the amount of all other extensions of credit or lines of credit to that person. This approval must be granted by a majority of the bank's directors and the interested party(ies) must abstain from participating directly or indirectly in the voting.

Any nonmember insured bank which violates or any officer, director, employee, agent or other person participating in the conduct of the affairs of a nonmember insured bank who violates any provision of Section 22(h) of the Federal Reserve Act may be subject to a civil penalty of not more than \$1,000 per day for each day the violations continue. In determining the amount of the penalty, the Corporation takes into account the financial resources and good faith of the bank or person charged, gravity of the violation, history if any of previous violations, and such other matters as justice may require. Examiners are reminded violations of Regulation 0 must be evaluated in accordance with the 13 factors specified in the

Interagency policy statement on assessment of civil money penalties.

Depository Institution Management Interlocks Act - (Part 348 of the FDIC Rules and Regulations) -

This act is contained in Title II of FIRIRCA and has as its general purpose the fostering of competition. It prohibits a management official of one depository institution or depository holding company from also serving in a similar function in another depository institution or depository holding company if the two organizations are not affiliated and are very large or are located in the same local area.

A person whose interlocking service in a position as a management official of two or more depository organizations began prior to November 10, 1978, and who was not immediately prior to that date in violation of Section 8 of the Clayton Act (15 U.S.C. Section 19), is not prohibited from continuing to serve in such interlocking positions until November 10, 1988, except for certain exceptions explained in the regulation. A number of other exceptions allowing interlocking relationships for certain organizations and their affiliates are detailed in Part 348 of the Rules and Regulations. Under Section 8(e) of the FDI Act, the Corporation may serve written notice of intention to remove a director or officer from office whenever, in its opinion, such director or officer of an insured bank has violated the Depository Institution Management Interlocks Act.

Securities Brokers - With certain exceptions, Section 78 of Title 12, U.S.C., provides that no officer, director, or employee of any corporation or unincorporated association, nor partner or employee of any partnership, and no individual employed or engaged in the general brokerage business shall serve at the same time as an officer, director, or employee of a bank which is a member of the Federal Reserve System. This prohibition does not apply to nonmember banks. Nevertheless, in applications for Federal deposit insurance which contemplate that securities brokers will be serving as bank directors, the Corporation generally requires written assurances that a separation of the roles of broker and bank director will be maintained. To preclude the possibility of improprieties or conflicts of interest, such assurances may also be required of securities brokers who are elected directors of operating banks.

Change in Bank Control Act of 1978 - Section 7(j) of the Federal Deposit Insurance Act prohibits any person, acting directly or indirectly or through or in concert with one or more other persons, from acquiring control of any insured bank through a purchase, assignment, transfer, pledge, or other disposition of voting stock of the insured bank unless the appropriate Federal banking agency has been

given sixty days' prior written notice of the proposed acquisition. An acquisition may be made prior to the expiration of the disapproval period if the agency issues written notice of its intent not to disapprove the action. The term "insured bank" includes any bank holding company which has control of any insured bank, and the appropriate Federal banking agency in the case of bank holding companies is the Board of Governors of the Federal Reserve System. The term "control" is defined as the power, directly or indirectly, to direct the management or policies of an insured bank or to vote 25% or more of any class of voting securities of an insured bank. Willful violations of this statute are subject to civil money penalties of up to \$10,000 per day. As was the case with respect to Section 22(h), this statute gives the Corporation important supervisory powers to prevent or minimize the adverse consequences that almost invariably occur when incompetent or dishonest individuals obtain positions of authority and influence in banks.

Indebtedness of Directors, Officers and Their Interests

The position of director or officer gives no license to special credit advantages or increased borrowing privileges. Loans to directors, officers and their interests must be made on substantially the same terms as those prevailing at the time for comparable transactions with regular bank customers. Therefore, management loans should be evaluated on their own merits. They should not be adversely classified merely because they are management loans. On the contrary, a bank directorate is often composed of the most reputable and creditworthy individuals in the community. Their business operations will, in many instances, necessitate bank loans, and these will ordinarily be among a bank's better assets. Since directors usually maintain a deposit relationship with their bank, this carries with it an obligation to meet their reasonable and prudent credit requirements.

On the other hand, there have been many instances where improper loans to officers, directors, and their interests resulted in serious losses. Unfortunately, when the soundness of a management loan becomes questionable, an embarrassing situation usually results. That is, management loans frequently may not be subject to the same frank discussion accorded other loans. Bank directors may assent to such loans, despite knowledge that they are unwarranted, rather than oppose a personal or business friend or associate. Moreover, directors who serve on the board in order to increase their opportunities for obtaining bank credit are reluctant to object to credit extensions to their colleagues. Problems that occur

with management loans have received considerable legislative attention and laws have been passed to curb abuses associated with the position of director or officer (e.g., Regulation O). However, while steps have been taken to reduce the potential for problems in this area, a review of the board's policies and actual practices regarding insider loans remains an intricate part of the examination process.

Nonbanking Activities Conducted on Bank Premises

Many banks conduct nonbanking activities on bank premises by selling insurance, e.g. credit life, accident and health, in conjunction with loan transactions of the bank. When these nontraditional banking activities take the form of establishment of a new department or subsidiary of the bank, the benefit and profit inures directly to the bank and its shareholders. When these activities are conducted on bank premises for the benefit of others, however, a bank may be deprived of corporate opportunity and profit. The FDIC has long taken the position that when nonbanking activities are conducted on bank premises either by bank personnel or others and when the benefit and profit does not flow directly to the bank, certain disclosures, approvals, and reimbursements must be made.

In all cases the bank's directors and shareholders should be fully informed regarding the activity. The operation should be approved by the bank's shareholders, and expenses incurred by the bank in connection with these operations formally approved by the board of directors annually. The bank should be adequately compensated for any expenses it incurs in furnishing personnel, equipment, space, etc. to this activity. It is recommended bank management disclose completely to its bonding company any such nonbanking activity conducted on its premises. Management would also be well advised to obtain acknowledgement from the bonding company that such activities do not impair coverage under the fidelity bond. Finally, the conduct of nonbanking activity must be in conformance with applicable state statutes and regulations.

Situations where the bank is being deprived of corporate opportunity through the diversion of opportunity or profit, or inadequately compensated for the utilization of its resources should be discussed with bank management and commented upon in the Examiner's Comments and Conclusions schedule. Additionally, the absence of disclosure and approval to the bank's directors, shareholders, and bonding company should be discussed with management and covered in the aforementioned schedule. Finally, in those in-

stances where the examiner believes, based on known facts, that a violation of applicable statutes or regulations has occurred, or where there is no question that a criminal violation has been committed, the matter should be handled in the usual manner as prescribed in other Sections of the Manual.

Directors of "One Man Banks" and Advisory Directors

Supervisory authorities are properly concerned about the "One Man Bank" wherein the institution's principal officer and stockholder dominates virtually all phases of the bank's policies and operations. Often this situation stems from the personality make-up of the principal officer or ownership control, and is usually abetted by an apathetic board of directors. Many bank directors when first elected have little or no technical knowledge of banking and feel dependent upon others more knowledgeable in banking matters. When this feeling becomes deep-seated and widespread, a managerial vacuum is created which an overly aggressive officer may fill and thus achieve a position of dominance. This development is facilitated by the fact that directors are very often nominated by bank officers to whom they feel indebted for the honor, even though stockholders elect them. Over the years, an officer can influence the election of a sufficient number of directors so that the officer is ultimately able to dominate the board and the affairs of the bank.

There are at least two potential dangers inherent in a "One Man Bank" situation. First, incapacitation of the dominant officer may deprive the bank of competent management, and because of the immediate need to fill the managerial void, may render the bank vulnerable to dishonest or incompetent replacement leadership. Second, problem cases resulting from mismanagement of such a bank's affairs are more difficult to solve through the normal course of supervisory efforts designed to induce corrective action by the bank.

A naturally sensitive situation develops where the value of a director diminishes due to extensive outside commitments, illness, etc. Often such individuals do not wish to relinquish their position and the bank may be hesitant to request they do so. Some banks have met this situation by establishing a position of honorary director (or similar title) for persons who are no longer able to effectively fulfill the demanding duties of bank director. Generally, the honorary director attends board meetings as desired and offers advice on a limited participation basis, but has no formal voice or vote in proceedings, nor the responsibilities or liabilities of the office, except where there may be

a continuing connection with a previous breach of duty as an official director.

III. APPRAISAL OF MANAGEMENT

Although the directorate is an indispensable part of management of a bank, the overall appraisal of management must include an accurate review and evaluation of the competency of the day-to-day management team. Information obtained by examiners from appraisal of the directorate's policies and procedures must be combined with the appraisal of executive officers in determining the overall quality of the bank's management.

In reviewing executive officers' performance, examiners need to determine: the consistency of objectives, policies and procedures in the various asset, liability and operational areas; that policies are being amplified and adhered to throughout the system; that systems have been established to facilitate efficient operation and communications; that the institution has developed planning processes which facilitate achievement of goals and objectives; that daily management has the experience and depth to make sound decisions and assure continuity of operations; and that management is capable of handling situations the institution might reasonably be expected to encounter in the future.

The appraisal of management is strongly contingent upon the assessments given the other four elements of the CAMEL rating system. That is, a bank's performance with respect to asset quality and diversification, capital adequacy, earnings capacity and trends, and liquidity and funds management is to a very significant extent a result of decisions previously made by the bank's directors and officers. Consequently, the management rating generally should be consistent with examiners' findings and conclusions in regard to these other factors. Several additional indicators of management's effectiveness, independent of or only indirectly related to the other four CAMEL elements, which must be considered in appraising management, are discussed in the following paragraphs.

Uniform Interagency Bank Rating System

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency have adopted for supervisory purposes a uniform Interagency system for rating the condition and soundness of the nation's banks. The uniform bank rating system involves an assessment of five critical aspects of a bank's condition and operations. Management and administration is one of those critical dimensions.

Management's performance must be evaluated against virtually all factors considered necessary to operate the bank within accepted banking practices and in a safe and sound manner. Thus, management is rated "1" through "5" with respect to: technical competence, leadership and administrative ability; compliance with banking regulations and statutes; ability to plan and respond to changing circumstances; adequacy of and compliance with internal policies; depth and succession; tendencies toward self-dealing; and demonstrated willingness to serve the legitimate banking needs of the community.

A rating of "1" is indicative of management that is fully effective with respect to almost all factors and exhibits a responsiveness and ability to cope successfully with existing and foreseeable problems that may arise in the conduct of the bank's affairs. A rating of "2" reflects some deficiencies but generally indicates a satisfactory record of performance in light of the bank's particular circumstances. A rating of "3" reflects performance that is lacking in some measure of competence desirable to meet responsibilities of the situation in which management is found. Either it is characterized by modest talent when above-average abilities are called for, or is distinctly below average for the type and size of bank within which it operates. Thus, its responsiveness or ability to correct less than satisfactory conditions may be lacking. A rating of "4" is indicative of management that is generally inferior in ability compared to the responsibilities with which it is charged. Finally, a rating of "5" is applicable in those instances where incompetence has been demonstrated. In these cases, problems resulting from management weakness are of such severity that management must be strengthened or replaced before sound conditions can be brought about.

Meetings with Bank Directors

In order to encourage director involvement in and enhance director awareness of the Corporation's supervisory efforts and to increase the effectiveness of such efforts, policies have been established governing meetings with bank boards of directors. The bank's composite rating is the single most important variable in the decision as to if and when these meetings should be held. Specifics of the Division's policies are detailed below.

Banks Assigned or Likely to be Assigned a Composite "4" or "5" Rating - The examiner-in-charge and the Regional Director or designee should meet with the board of directors (the required quorum in attendance) during or subsequent to the examination. Additional meetings or other contacts with the board of directors or appropriate

board committee may be scheduled at the Regional Director's discretion.

Banks Assigned or Likely to be Assigned a Composite "3" Rating - The examiner-in-charge should meet with the board (the required quorum in attendance) during or subsequent to the examination. Regional Office representation is at the discretion of the Regional Director. Additional meetings or other contacts with the board of directors or appropriate board committee may be scheduled at the discretion of the Regional Director or designee.

Banks Assigned or Likely to be Assigned a Composite Rating of "1" or "2" - The examiner-in-charge will meet with the board or a board committee during or subsequent to the examination when: 36 months or more have elapsed since the last such meeting; the management component of the CAMEL rating is "3", "4" or "5"; any other CAMEL performance rating is "4" or "5"; or any two performance ratings are "3", "4" or "5". It is important to note that meeting with a board committee (in lieu of the entire board) in conjunction with an examination is permissible only when the committee is influential as to policy, meets regularly, contains reasonable outside director representation and reports regularly to the entire board. Other factors which may be relevant to the decision of whether or not to hold a board meeting include recent changes in control ownership and/or top management, economic conditions, request by management for a meeting and any unique conditions or trends pertinent to the institution. Regional Office participation in meetings with composite-rated "1" or "2" banks is at the Regional Director's discretion.

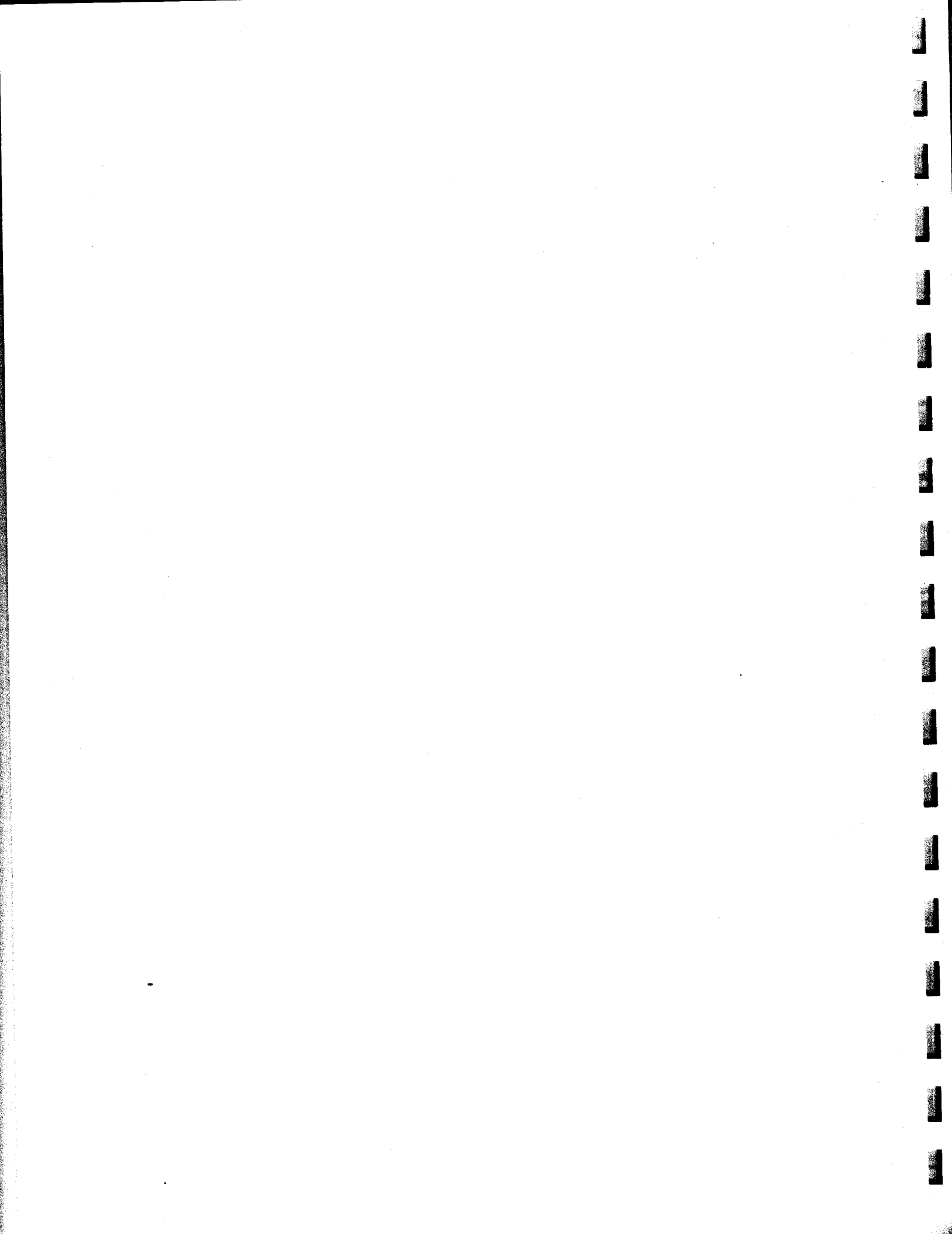
Other Considerations - When a meeting is held in conjunction with an examination, the names of board and/or committee members in attendance should be included on the Examiner's Comments and Conclusions schedule. A clear but concise presentation of the items covered at the meeting,

including corrective commitments and/or reactions of management, should also be indicated. If the meeting is not held in conjunction with an examination, a summary of the meeting should be prepared and a copy mailed to the institution, via certified mail, for consideration by the board and inclusion in the official minutes of the directorate's next meeting. As above, this meeting summary should include the names of attendees and the corrective commitments and/or reactions of management.

When it is concluded a meeting with a board committee rather than the full board is appropriate, selection of the committee must be based on the group's actual responsibilities and functions rather than its title. In all cases, the committee chosen should include an acceptable representation of board members who are not full time officers.

The success of the board meeting is highly dependent upon the examiner's preparation. A written agenda which lists all areas to be discussed and provides supporting documents or schedules will usually be worthwhile as a means of assisting in the explanation of certain aspects of the examination. Failure to adequately prepare for the meeting may substantially diminish the supervisory value of the examination.

To encourage awareness and participation on the part of board members, examiners should inform bank management that the examination report (or copies thereof) should be made available to each director for thorough and timely review. Management should also be reminded the report is confidential, remains the property of the Corporation, and that utmost care should be exercised in its reproduction and distribution. The bank should be advised to retrieve, destroy and record the fact of destruction of any reproduced copies when they have served their purpose.



THE TEN COMMANDMENTS
FOR
AVOIDING LENDER LIABILITY (ANNOTATED)
(Sixth Edition)

By

Helen Davis Chaitman
Ross & Hardies
Somerset, New Jersey



THE TEN COMMANDMENTS FOR AVOIDING LENDER LIABILITY

TABLE OF CONTENTS

	<u>PAGE</u>
I. THOU SHALT NOT MAKE A SUDDEN MOVE.....	I - 1
II. THOU SHALT NOT TELL A LIE (OR FUDGE THE TRUTH).....	I - 9
III. THOU SHALT HONOR THY COMMITMENTS.....	I - 14
IV. THOU SHALT NOT RUN THY BORROWER'S BUSINESS.....	I - 25
V. THOU SHALT NOT BAIL THYSELF OUT ON THY BROTHER'S MONEY.....	I - 31
VI. THOU SHALT KEEP THINE OWN FILES CLEAN.....	I - 39
VII. THOU SHALT TRANSFER A TROUBLED LOAN TO A WORKOUT OFFICER.....	I - 40
VIII. THOU SHALT CONFER WITH WORKOUT COUNSEL.....	I - 41
IX. THOU SHALT THINK CAREFULLY BEFORE SUING ON A DEFICIENCY.....	I - 42
X. THOU SHALT NOT BE ARROGANT.....	I - 44



THE TEN COMMANDMENTS FOR AVOIDING LENDER LIABILITY

TABLE OF CASES AND AUTHORITIES

999 v. C.I.T. Corp., 776 F.2d 866 (9th Cir. 1985).....	I -14
Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983).....	I - 6
Allied Sheet Metal Fabricators, Inc. v. Peoples National Bank, 518 P.2d 734 (Wash. App. 1974) <u>cert. den.</u> 419 U.S. 967 (1974).....	I - 4
In re American Lumber Co., 7 B.R. 519 (B. Minn. 1979, aff'd, 5 B.R. 470 (D. Minn. 1980).....	I -27
Bank of California, N.A. v. California Land & Equipment Leasing Co., Inc., et al., No. 3 Civ. C003135 (Court of Appeal, Third Appellate District, California)	I -34
Barnett Bank of West Florida v. Hooper, 498 So.2d 923 (Fla. 1986).....	I -32
Berkline Corp. v. Bank of Mississippi, 453 So.2d 699 (Miss. 1984).....	I -11
Betterton v. First Interstate Bank, 800 F.2d 732 (8th Cir. 1986).....	I- 4,23
In re Bowman Hardware & Elec. Co., 67 F.2d 792 (7th Cir. 1933).....	I -11
Brayton Chemicals, Inc. v. First Farmers State Bank of Minier, 671 F.2d 1047 (7th Cir. 1982).....	I -10
Brock v. Citicorp Industrial Credit, Inc., 107 S. Ct. 2694 (1987).....	I -30
Brown-Marx Associates Ltd. v. Emigrant Savings Bank, 703 F.2d 1361 (11th Cir. 1983).....	I - 4
Brown v. Avemco Investment Corp., 603 F.2d 1367 (9th Cir. 1979).....	I - 6
Carrico v. Delp, 490 N.E.2d 972 (Ill. App. 1986).....	I - 4
Central States Stamping Co. v. Terminal Equipment Co., Inc., 727 F.2d 1405 (6th Cir. 1984).....	I - 9
Centerre Bank of Kansas City, N.A. v. Distributors, Inc., 705 S.W.2d 42 (Mo. App. 1985).....	I-4,42,45
Commercial National Bank of Peoria v. Federal Deposit Insurance Corp., 476 N.E.2d 809 (Ill. 1985).....	I-12

Delcon Group, Inc., et al. v. Northern Trust Co., et al, No. 86 CH 0859 (Ill. Cir. Ct. DuPage County, 18th Judicial Cir. Dec. 3, 1987).....	I- 16
FDIC v. Scharenberg v. Continental Illinois National Bank No. 84-2712-CIV-DAVIS; No. 87-0211-CIV-DAVIS; No. 87-0238-CIV-DAVIS (U.S.D.Ct. S.D. Fla. 1987).....	I- 20
First National State Bank in Libby v. Twombly, 689 P.2d 1226 (Mont. 1984).....	I- 4, 23
First Virginia Bankshares v. Benson, 559 F.2d 1307 (5th Cir. 1977), <u>cert. den.</u> 435 U.S. 952 (1978).....	I- 11
First Wyoming Bank, Casper v. Mudge, 748 P.2d 713 (Wyo. 1988).....	I- 34
Flagship National Bank v. Gray Distribution Systems, Inc., et al., 10 F.L.W. 2722 (Fla. App. 1985) op. replaced 485 So.2d 1336 (Fla. App. 1986).....	I- 3
Fulton National Bank v. Willis Denney Ford, Inc., 269 S.E.2d 916 (Ga. App. 1980).....	I- 3
Gulf Oil Trading Co. v. Creole Supply, 596 F.2d 515 (2d Cir. 1979).....	I- 10
Hill v. Equitable Bank, N.A., 655 F.Supp. 631 (D. Del. 1987).....	I- 32
Jacques v. First National Bank, 515 A.2d 756 (Md. 1986).....	I-21, 33
Jersey Shore State Bank v. United States, 107 S. Ct. 782 (1987).....	I- 29
K.M.C., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985).....	I-1, 3
Kendal Yacht Corp. v. United California Bank, 50 Cal. App.3d 949 (1975).....	I- 7
Kruse v. Jewell v. Bank of America, No. 112439, Superior Court of Cal., Sonoma County (1985).....	I- 31
Landes Construction Co., Inc. v. Royal Bank of Canada, 833 F. 2d 1365 (9th Cir. 1987).....	I- 15
LeMaire v. MBank Abilene, N.A., No. 52,587 (240th Dist. Ct. Texas 1986).....	I- 15
In re Letterman Bros. Energy Securities Litigation, 799 F.2d 967 (5th Cir. 1986), <u>cert. den.</u> 107 S.Ct. 1373 (1987).....	I- 32

Lincoln National Life Ins. Co. v. NCR Corp., 772 F.2d 315 (7th Cir. 1985).....	I- 17
Melamed v. Lake County National Bank, 727 F.2d 1399 (6th Cir. 1984).....	I- 28
Monsen v. Consolidated Dressed Beef Co., 579 F.2d 739 (3d Cir.) <u>cert. den.</u> , 439 U.S. 930 (1978).....	I- 31
In re Osborne, 42 B.R. 988 (W.D. Wisc. 1984).....	I- 10
Penthouse International Ltd. v. Dominion Federal Savings & Loan Assoc. and Melrod, Redman & Gartlan, P.C., Civ. No. 84-4325 (S.D.N.Y. July 29, 1987).....	I- 17
Reid v. Key Bank of Southern Maine, Inc., 821 F.2d 9 (1st Cir. 1987).....	I- 3
Ricci v. Key Bancshares of Maine, Inc., No. 82-0249-P (D. Me. April 10, 1987).....	I- 5
Rigby Corp. v. Boatmen's Bank and Trust Co., 713 S.W.2d 517 (Mo. App. 1986).....	I- 4
Robinson v. McAllen State Bank, No. C-1948-84-D (Texas 206th Dist. Ct. (1987).....	I- 24
Rubin Bros. Footwear, Inc. v. Chemical Bank, 83 CIV. 6910 (S.D.N.Y. 1987).....	I- 33
Sahadi v. Continental Illinois National Bank & Trust Co., 706 F.2d 193 (7th Cir. 1983).....	I- 5
Schaller v. Marine National Bank of Neenah, 388 N.W. 2d 645 (Wisc. App. 1986).....	I- 7
Security Pacific National Bank v. Williams, Nos. 457727/ 457728, San Diego County Superior Court (1986).....	I- 25
Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944 (Mo. App. 1986).....	I- 14
Skeels v. Universal C.I.T. Credit Corp., 335 F.2d 846 (3d Cir. 1964).....	I- 22
Snow v. Western Savings & Loan Assoc., 730 P.2d 204 (Ariz. 1986).....	I- 7

Southeast Bank, N.A. v. Atrio Consolidated Industries, Inc. <u>et al.</u> , No. 82-552 CA16 (Circuit Court of the Eleventh Judicial Circuit, Dade County, Florida 1985).....	I-42
Spencer Companies, Inc. v. Chase Manhattan Bank, N.A., et al., No. 87-0911-C (D. Mass. Dec. 1, 1987).....	I-3,7
State National Bank of El Paso v. Farah Manufacturing Co., Inc., 678 S.W.2d 661 (Tex. App. 1984).....	I-12,25,45
Sterling Faucet Co. v. First Municipal Leasing Corp., No. LR-C 80-276 (W.D. Ark. July 30, 1982), aff'd, 716 F.2d 543 (8th Cir. 1983).....	I-16
Teachers Insurance & Annuity Assn. v. Butler, 626 F.Supp. 1229 (S.D.N.Y. 1986).....	I-17
United States v. Maryland Bank & Trust Co., 632 F.Supp. 573 (D.Md. 1986).....	I-28
United States v. Mirabile, 15 Envir. L. Rep. 20992 (E.D. Pa. 1985).....	I-28
Walton Motor Sales v. Ross, 736 F.2d 1449 (11th Cir. 1984).....	I-28
Whitney v. Citibank, N.A., 782 F.2d 1106 (2d Cir. 1986).....	I-33
Yankton Production Credit Assn. v. Larsen, 365 N.W.2d 430 (Neb. 1985).....	I- 4
Internal Revenue Code § 3505(b).....	I-29
29 U.S.C. § 201 <u>et seq.</u>	I-29
42 U.S.C. § 9601 <u>et seq.</u>	I-29

I. THOU SHALT NOT MAKE A SUDDEN MOVE ¹

Lenders cannot rely upon provisions in their loan documents which permit them to call a loan without notice or to refuse to continue a long-term financing relationship without notice. Unless a lender must take sudden action to protect the business interests of his lending institution, he must give a borrower a reasonable period of notice to allow the borrower an opportunity to obtain other financing.

For example, in K.M.C, Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985), the Court of Appeals for the Sixth Circuit affirmed a \$7.5 million jury verdict against Irving Trust for damages caused by Irving Trust's refusal to advance, under a discretionary advance clause. Irving Trust had an inventory and accounts receivable financing arrangement with K.M.C., a whole-sale grocery business in Knoxville, Tennessee, under which Irving Trust could advance "in its discretion" up to \$3.5 million based upon eligible accounts receivable and inventory. The financing provided for a lockbox arrangement pursuant to which all accounts were received directly by Irving Trust and Irving Trust advanced on a daily basis to cover K.M.C.'s checks.

On March 1, 1982, the president of K.M.C. called his loan officer at Irving Trust and asked for an \$800,000 advance to cover checks which would be presented to the bank that day. The

^{1/} The annotations herein are by no means exhaustive. They are merely intended to illustrate the consequences of violating these commandments.

loan officer, who was unhappy with K.M.C. management, refused to make the advance, even though it was within the \$3.5 million line of credit and even though the bank was fully collateralized.

The president of K.M.C. begged the loan officer to make the advance, explaining that if checks bounce in the wholesale grocery industry it destroys the business. The loan officer still refused. A lawyer for someone who was negotiating to acquire K.M.C. then called the loan officer and asked him to continue K.M.C.'s financing at least for enough time for his client to come to Knoxville and evaluate the business for purposes of acquisition. The loan officer conceded that Irving Trust was adequately collateralized to cover the \$800,000 advance and finally agreed to make the advance, but changed his mind the next day and refused to make the advance.

The checks issued by K.M.C. bounced and, although Irving Trust did make a \$700,000 advance three days later, and thereafter financed the company for a few months, the company was forced to liquidate as a result of the March 1, 1982 refusal to cover outstanding checks.

The Court of Appeals, interpreting New York law, held that under the Uniform Commercial Code there is an obligation of a lender to deal in good faith with a borrower and that in the kind of financing involved here, the lender must give the borrower some notice to permit the borrower to obtain alternate financing. The Court stated:

"The record clearly established that a medium-sized company in the wholesale grocery busi-

ness, such as K.M.C., could not operate without outside financing. Thus, the literal interpretation of the financing agreement urged upon us by Irving, as supplemented by the 'blocked account' mechanism, would leave K.M.C.'s continued existence entirely at the whim or mercy of Irving, absent an obligation of good faith performance. Logically, at such time as Irving might wish to curtail financing K.M.C., as was its right under the agreement, this obligation to act in good faith would require a period of notice to K.M.C. to allow it a reasonable opportunity to seek alternative financing, absent valid business reasons precluding Irving from doing so." (Id. at 759.)

In Reid v. Key Bank of Southern Maine, Inc., 821 F.2d 9 (1st Cir. 1987), the First Circuit followed the K.M.C. holding in affirming a \$100,000 compensatory damage award against a lender which terminated a line of credit without adequate notice. The court refused to enforce the strict language of the demand note executed by the borrower because of the provisions - such as events of default - in the loan documents which were inconsistent with a demand note relationship.

The K.M.C. holding was expressly rejected by a federal court in Massachusetts construing New York law. In Spencer Companies, Inc. v. Chase Manhattan Bank, N.A., et al., Civil No. 87-0911-C (D. Mass. Dec. 1, 1987), the court held that the duty of good faith does not apply to demand instruments.

Courts in four other states (Georgia, Florida, Missouri and Washington) have held that the duty of good faith under the Uniform Commercial Code does not apply to limit the enforceability of a demand instrument. Fulton National Bank v. Willis Denney Ford, Inc., 269 S.E.2d 916 (Ga. App. 1980); Flagship

National Bank v. Gray Distribution Systems, Inc., et al, 10 F.L.W. 2722 (Fla. App. 1985) op. replaced 485 So.2d 1336 (Fla. App. 1986); Centerre Bank of Kansas City, N.A. v. Distributors, Inc., 705 S.W.2d 42 (Mo. Ap. 1985); Allied Sheet Metal Fabricators, Inc. v. Peoples National Bank, 518 P.2d 734 (Wash. App. 1974), cert. den. 419 U.S. 967 (1974).^{2/}

In most jurisdictions, however, courts will probably analyze any sudden action taken by a lending institution in the context of the duty to deal in good faith with a borrower. In Carrico v. Delp, 490 N.E.2d 972 (Ill. App. 1986), an Illinois court held that a lender could not terminate a line of credit at will even though the loan agreement did not state a specific term and even though it gave the lender the right to advance in its discretion. The court held that the agreement gave the lender "reasonable, not absolute discretion" and remanded the case to the trial court for a determination as to what constituted a reasonable term for the financing agreement and whether the lender's refusal to lend was a reasonable exercise of discretion.

^{2/} Some courts have held that a claim for breach of the covenant of good faith under the Uniform Commercial Code does not give rise to a claim for punitive damages. E.g., Rigby Corp. v. Boatmen's Bank and Trust Co., 713 S.W.2d 517 (Mo. App. 1986). See also, Carrico v. Delp, 490 N.E.2d 972 (Ill. App. 1986) (breach of line of credit agreement does not give rise to claim for punitive damages); Betterton v. First Interstate Bank, 800 F.2d 732 (8th Cir. 1986) (breach of UCC duty of good faith is not a tort); Brown-Marx Associates Ltd. v. Emigrant Savings Bank, 703 F.2d 1361 (11th Cir. 1983); Yankton Production Credit Assn. v. Larsen, 365 N.W.2d 430 (Neb. 1985); First National Bank in Libby v. Twombly, 689 P.2d 1226 (Mont. 1984).

The largest jury verdict in the history of the State of Maine was returned against a lender which took sudden action in terminating a line of credit. On April 13, 1987, a jury in Portland, Maine returned a verdict of \$15 million plus \$6 million in prejudgment interest in favor of Joseph J. Ricci and against Key Bank of Southern Maine. The jury also awarded \$12 million of punitive damages which was set aside by the trial judge.

In 1981 bank officers were told by FBI agents that Ricci was connected to organized crime, that he was suspected of laundering money and that he was believed to be responsible for the 1979 killing of a local mobster, Anthony (Little Joe) Napolitano.

The bank cut off Ricci's credit, thereby destroying his business. At trial, FBI agents testified that their information about Ricci was incorrect -- that they had confused him with another man named Ricci. The bank's attempt to bring the FBI in as a third party defendant failed because the FBI successfully asserted immunity from suit.

The federal district court jury found that the bank, which was then called Depositors Trust Co., had violated federal banking laws dealing with equal credit opportunities, had breached its contract with Ricci, and had intentionally caused him emotional distress. Ricci v. Key Bancshares of Maine, Inc., No. 82-0249-P (D. Me. April 10, 1987).

Even where a bank feels it has a debtor's default to rely upon, a court may hold a bank liable for accelerating a debt. In Sahadi v. Continental Illinois National Bank & Trust Co., 706

F.2d 193 (7th Cir. 1983), the Court of Appeals held that a borrower's failure to make an interest payment on the date required under a workout agreement was not a sufficient ground for the lender to call the loan one day after the interest payment was due, even though the agreement specifically authorized acceleration of the debt if an interest payment was late. The Court, noting that the borrower had ample funds on deposit with the lender to cover the interest payment, remanded the case for trial on the issue of whether the late payment was a "material" breach of the loan agreement sufficient to absolve the lender of liability for accelerating the loan.

In Brown v. Avemco Investment Corp., 603 F.2d 1367 (9th Cir. 1979), the Court of Appeals held that the duty to deal in good faith under the Uniform Commercial Code applies to a "due on sale" clause in a security agreement covering an airplane and that a creditor may not exercise an option to accelerate based upon the debtor's lease of the airplane in breach of the agreement unless the creditor believes in good faith that the breach has impaired the creditor's ability to be repaid.

In Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983), the Alaska Supreme Court held that a borrower could recover actual and punitive damages from a lender who had taken possession of its collateral without notice, in spite of the fact that the loan agreement authorized such repossession. The court held that the lender had waived its right to strictly enforce the loan agreement by previously accepting late payments and by nego-

tiating with the borrower for an extension of the loan.^{3/}

In Snow v. Western Savings & Loan Assoc., 730 P.2d 204 (Ariz. 1986), the Arizona Supreme Court held that a mortgagee could be liable in contract or tort for preventing a sale of commercial real estate by threatening to enforce an invalid due-on-sale clause in spite of the mortgagee's good faith belief that the clause was enforceable.

The mortgagee refused to consent to the Snows' sale of an apartment complex in 1982 unless the purchasers accepted certain changes in the mortgage including an increased interest rate. As a result, the sale fell through and the Snows sued the mortgagee alleging that the mortgagee prevented the sale without any legal right to insist on the changes in the mortgage. While the mortgagee conceded that the law today clearly prohibits the enforcement of a due-on-sale clause against commercial real estate, it claimed that its good faith belief that the clause was enforceable in 1982 shields it from any liability to plaintiffs for anticipatory breach of contract or the tort of interference

^{3/} In Schaller v. Marine National Bank of Neenah, 388 N.W.2d 645 (Wisc. App. 1986), it was held that the duty of good faith does not require a bank to give a customer notice of its intention to dishonor overdrafts even though it had established a practice of honoring this customer's overdrafts for years. But see Kendal Yacht Corp. v. United California Bank, 50 Cal. App.3d 949 (1975) (bank liable for compensatory, but not punitive, damages for not honoring overdrafts after encouraging plaintiff to believe that overdrafts would be honored); Spencer Companies, Inc. v. Chase Manhattan Bank, N.A., et al, No. 87-0911-C (D.Mass. Dec. 1, 1987) (construing New York law, duty of good faith requires notice before changing course of dealing of honoring overdrafts).

with contract.

The trial court granted summary judgment in favor of the mortgagee on both the contract and tort claims and this holding was affirmed by the court of appeals. In reversing, the Supreme Court held that the adverse effects of a dispute over the meaning of a contract should be borne by the mistaken party, even if acting in good faith. The Supreme Court also held that, based on the record before it, a jury could reasonably find that the mortgagee intentionally interfered with the Snows' contract to sell the property and therefore reversed the order granting the mortgagee summary judgment dismissing the Snows' tort claim. The Supreme Court expressly reversed the trial court's finding that the mortgagee established a privilege defense against the interference with contract claim by its good faith belief in the enforceability of the due-on-sale clause.

II. THOU SHALT NOT TELL A LIE (OR FUDGE THE TRUTH)

(a) Credit Inquiries

One of the most difficult problems for commercial lenders is answering credit inquiries in situations where their borrowers are in trouble. The law imposes no obligation upon a lender to answer a credit inquiry in most situations. But once an answer is given, the answer must be truthful and complete.

In Central States Stamping Co. v. Terminal Equipment Co., Inc., 727 F.2d 1405 (6th Cir. 1984), the prospective purchaser of a machine contacted the seller's bank which had assumed a supervisory role over the seller's business. The purchaser asked about the integrity of the seller's chief executives and the seller's relationship with the bank. The bank officer was positive in his responses except he said the company was "under-capitalized." Based upon this information, the purchaser agreed to purchase a machine from the seller and gave the seller advance payments which were used by the seller to pay attorneys' fees and other personal expenses. The machine was never delivered and the seller went bankrupt. The appellate court affirmed a jury verdict of \$50,000 in favor of the purchaser and against the bank based upon a theory of fraudulent misrepresentation since the bank officer failed to disclose that the seller was in default on two loans with the bank and that the seller's financial position was shaky. The court held that the loan officer, having advised the purchaser about the seller's financial position, had a duty to disclose all information which would reasonably be considered

important to the purchaser.

Where a lender encourages a creditor to ship goods to the lender's borrower by giving assurances of payment, courts will often compel the lender to pay the creditor's claim directly if the borrower is in bankruptcy. In Brayton Chemicals, Inc. v. First Farmers State Bank of Minier, 671 F. 2d 1047 (7th Cir. 1982), the Court of Appeals affirmed a supplier's judgment against a lender in the amount of an invoice for goods shipped to the lender's customer after a misleading response by the lender to a credit inquiry. The supplier spoke to the lender and was told that the lender's customer was "A-1" and that the lender did not feel there was any cause for worry. In fact, at the time of that conversation, the lender had refused to make any further advances to that customer for nine months, the customer was unable to meet its financial obligations, and the lender had been involved in unsuccessful efforts to sell the customer's business.

Similarly, in In re Osborne, 42 B.R. 988 (W.D. Wisc. 1984), the court subordinated the claim of Production Credit Association ("PCA") to the claim of a creditor who shipped grain to a PCA borrower to feed cattle pledged to the PCA to secure the borrower's loan. When the borrower went into bankruptcy, the court, in effect, ordered the PCA to pay the grain supplier's claim directly because the grain supplier relied upon PCA assurances of payment in delivering the grain.

In Gulf Oil Trading Co. v. Creole Supply, 596 F. 2d 515 (2d Cir. 1979), the Court of Appeals affirmed a judgment against

Chase Manhattan Bank in favor of Gulf Oil which had supplied fuel to ships which were mortgaged to Chase. The fuel was used to move the vessels out of United States waters into Bahamian waters where Chase had the ships arrested and sold. The evidence showed that Chase knew that if the ships were arrested in United States waters, creditors of the ships might be given priority over Chase, whereas in the Bahamas Chase would have priority over the other creditors. Under these circumstances, the Court held that Chase would be unjustly enriched if it were not required to pay Gulf Oil for the fuel.

Finally, in In re Bowman Hardware & Elec. Co., 67 F.2d 792 (7th Cir. 1933), the court subordinated the lender's claim to the claim of a creditor to whom the bankrupt, at the lender's request, had denied that he had any indebtedness to anyone. Since the lender insisted on the nondisclosure, the lender was held responsible to the creditor who relied upon the bankrupt's misrepresentations.

In First Virginia Bankshares v. Benson, 559 F.2d 1307 (5th Cir. 1977) cert. den. 435 U.S. 952 (1978), the Court of Appeals for the Fifth Circuit held that a commercial lender was liable under the federal securities laws and under applicable common law for failing to disclose to a business broker, in response to a credit inquiry, that the borrower was behind in payments and had been doctoring its books.

In Berkline Corp. v. Bank of Mississippi, 453 So.2d 699 (Miss. 1984), a cause of action was sustained against a lender

where a furniture supplier alleged that the lender had given credit information to the supplier which was misleading and inaccurate.

In Commercial National Bank of Peoria v. Federal Deposit Insurance Corp., 476 N.E.2d 809 (Ill. 1985), a jury verdict for fraud was affirmed against a bank which had misled a participant bank in failing to advise the participant bank that the borrower had laid off all of its employees, that the contract which was to provide the money to repay the loan never existed, and that the proceeds of the loan were used to pay off an overdraft at the defendant bank.

(b) Negotiations

In negotiating in a workout context, the lender must be very careful not to make threats which he does not intend to carry out. In State National Bank of El Paso v. Farah Manufacturing Co., Inc., 678 S.W.2d 661 (Tex. App. 1984), a jury verdict for \$18.9 million compensatory damages was affirmed (but reduced to \$18.6 million), based in part upon evidence that the bank had, along with three other participating lenders, defrauded the borrower by telling a member of the borrower's board of directors that it would call the loan and bankrupt the company if the board elected Willie Farah as chief executive officer. The banks relied upon a management change clause in their loan agreement which allowed them to call the loan if two of the four banks considered a management change to be adverse to their interests. The evidence at trial showed that the banks had met and

agreed that they would not call the loan if the change in management were made, but that they should threaten that they would call the loan in order to influence the board to vote against Willie Farah as CEO. The Texas appellate court held that the threat constituted a fraudulent misrepresentation on which the board member relied in changing his vote because he didn't want to be responsible for the bankruptcy of the company.

III. THOU SHALT HONOR THY COMMITMENTS

Once a commitment for financing has been given, a lender cannot refuse to honor that commitment. For example, in 999 v. C.I.T. Corp., 776 F.2d 866 (9th Cir. 1985), the Court of Appeals for the 9th Circuit affirmed a jury verdict (\$1.9 million reduced by the trial court to \$925,000), for compensatory damages caused by the lender's refusal to honor a commitment for financing. The jury verdict was based upon theories of breach of contract and breach of an implied covenant of good faith.

The commitment had been evidenced by a letter, written for the borrower by the lender and addressed to the lender, calling for the borrower to make a deposit with CIT of \$25,000 and to submit an application for financing. Upon request by the borrower, the lender outlined in handwriting on the letter the terms of the proposed financing. The lender then signed the letter.

Thereafter, CIT sought to add a provision for a \$25,000 per month prepayment penalty. The borrower would not agree to that provision and demanded the return of its deposit. CIT refused. The borrower sought other financing but the financing could not be obtained before the borrower's creditors filed an involuntary bankruptcy petition. The damages were based upon the borrower's lost business opportunities caused by CIT's refusal to finance pursuant to the commitment.

In Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944 (Mo. App. 1986), the court affirmed an award of damages to a borrower

where the bank had charged the borrower a commitment fee for a line of credit, had failed to call the borrower in default, and yet had refused to fund the line of credit.

In Landes Construction Co. Inc. v. Royal Bank of Canada, 833 F. 2d 1365 (9th Cir. 1987), the Ninth Circuit affirmed a jury award of \$18.5 million in compensatory damages to the plaintiff based upon the breach of an oral promise to make a \$10 million loan for purposes of acquiring real estate in Los Angeles. The Ninth Circuit rejected the bank's arguments (i) that there was insufficient evidence to establish the existence of the agreement to lend money for the real estate acquisition and (ii) that the oral agreement was unenforceable under California's statute of frauds which bars enforcement of an oral agreement to give a mortgage. The Ninth Circuit held that there were two promises involved: Landes' promise to give a mortgage which was unenforceable because it was not in writing; and the bank's promise to lend \$10 million which was enforceable because it was separate from Landes' promise.

In LeMaire v. MBank Abilene, N.A., No. 85,587 (240th Dist. Ct. Texas 1986), a jury awarded \$69.4 million to shareholders of Lingen Energy Corporation based upon the bank's refusal to honor an oral commitment to lend an amount in excess of the bank's lending limit. Numerous details of the oral commitment were left out, including the exact corporate entity which would receive the loan, the date of the loan, the repayment schedule, and the details of the collateral which would secure the loan. The

commitment was apparently made under the incorrect assumption that the Lingen subsidiaries would be treated as separate borrowers for purposes of determining the bank's lending limit.

In Delcon Group, Inc., et al. v. Northern Trust Corp., et al., No. 86 CH 0859 (Ill. Cir. Ct. DuPage County, 18th Judicial Cir. Dec. 3, 1987), a jury awarded the plaintiffs \$1.2 million in compensatory damages and \$1.2 million in punitive damages for breach of an oral commitment to increase a line of credit. The plaintiffs produced an expert witness who testified that banks commonly make oral commitments to lend money and they intend that people will rely upon such commitments. The punitive damages were for tortious interference with contract based upon (i) the impairment of the borrowers' ability to complete existing contracts because the bank reneged on its promised line of credit; and (ii) the bank's improper notification of the borrowers' account debtors that all receivables should be paid to the bank.

In Sterling Faucet Co. v. First Municipal Leasing Corp., No. LR-C 80-276 (W.D. Ark. July 30, 1982), aff'd., 716 F.2d 543 (8th Cir. 1983), a letter which the lender claimed was a mere proposal was held to be a binding commitment. The letter stated that any financing arrangements were conditioned on documentation being "satisfactory in substance and form to all parties." The trial court ruled that the lender was obligated to act in good faith in deciding whether the loan documents were satisfactory and that the lender had to negotiate a loan agreement consistent

with the terms of the commitment letter.^{4/}

The largest lender liability judgment of all was entered in a case where a court, sitting without a jury, found that a savings and loan had conspired to sabotage a borrower's project to conceal its own inability to close pursuant to a commitment to lend money for the project. In Penthouse International, Ltd. v. Dominion Federal Savings & Loan Association and Melrod, Redman & Gartlan, P.C., Civ. No. 84-4325 (S.D.N.Y. July 29, 1987), Judge Kevin Duffy entered a judgment for \$129,904,455 against both defendants for breach of a contract to lend money.

In 1983, Penthouse, which had spent more than \$60 million in preparation for a proposed casino and hotel in Atlantic City, obtained a loan commitment from Queen City Savings & Loan Association in the amount of \$97 million. Pursuant to the loan commitment, Queen City was to be lead lender and was to lend \$7

^{4/} A borrower can also be held liable to a lender for failure to negotiate loan documents in good faith pursuant to the terms of a commitment letter. Teachers Ins. & Annuity Assn. v. Butler, 626 F.Supp. 1229 (S.D.N.Y. 1986). In this case, the borrower refused to close on a loan with a prepayment penalty provision in spite of the fact that the commitment letter prohibited prepayment for the first 17 years and then allowed prepayment only with a premium payment. The court awarded the lender \$3 million in compensatory damages representing the difference between the interest rate specified in the commitment letter and the lower, market rate of interest at the time of the scheduled closing. But see, Lincoln National Life Ins. Co. v. NCR Corp., 772 F.2d 315 (7th Cir. 1985), where lender was denied damages for borrower's refusal to close pursuant to a commitment because the lender had removed the NCR loan from its cash flow charts; no funds were ever set aside for NCR; and the lender had no records from which the nature, terms and yield of substitute investments could be determined.

million while Penthouse was to procure additional participants for the balance of the loan.

On June 29, 1983, Penthouse accepted the commitment and on November 21, 1983, Dominion signed a written agreement to participate in the loan to the extent of \$35 million, recognizing that because of its legal lending limit, it would have to sell \$18.5 million of its participation to another lender. Dominion had already obtained a "handshake" agreement from Community Savings & Loan Association to purchase \$17.5 million of Dominion's participation. Community signed a written agreement with Dominion on December 2, 1983. From December 1983 to February 1984, Dominion attempted to sell further participations to other lenders.

In December 1983, Community hired a new underwriter who expressed a very negative view of the Penthouse loan. At a meeting of the lenders on February 7, 1984, Community's newly-hired underwriter announced that Community was opposed to hotel and casino loans for "moral reasons." Based upon the fact that Dominion had removed Penthouse from its February 1984 list of borrowers on its Commitment Participation Report, Judge Duffy concluded that Dominion's officers had decided to breach their commitment by that time.

At the February 7th meeting, the Chairman of Dominion announced that Dominion had retained new counsel, Philip Gorelick, of the Melrod firm, and that he was going to handle the transaction. Judge Duffy's finding as to the retention of new

counsel was as follows:

"Recognizing the potential liability they were incurring, Walde and his underlings sought a cover-up. In this plot, they found a willing tool in Gorelick.

In particular, I make the finding that Dominion hired Gorelick to bully and intimidate the plaintiffs into delaying the loan until Community could be replaced or failing that, to delay until the Commitment expired and Dominion was released from its obligation."

Thereafter, Gorelick insisted upon redrafting all of the loan documents and then failed to circulate new drafts. Judge Duffy found:

"From the date of the preclosing meeting on, Gorelick became Dominion's hatchet man intent on destroying the deal. Yet, neither Penthouse, Queen City, nor any of the other participants knew the role he was playing."

Eventually, Penthouse recognized that the loan would never close with Dominion. They sought other financing unsuccessfully and the entire project failed. Judge Duffy found that Penthouse suffered damages of approximately \$130,000,000. In addition, Judge Duffy awarded Queen City, the lead lender, approximately \$7.6 million in compensatory damages.

A lender's refusal to honor a commitment to continue to finance a project can result in enormous liability. On April 29, 1987, Continental Illinois National Bank suffered a \$105 million jury verdict in favor of a real estate developer who claimed that the bank deliberately declared a technical default in his loans so that it could terminate its obligation to fund future loans and could sell the loans to the FDIC. Fritz Scharenberg claimed

that the bank declared his loans in default on July 9, 1984 after having executed a \$31 million revolving line of credit agreement for the construction of 387 condominium units on May 25, 1984 and after having made a commitment to originate up to \$10 million in mortgage loans for the project on June 26, 1984.

In a stipulation of facts submitted to the trial court, Continental acknowledged that until the day the loans were called, the bank had categorized them as performing loans and that after the loans were in default, the FDIC bought the loans from the bank. According to the stipulation, Scharenberg had not received numerous governmental permits necessary for completion of the project at the time the loans were called.

At trial, Scharenberg established that on June 25, 1984, the same day that the bank's inspector reported that all was going well on the project, Continental had sent to the FDIC a list of proposed loans to sell to the FDIC as part of the FDIC's bailout of Continental. Included in the list were the loans to Scharenberg. After reviewing the list, the FDIC told Continental that it would not purchase loans like Scharenberg's with substantial future funding commitments. A few days later, the bank placed the loans in default, thereby eliminating the future funding obligations. In September 1984, the FDIC purchased the Scharenberg loans. FDIC v. Scharenberg v. Continental Illinois National Bank, No. 84-2712-CIV-DAVIS; No. 87-0211-CIV-DAVIS; No. 87-0238-CIV-DAVIS (S.D. Fla. 1987).

A lender may also incur liability if it negligently

processes a loan application and offers the applicant a smaller loan than industry standards would support. In Jacques v. First National Bank, 515 A.2d 756 (Md. 1986), the court held that a bank's denial of a mortgage loan in the amount requested, which resulted from negligent calculation of the applicant's ability to pay, gives rise to a claim in tort against the bank.

In that case, the Jacques put down a \$10,000 deposit on a contract to purchase a home which required them to close with whatever mortgage loan they could obtain at an agreed upon rate. The Jacques paid the bank an application fee of \$144.00 to consider their application for a \$112,000 mortgage loan at 12-1/2%. The bank first advised the Jacques that they would qualify only for a \$74,000 loan. Thereafter, they told the Jacques that they would loan only \$41,400.

The Jacques applied to another lender and were offered a \$100,000 mortgage but at the then-prevailing interest rate of 13-7/8%. The Jacques calculated that the increased rate would cost them \$50,000 over the life of the loan. Rather than refuse to close and forfeit the \$10,000 deposit, the Jacques accepted the \$41,400 loan, raised additional capital on a 15% loan and closed on the house. They then sued the bank alleging that the bank was negligent in calculating the Jacques' ability to repay the mortgage loan according to standard industry criteria. The Jacques alleged that the bank (i) failed to consider their income from investments; (ii) included in its calculations the Jacques' payments on their current home; and (iii) averaged the Jacques'

income for two instead of three years. They obtained a jury verdict of \$10,000, based upon the court's instruction to the jury that the Jacques had a duty to mitigate their damages.

Both parties appealed and the Maryland Court of Special Appeals reversed the judgment, holding that the bank owed no duty of care to the Jacques in processing their application. On appeal to the Maryland Court of Appeals, the appellate court's holding was reversed. The Court of Appeals, noting the public's interest in the banking business, held that the bank had a duty to calculate accurately the amount of a mortgage loan for which the Jacques could qualify, based upon industry standards. The Court remanded the case to the Court of Special Appeals for consideration of the Jacques' contention that they should not be limited to \$10,000 in damages, representing the deposit which they would have forfeited if they failed to close on the contract. On remand, the Court of Special Appeals affirmed the \$10,000 damage award, holding that the Jacques had a duty to mitigate damages.

Just as courts enforce commitments to lend money, courts will enforce other kinds of promises and commitments as well. In Skeels v. Universal C.I.T. Credit Corp., 335 F.2d 846 (3d Cir. 1964), the Court of Appeals for the Third Circuit affirmed a judgment for damages against a lender whose local manager assured the borrower of extensions of credit and then without notice, and in ignorance of the local manager's assurances, foreclosed on the car dealer's automobiles pledged to the lender as collateral.

In First National Bank in Libby v. Twombly, 689 P.2d 1226 (Mont. 1984), a lender promised his borrower that the bank would convert a term note into an installment note if the principal were reduced and the interest were brought current. That loan officer left town and his replacement didn't know about the promise and set off against the borrower's account. The borrower sued and the court held that the bank could be held liable for actual and punitive damages for breach of the duty to act in good faith.

In Betterton v. First Interstate Bank, 800 F.2d 732 (8th Cir. 1986), the Court of Appeals held that a lender could be liable to a customer for fraud and breach of contract where the lender had agreed to accept certain payments, had assured the borrower that the bank would not repossess the collateral, and repossessed the collateral the very next day.

A lender's refusal to honor the terms of its loan agreement can be very costly. On May 12, 1987, a Texas jury rendered a verdict of \$59,260,000 against Texas Commerce Bank-McAllen based upon allegations that the bank had wilfully refused to release a mortgage which the bank had no right to retain. The Robinsons had borrowed \$1.5 million from the Bank, secured by a piece of real estate, to build a furniture store and showroom. Thereafter, the Robinsons obtained letters of credit from the bank totalling \$165,000, secured by a mortgage on a second piece of real estate.

The Robinsons paid off the obligations secured by the second

piece of real estate but the bank refused to release its mortgage, claiming it was entitled to keep that mortgage as further collateral for the \$1.5 million loan. There was no cross-collateralization provision in the loan agreement but the bank claimed the Robinsons orally agreed to have the second mortgage serve as additional collateral for the first loan. The Robinsons needed the release of the mortgage on the second piece of real estate so that they could borrow funds to complete construction of the store and showroom. The bank's refusal to release the mortgage, the Robinsons claimed, forced them into bankruptcy. At trial, bank officers testified that they were "stonewalling" the Robinsons. Robinson v. McAllen State Bank, No C-1948-84-D (Texas 206th Dist. Ct. 1987).

IV. THOU SHALT NOT RUN THY BORROWER'S BUSINESS

Lenders must be very careful to avoid involvement in the management of their borrowers' businesses. One of the bases of liability in State National Bank of El Paso v. Farah Manufacturing Co., Inc., 678 S.W.2d 661 (Tex. App. 1984), was interference with corporate governance, based upon the fact that the lenders had packed the board with directors of their own choice; forced the resignation of directors they didn't like; and forced the hiring of a consultant of their own choosing who sold off assets of the company to prematurely retire the lenders' indebtedness. The \$18.9 million jury verdict was based upon testimony that the company suffered losses in that amount during the time that the lenders' "consultant" was running the company.

A lender who exercises control over a borrower's business operations exposes itself to an increased risk that it will be held to the standards of a fiduciary. In Security Pacific National Bank v. Williams, Nos. 457727/457728, San Diego County Superior Court (1986), a trial judge awarded a borrower \$2.3 million in compensatory damages and \$2.5 million in punitive damages, based in part upon findings that the lender had a fiduciary relationship with the owner of a car dealership which the lender financed and that the lender had misled the owner into taking certain actions with respect to his business which caused him injury.

Williams operated a Buick dealership in San Diego. He was a favored customer of the bank. In early 1979, Williams and his

loan officer, Ross, in whom he placed a great deal of trust, met to discuss Williams' purchase of a second car dealership. Ross vetoed several of Williams' suggestions and even threatened to "pull the chain" on Williams' loans if Williams persisted. Then Ross indicated to Williams that he should purchase a dealership in Los Angeles called Viking Dodge. Ross offered Security Pacific's assistance with the purchase. Ross was familiar with Viking Dodge because it was one of his troubled credits.

During the negotiations of Williams' purchase of Viking Dodge, Ross made several representations to Williams about Viking's finances which he later claimed were fraudulent. The purchase closed on May 3, 1979. That month, the gas crisis struck California and business conditions deteriorated. Security Pacific instituted increasingly restrictive financing practices and Williams was forced to release Viking Dodge to Chrysler Credit which obtained a deficiency judgment against Williams as guarantor on certain loans. Williams then turned his attentions full time to his Buick dealership. Security Pacific was clamping down on that operation as well. Ross urged Williams to find a new investor but then Ross refused to provide a letter assuring the investor of the bank's continued financial support and the deal fell through. Security Pacific closed the business and bankruptcy ensued.

Security Pacific then sued Williams on his guarantee and he counterclaimed against the bank alleging fraud, negligent misrepresentation, breach of contract, tortious interference with

prospective economic advantage, and breach of the implied covenant of good faith and fair dealing. The court found that the bank had a relationship of trust with Williams and wrote as follows:

"The Williams-Security Pacific National Bank relationship went far beyond a lender-borrower relationship. It was an all-encompassing, mutually beneficial, day-to-day relationship in which both sides reposed trust and confidence in one another.... The relationship here had much the makings of a mutually beneficial partnership."

Based on this relationship, the court found that Security Pacific acted fraudulently when it failed to disclose material financial information concerning Viking Dodge to Williams prior to his investment in that business.

In In re American Lumber Co., 7 B.R. 519 (B. Minn. 1979), aff'd., 5 B.R. 470 (D. Minn. 1980), the court held that a lender who took control of a company in order to liquidate its assets and satisfy its own debt had breached its fiduciary duty to deal fairly and impartially with the debtor and with all of its creditors. The court subordinated the lender's \$1.7 million claim to the claims of all the general unsecured creditors. The actions upon which the court relied in finding that the lender controlled the borrower included taking physical control of the borrower's premises; terminating all of the borrower's employees other than those necessary for the liquidation; becoming the sole signatory on the borrower's checks; paying only those creditors who could assist the lender in the liquidation process; and monitoring the borrower's mail.

In Melamed v. Lake County National Bank, 727 F.2d 1399 (6th Cir. 1984), the court sustained a claim for tortious interference with a business where the bank required the debtor's president to take a 50% salary cut; replaced the debtor's accountant with its own accountant; required bank approval of all payments; suggested that the landlord change the locks on the debtor's premises; and wrote a 13-point program to "help salvage whatever is possible" from the debtor's business.

In Walton Motor Sales v. Ross, 736 F.2d 1449 (11th Cir. 1984), the Court of Appeals noted that a contract granting a secured lender control over all financial and credit policies of the debtor abrogated the independent decision-making authority of the board of directors and would normally be void. The contract was saved by a Georgia statute allowing shareholders of a closely-held corporation to divest themselves of control.

A major risk for lenders who become involved in the business operations of their borrowers is the possible liability of an "operator" under federal and state environmental clean-up laws. In United States v. Mirabile, 15 Envir. L. Rep. 20992 (E.D. Pa. 1985), the court denied Mellon Bank's motion for summary judgment dismissing the government's complaint, seeking liability for clean-up of a contaminated property, based on evidence that Mellon Bank had exercised control over the business operations of

a former owner of the property.^{5/}

Lenders must also be concerned with liability to the United States for a borrower's unpaid withholding taxes under Section 3505(b) of the Internal Revenue Code which provides:

"If a lender . . . supplies funds to . . . an employer for the specific purpose of paying wages . . ., with actual notice or knowledge . . . that such employer does not intend to or will not be able to make timely payment on deposit of the amount of tax required . . . to be deducted and withheld by such employer . . . such lender . . . shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid. . . . However, . . . the liability of such lender . . . shall be limited to an amount equal to 25 percent of the amount so supplied to . . . such employer for such purpose."

See also, Jersey Shore State Bank v. United States, 107 S. Ct. 782 (1987) (U.S. does not have to give a lender notice of an assessment prior to suing under §3505).

A lender will also be held liable for its borrower's

^{5/} In United States v. Maryland Bank & Trust Co., 632 F.Supp. 573 (D. Md. 1986), the court held the bank liable for clean-up of a property upon which the bank had foreclosed where hazardous waste was discovered on the property a year after the bank had foreclosed. The 1986 Superfund Amendments and Reauthorization Act (SARA) amends CERCLA, the federal Superfund law, to provide an "innocent purchaser" defense to liability. That defense requires proof that the purchaser "did not know and had no reason to know that any hazardous substance. . . was disposed of on, in, or at the facility." The owner is required to show that it undertook appropriate inquiries prior to purchase as to the previous ownership and operation, taking into consideration the relative sophistication of the buyer, the relationship of the purchase price to the value of the property, and the ability to discover contamination by appropriate inspection. 42 U.S.C. §9601 et seq.

violations of the minimum wage and overtime provisions of the Fair Labor Standards Act, 29 U.S.C. §201 et seq., to the extent that the lender forecloses on "hot goods" and seeks to introduce such goods into interstate commerce. Brock v. Citicorp Industrial Credit, Inc., 107 S. Ct. 2694 (1987).

V. THOU SHALT NOT BAIL THYSELF OUT ON THY BROTHER'S MONEY

A lender must be scrupulously careful not to injure others in the process of working out a bad loan. In September 1985, a jury in Sonoma County, California, awarded \$46 million against Bank of America based, in part, upon allegations that the Bank had dealt unfairly with its borrowers, the Jewells, who managed an apple orchard and who functioned as brokers for other apple growers who were not part of the Sebastopol Cooperative, in order to work itself out of a bad loan to the Cooperative. Kruse v. Jewell v. Bank of America, No. 112439, Superior Court of California, Sonoma County (1985).

In Monsen v. Consolidated Dressed Beef Co., 579 F.2d 739 (3d Cir.), cert. den., 439 U.S. 930 (1978), a bank was held liable as an aider and abettor for federal securities law violations committed by the borrower. The borrower had a longstanding practice of borrowing money from its employees. The bank loaned money to the borrower, secured by all of the borrower's assets. Thereafter, the borrower continued to borrow money from its employees who were not informed of the pledge of the borrower's assets to the bank. When the bank loan went into default, the bank foreclosed and satisfied its debt from the liquidation of the assets, leaving nothing for the employees. The Third Circuit held that the bank's knowledge of the borrower's failure to disclose the pledge of the borrower's assets to the bank was a sufficient basis for holding the bank liable for aiding and abetting under the securities laws.

In Barnett Bank of West Florida v. Hooper, 498 So. 2d 923 (Florida 1986), the Florida Supreme Court held that when a bank stands to benefit from a transaction involving a customer with whom it has a confidential or fiduciary relationship, the bank has an obligation to disclose material information. In that case, the bank had loaned money to a customer for investment in a venture of a second customer at a time when the bank knew the second customer was involved in a check-kiting scheme. The first customer borrowed the funds and gave a check to the second customer which was deposited in the second customer's account at the bank. The bank immediately set off against the deposited funds in order to satisfy all outstanding obligations of the second customer.^{6/}

A lender has to be particularly careful in discussions with customers who are investing in another customer's business ventures. In Hill v. Equitable Bank, N.A., 655 F.Supp. 631 (D. Del. 1987), the United States District Court denied summary judgment dismissing a bank customers' claims that the bank (i) had violated the federal securities laws and (ii) was liable for negligent misrepresentation, where the bank officer had met with the customers, had told them the investment in another customer's business venture was "sound," and the customers relied on that statement in borrowing from the bank to make the investment. The

^{6/} In In re Letterman Bros. Energy Securities Litigation, 799 F.2d 967 (5th Cir. 1986), cert. den. 107 S.Ct. 1373 (1987), a lender to oil and gas ventures was held to have no fiduciary duty to investors in its customer's oil and gas leases.

bank officer did not disclose that the proceeds of the new investment would be used, in part, to pay off a defaulted loan to the bank.

The court cited with approval the language in the Jacques case concerning the public interest in the banking industry (see pages 21-22 supra), and held that once plaintiffs deposited substantial money at the bank in order to establish a banking relationship, the bank had a contractual duty to exercise due care in communicating to the plaintiffs information concerning the proposed investment in another customer's business venture.

In Whitney v. Citibank, N.A., 782 F.2d 1106 (2d Cir. 1986), the Second Circuit affirmed a verdict for compensatory and punitive damages against a lender who induced two of three general partners to consent to a deed in lieu of foreclosure of partnership property without the knowledge of the third general partner and in violation of partnership law and the partnership agreement. The court found that the bank's employees knew that there was a dispute among the partners over the disposition of the property and were motivated by a desire to make a profit on the real estate.

A lender has to be particularly careful in a workout situation that it does not mislead the borrower into taking a course of action which benefits the lender at the borrower's expense. In Rubin Bros. Footwear, Inc. v. Chemical Bank, 83 CIV. 6910 (S.D.N.Y. 1987), the district court held that a borrower stated a claim under the Federal Racketeer Influenced

and Corrupt Organizations Act against Chemical Bank where the complaint alleged that the lender conspired with several employees to induce Rubin not to file for bankruptcy; represented that Rubin would be better off not filing; then persuaded Rubin to hire Chemical's own consultant who conspired with Chemical to convert largely unsecured debt to secured debt and then to reduce Chemical's debt, while at the same time falsely assuring creditors of payment.

One court has even held a lender liable for tortious interference with contract where the lender took a security interest in assets in violation of a non-encumbrance provision in the asset sale agreement between the borrower and the seller of the assets. The Wyoming Supreme Court, in affirming the jury award of \$123,997.38, held that the bank president's testimony that the bank had a copy of the asset sale agreement and his testimony that usually the bank read such agreements when they were given to the bank, was sufficient to permit the jury to conclude that the bank had knowledge of the non-encumbrance provision, in spite of the bank's testimony to the contrary. First Wyoming Bank, Casper v. Mudge, 748 P.2d 713 (Wyo. 1988).

In Bank of California, N.A. v. California Land & Equipment Leasing Co., Inc. et al., No. 3 Civ. C003135 (Court of Appeal, Third Appellate District, California), a jury awarded \$26.3 million to limited partners whose funds were misappropriated by the general partner with the knowledge of its bank. The trial

court remitted the verdict to \$3.7 million compensatory damages and \$11.2 million punitive damages but noted that the conduct of the bank and of its officers was "reprehensible."

The bank had instituted suit against individuals who invested, from 1976 on, in limited partnerships which contracted with the bank's customer, Calland. Calland entered into farm management contracts with the partnerships to perform all farming activities including leasing ground to the investors, cultivating, planting, harvesting and selling of crops for a set fee. The partnership agreements required Calland to keep the investors' funds separate from the funds of other entities and that farm loans made to the partnerships be placed in separate bank accounts and used only for farming purposes.

Following the chapter 11 filing of Calland, the investors sued the principals of Calland for fraud and obtained a monetary settlement. The bank then sued the investors claiming that the settlement fund belonged to the bank. The investors counterclaimed against the bank alleging that the bank had participated in the fraud upon the investors. At trial, the investors were able to establish the following:

1. Each of the loan officers involved with Calland had read the investors' agreements and was familiar with the restrictions contained in those agreements.
2. Each of the loan officers involved with Calland reviewed Calland's books on a regular basis.
3. The investors' funds had been misappropriated from the

inception of their investments. Their capital investments had been paid into a Calland general account and used for purposes not permitted by the partnership agreements. Moreover, the proceeds of the bank's crop line of credit were diverted from the farm companies into Calland through an interbank transfer, in violation of the investors' agreements. Bank officers knew that the crop line was being utilized for real estate investments and personal expenses of the principals.

4. Bank officers knew that one of the principals was diverting earnings due to the investors by selling the investors' crops to a wholly-owned corporation through which he would skim commissions in violation of the farm contracts with the investors.

5. In 1979, the bank started a new internal unit called the Agribusiness unit which agreed to extend an \$8.5 million line of credit to a new business formed by the principals of Calland. The loan grew to a three-bank, \$30 million line. The principals put no equity into the new business. Instead, it was financed through borrowed funds and through a "grower deferral program," undisclosed to the investors, through which 50% of the investors' produce would not be paid for until one year after it was sold. The control over the investors' money and crops was described in bank memoes as a central selling point of the new project.

6. In 1979, one of the bank's loan officers recommended a \$950,000 crop line, noting that one of the advantages was that it allowed the principals to use the investors' farming companies to

buy farm land and other land for themselves. The loan officer also noted that the single greatest risk to the bank and to Calland was that the investors would want the return of their investments. Bank records also substantiated that Calland owed a debt to one of the principals which was being paid, at a high interest rate, with investors' monies.

7. In 1980, the first year of the new venture, National Bank Examiners classified the loans to both the new venture and to Calland as unsafe. The bank's internal auditors also graded the Calland loan as unduly risky.

8. The bank fired the loan officer who first reported the problem to the bank. The replacement officer, according to his testimony at trial, took one look at the situation and knew that the principals were in a conflict of interest with the investors, knew that the principals were misusing the investors' funds, knew that the investors were being lied to by the principals, and recommended that the line be "yanked." Instead, the loan officer was replaced and the line was continued.

9. In late 1980, one of the loan officers discovered that one of the principals had diverted at least \$500,000 from the loan to the new venture. He was afraid to tell his superior because the superior was having "surreptitious" meetings with the principal. He did later report it but the bank took no action.

10. In 1981, the bank increased the crop line from \$950,000 to \$1.4 million. At that time, the bank realized that the new venture could not repay Calland the monies which were owed to

it. Even though the loans were in default, the bank responded to credit inquiries by saying that the principals were highly regarded and that the loans were "never in default."

11. In 1981, the bank learned of an actual embezzlement by the principals of trust funds from a customer. The bank took no action other than to have the principals' agreement that the investors should be obligated as guarantors on the crop loan. The bank's loan policy manual required that under such circumstances the investors had to be contacted directly but the loan officer did not contact the investors because he did not want to "alarm" them.

VI. THOU SHALT KEEP THINE OWN FILES CLEAN

It is absolutely essential that lenders train themselves to write memos which are objective, unemotional and accurate. There is no place for vulgarity, epithets, jokes, threats or colloquialized expressions in a credit memo.

It is extraordinary how often, in lender liability litigation, the borrower's counsel discovers a document in the lender's files which creates an image before the jury that the lender is callous and calculating with regard to the borrower's interests. In view of the fact that most jurors can more readily identify with borrowers than with lenders, these memos often fire the emotions of the jurors and result in multimillion dollar verdicts which might have been avoided.

VII. THOU SHALT TRANSFER A TROUBLED LOAN TO A WORKOUT OFFICER

It is particularly difficult for the loan officer in charge of an account to properly handle that account once the loan goes into default. At that time, the loan officer should be required, as a matter of bank procedure, to transfer the file to the bank's workout team. The loan officer who developed the account when it was prosperous will have mixed emotions -- of loyalty to the borrower, of concern for his status within the bank, of guilt that he may not have watched the loan as closely as he should have -- which will cloud his judgment in handling the loan in this crucial stage. In view of the seriousness of the jury verdicts which have been awarded against lenders in the past few years, workouts are serious business and they should be handled by people who specialize in handling troubled loans.

VIII. THOU SHALT CONFER WITH THY WORKOUT COUNSEL

Just as the troubled loan should be handled by the bank's workout team, the workout team must bring in its own counsel who specialize in handling workouts. The lawyers who have developed the fine points of commercial loan documentation are not the lawyers who can effectively negotiate with borrower's counsel in a loan default situation. At this juncture, and in the present social and legal climate, reliance upon the plain language of a loan document will put you, like Irving Trust Company, behind a \$7.5 million judgment.

This is an area of the law which is developing so rapidly that a lender should retain counsel who fully understands the issues and risks of litigating with a borrower. Most lender liability cases are avoided because of the work of able counsel working with competent, objective in-house workout people.

IX. THOU SHALT THINK CAREFULLY BEFORE SUING ON A DEFICIENCY

In Centerre Bank of Kansas City, N.A. v. Distributors, Inc., 705 S.W.2d 42 (Mo. App. 1986), the bank had sued seven guarantors, six of whom were virtually insolvent, for a deficiency in the principal amount of \$276,000. The guarantors counterclaimed on theories of breach of contract, fraudulent misrepresentation and prima facie tort and won a jury verdict of \$7.5 million against the bank. Ultimately, the verdict was reversed by the appellate court but not without tremendous cost to the bank, both monetary and otherwise.

In Southeast Bank, N.A. v. Atrio Consolidated Industries, Inc., et al., No. 82-552 CA16 (Circuit Court of the Eleventh Judicial Circuit, Dade County, Florida 1985), an unreported Florida case, the bank sued a borrower and the guarantors for a \$250,000 deficiency. The counterclaim in that case sought \$3 million compensatory damages and \$9 million punitive damages. The jury came in with exactly that: \$3 million compensatory damages and \$9 million punitive damages. The case was settled while the appeal was pending.

In both of these cases, it is probable that the guarantors' claims would never have been filed had the banks not sued for the deficiencies. In view of the present litigation climate, a lender must think very carefully before it institutes suit for a deficiency. There is certainly no point suing if the guarantors don't have the money to pay the judgment, once won. Moreover, if there is any question that the bank's actions may have

contributed to the need to sue the guarantors, the lender would be well advised to write off the loan and move on to the next case.

X. THOU SHALT NOT BE ARROGANT

This may be the most important of the ten commandments because this is the hardest one to know you are violating. When in doubt, assume you are being arrogant and think carefully about what you are doing. Lenders are traditionally arrogant and their counsel are traditionally arrogant. Lenders are arrogant because for years people a lot richer then they are have been coming to them and asking for money. Lenders' counsel have traditionally been arrogant because they have been able to force borrowers' counsel to accept whatever provisions they draft for their loan documents.

Times are changing. Neither lenders nor their counsel can afford to be arrogant anymore. Lenders must force themselves not to rely upon the express provisions of their loan agreements in situations where commercial loans are in default. They must ask themselves, with respect to whatever action they are contemplating, whether that action is fair to the borrower and whether any action which injures the borrower is absolutely necessary to protect the bank's interests.

In most instances, repossession without notice is not absolutely necessary to protect the bank's interests. In instances where the bank is adequately collateralized, termination of the financing without giving the borrower an opportunity to get replacement financing is not necessary to protect the bank's interests. Indeed, in the absence of fraud or criminal

conduct, it is unlikely that a lender is ever justified in terminating a financing relationship without notice.

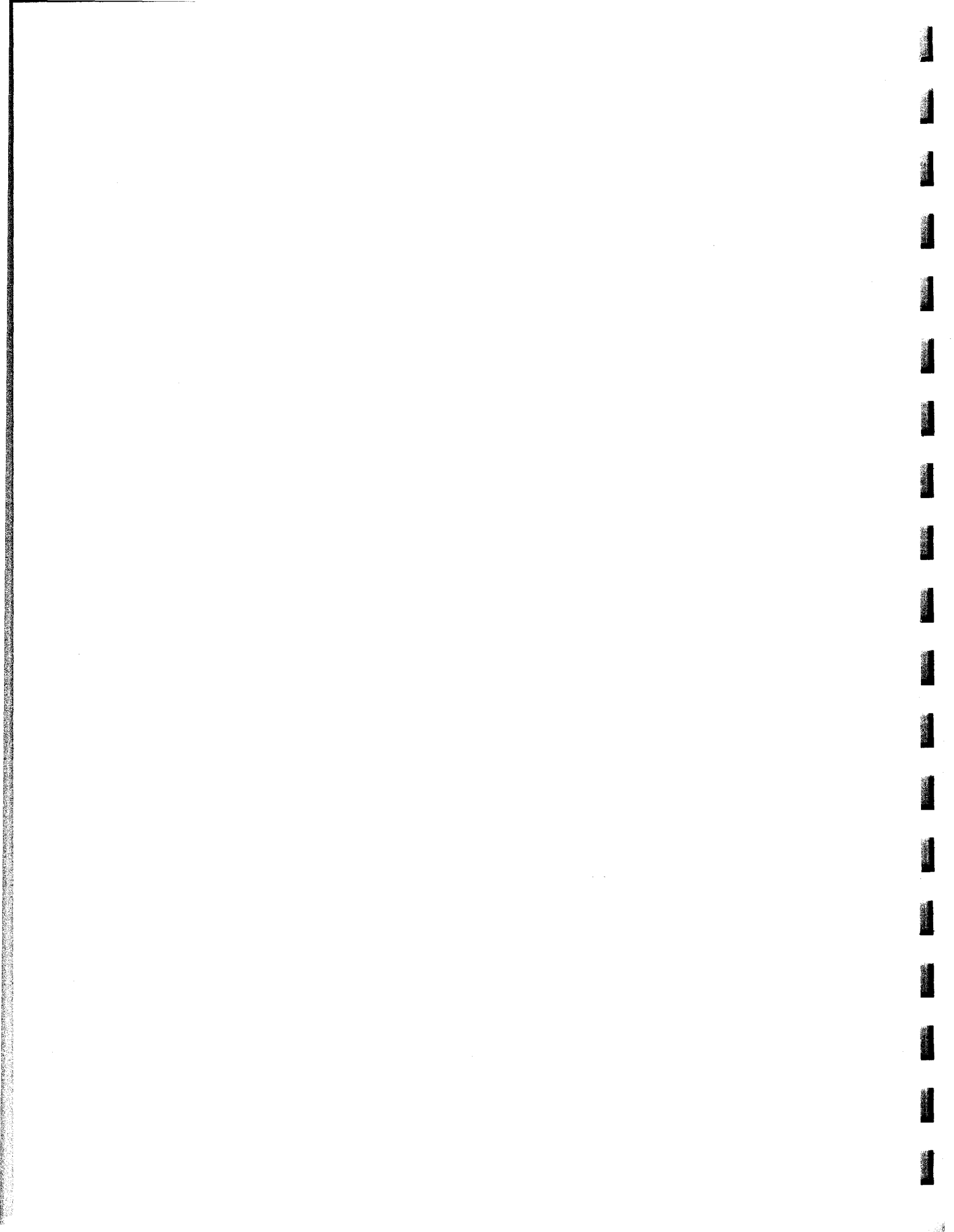
Lenders' arrogance also results at times in a refusal to negotiate a settlement because of the lenders' concern with 'setting a bad precedent.' It is often better to pay something to the borrower than to risk an adverse jury verdict. Almost without exception, all of the multimillion dollar verdicts against lenders could have been avoided had the lenders been more compromising. For example, the \$18.9 million jury verdict in Farah Manufacturing could have been avoided if the lenders had agreed to certain modifications in the loan agreement giving the borrower more time to repay its loan and a more favorable interest rate. In the Centerre Bank case, the \$7.5 million verdict could have been avoided if the bank had agreed to a walk-away. Indeed, in that case the jury, while deliberating, asked the judge whether punitive damages had to be allocated in favor of each guarantor or could be awarded generally. Even at that point, counsel for the guarantors were willing to settle for a walk-away and the bank refused.

When one considers the enormous cost of litigating a lender liability case, and when one adds to that the emotional and business cost to bank personnel, it is clear that on a business basis, settlements make much more sense than going to trial. The problem is that in many instances the decision not to settle is made by people personally involved in the litigation. This is a situation which must be avoided.

STATUTORY AND COMMON LAW THEORIES
OF
LENDER LIABILITY

By

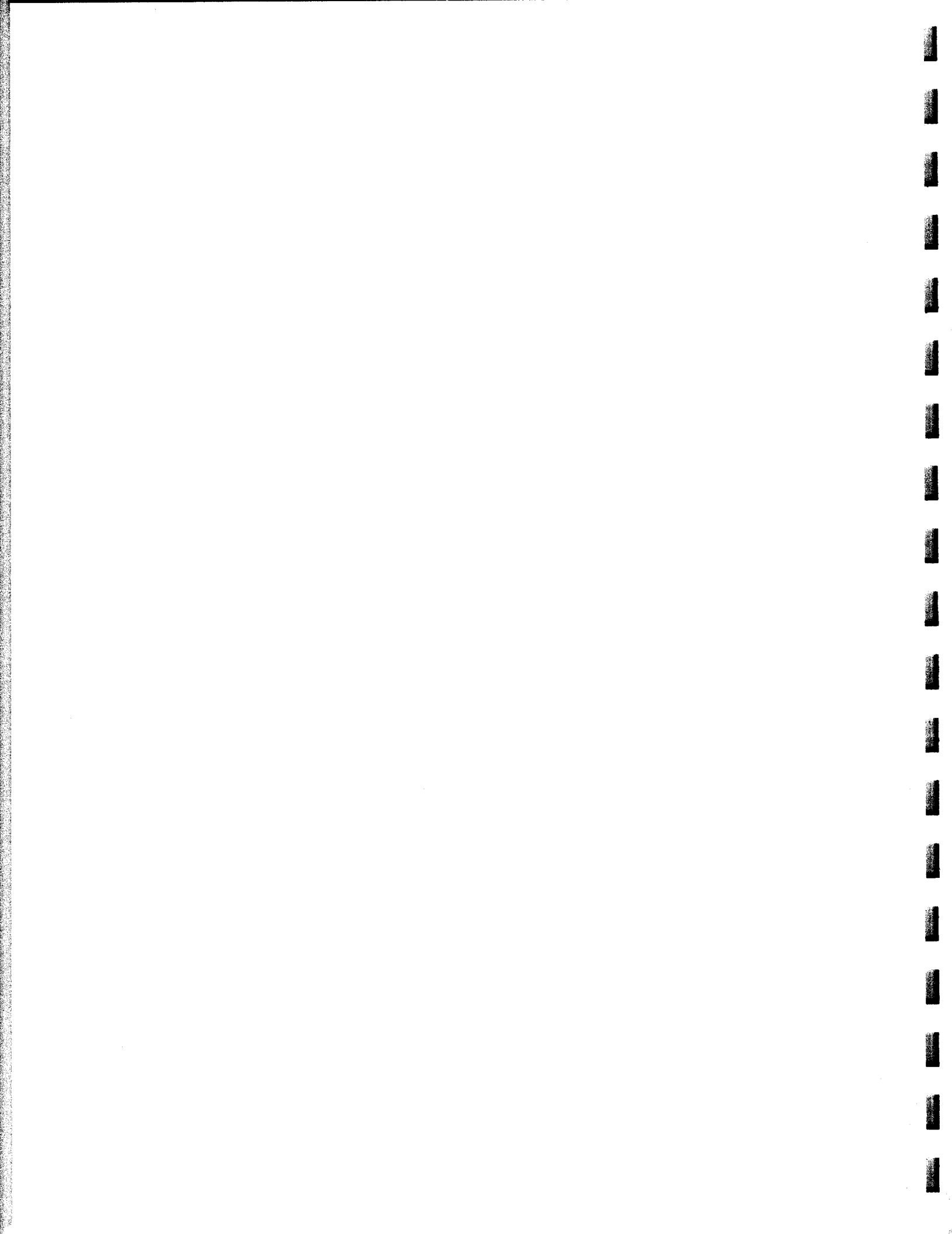
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STATUTORY AND COMMON LAW THEORIES OF LENDER LIABILITY

TABLE OF CONTENTS

A. Statutory and Common Law Theories of Lender Liability	J- 1
B. Breach of Contract	J- 3
C. Promissory Estoppel	J- 5
D. Implied Covenant of Good Faith and Fair Dealing	J- 5
E. Breach of Fiduciary Duty	J- 6
F. Duress	J- 8
G. Fraud	J- 9
H. Negligent misrepresentation	J-11
I. Constructive Fraud	J-11
J. Negligence	J-11
K. Defamation	J-13
L. Interference	J-13
M. Racketeering	J-14
N. Instrumentality Liability	J-15
O. Conversion	J-16
P. Outrage/Intentional Infliction of Emotional Distress	J-16
Q. Prima Facie Tort	J-17



STATUTORY AND COMMON LAW THEORIES OF LENDER LIABILITY

by Neal L. Wolf

- A. Statutory and common law theories of lender liability
1. Various legal theories have been invoked by creative counsel to establish a basis for imposition of liability upon lenders.
 2. For purposes of this discussion, we have identified 18 separate common law and statutory theories.
 3. These theories include:
 - a. breach of contract
 - b. promissory estoppel
 - c. breach of implied covenant of good faith and fair dealing
 - d. breach of fiduciary duty
 - e. duress
 - f. fraud
 - g. negligent misrepresentation
 - h. constructive fraud
 - i. negligence
 - j. defamation
 - k. tortious interference with prospective advantage
 - l. tortious interference with contractual relationships
 - m. tortious interference with corporate governance

- n. civil racketeering (RICO)
 - o. instrumentality liability
 - p. conversion
 - q. intentional infliction of emotional distress/outrage
 - r. prima facie tort
4. Usually defense counsel encounters a combination of these claims.
- a. Frequently, plaintiffs allege tort claims (even tort claims which are based upon the same facts and circumstances giving rise to a contract claim) in order to convert a claim for compensatory damages into a claim for compensatory and punitive damages.
 - b. Indeed, under the Racketeer Influenced and Corrupt Practices Act (RICO), a successful plaintiff has a right to recover treble damages.
 - c. Where plaintiffs' attorneys recast contract claims as tort claims, the lender may have a strong basis for a motion to dismiss the tort claims; such a motion would be based upon the long-recognized doctrine that where the facts giving rise to the alleged tort claim amount only to a breach of contract, plaintiffs' only claim is for breach of contract.
5. A number of the legal theories listed above may be asserted by the borrower, not merely as theories of recovery, but as affirmative defenses to a claim made by a bank against its borrower or a guarantor for recovery of the amount due under a note or a deficiency.
- a. estoppel
 - b. duress
 - c. fraud

d. negligence

6. Some of the theories, or at least the facts underlying some of the theories, may constitute a basis for the equitable subordination of the bank's claim against its borrower in a bankruptcy case involving the borrower.

a. Equitable subordination is an equitable doctrine expressly made a part of the Bankruptcy Code (§510) under which, among other things, (i) a claim may be subordinated to all or part of any other claim, or (ii) a security interest may be invalidated.

b. Although the doctrine of equitable subordination does not provide for the disallowance of a claim, as a practical matter in most cases, to subordinate a claim under the doctrine of equitable subordination to all unsecured claims is tantamount to disallowance of the claim.

B. Breach of Contract

1. Generally, in the lender liability context, a breach of contract claim arises in one of three situations:

a. the loan agreement;

(1) refusal to advance -
K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985)

(2) wrongful acceleration -
Sahadi v. Continental Illinois National Bank and Trust Co., 706 F.2d 193 (7th Cir. 1983) (borrower's failure to make interest payment on the date that it was due was not a basis upon which the lender could accelerate the borrower's obligations one day after the payment was due, notwithstanding the fact that the loan agreement authorized acceleration in that circumstance.

b. verbal, written, or implied modifications to the loan agreement

(1) alleged waiver of event of default In Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983), the Supreme Court of Alaska held that a borrower could recover compensatory and punitive damages from lender which had repossessed collateral securing the borrower's delinquent obligation to the bank without notice. The court found that the statements and conduct of the parties following default, including lack of an outstanding demand for payment, ongoing workout negotiations, and consistent acceptance by the bank of late payments, modified the loan agreements or gave rise to a waiver by the bank of the default.

(2) alleged agreement to modify lending ratios

c. loan commitments

(1) For example, in an 8th Circuit case, Sterling Faucet v. First Municipal Leasing Corp., 716 F.2d 543 (8th Cir. 1983), the court held that a mere proposal, which was conditioned on documentation being in form and substance satisfactory to all parties, was a binding loan commitment. The lender was obligated to act in good faith in deciding whether the loan documents were satisfactory and had to negotiate loan documents which were consistent with commitment letter. In short, a party to a loan commitment cannot unreasonably fail to agree on loan documents.

The principle goes both ways. In Teachers Insurance Annuity Association of America v. Butler, 626 F. Supp. 1229 (S.D.N.Y. 1986) the court held a borrower liable for failure to negotiate loan documents in good faith after execution of a commitment letter.

C. Promissory Estoppel

1. Elements - Restatement (Second) of Contracts §90
 - a. lender made promise that it did not keep
 - b. promisor could reasonably expect promise to induce action or forbearance of a definite and substantial character
 - c. promisee did act and change its position in reliance upon the promise
 - d. promisee was justified in relying upon the promises
 - e. injustice can be avoided only if promise is enforced
2. There may not be right to jury trial on a promissory estoppel claim because it is an equitable doctrine. See, A-C Co. v. Security Pacific National Bank, 173 Cal. App. 3d 462 (1985). (Court of Appeals reversed a jury verdict of \$1,000,000 in actual damages and \$900,000 in punitive damages on the ground that the trial court erred in submitting the promissory estoppel claim, which is equitable in nature, to the jury.

D. Implied Covenant of Good Faith and Fair Dealing

1. The source of the doctrine - The courts of some states imply a covenant of good faith and fair dealing into all contracts, as a matter of common law; other states find the source of the covenant, in commercial transactions, in section 1-203 of the Uniform Commercial Code.
2. There must be a contract for there to be an implied covenant of good faith and fair dealing.
3. Good faith means honesty in fact. It does not require the lender to change the contract.
4. Generally, breach of the implied covenant is treated as a breach of contract and the plaintiff is not entitled to recover punitive damages. Carrico v. Delp, 141 Ill. App. 3d 684, 490 N.W.2d 972 (Ill. App. 1986)

5. In a few cases, however, courts have treated breach of the implied covenant as a tort, and have awarded or permitted a jury to award punitive damages. E.g., First National Bank in Libby v. Twombly, 689 P.2d 1226, 1230 (Mont. 1984) ("When the duty to exercise good faith is imposed by law rather than the contract itself,...the breach of that duty is tortious. Therefore, punitive damages are recoverable if the bank's conduct is sufficiently culpable.")

E. Breach of Fiduciary Duty

1. Generally - a lender owes no fiduciary duty to its borrower. See, W.T. Grant, 4 Bankr. 53 (Bankr. S.D.N.Y. 1980) aff'd., 699 F.2d 599 (2nd Cir. 1983); Krivo Industrial Supply v. National Distillers, 483 F.2d 1098 (5th Cir. 1973).
2. In a few recent cases, courts have held that a lender may have a fiduciary relationship with its borrower.
3. This requires a finding of special circumstances, which are usually not present in lender-borrower relationships, creating an extraordinary relationship of confidence and trust under which the borrower reasonably relied on the lender to look after its (the borrower's) interest.
4. A fiduciary has a legal duty to act in the utmost good faith, for the benefit of the other party, the beneficiary of the trust relationship.
5. A fiduciary may not prefer its own interest to that of the other party.
6. A fiduciary duty is a much higher duty than that of good faith and fair dealing.
7. A bank trust department often undertakes contractually to act as a fiduciary. This contract, without more, does not create a fiduciary duty in the lender-borrower context.
8. For a case in which the court found the existence of such a relationship, see Barrett v. Bank of America, 183 Cal. App. 3d 1362

In Barrett, the trial judge refused to instruct a jury with certain instructions requested by the borrower-plaintiffs and entered judgment in favor of the bank. The Court of Appeals reversed primarily on grounds of the trial judge's failure to instruct the jury on a constructive fraud theory, stating that the relationship of the bank to its depositors is at least "quasi-fiduciary" and that a relationship of confidence and trust may exist between them such that the bank has a duty to disclose to its borrower facts which may place the bank or third party at an advantage in dealing with customer. In Barrett, the borrower had relied implicitly on the financial advice of loan officer with respect to need for a merger and the effect of merger. The officer never disclosed the fact that the SBA would never release personal guarantees.

10. Other cases holding that a fiduciary relationship exists between the bank and its customer.
 - a. Commercial Cotton Co. v. United California Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985) (duty of bank to depositor)
 - b. American Spacers, Ltd. v. Ross, 269 S.E.2d 176 (Ga. 1982) (duty of factor of accounts to its principal)
11. A case holding that a bank owes a fiduciary duty to other loan participants.

Women's Federal Savings and Loan Association v. Nevada National Bank (9th Cir. March 2, 1987) In Women's, 90 percent participant sued an agent bank for breach of contract, breach of fiduciary duty, rescission, and disgorgement after the bank had entered into a written participation agreement with respect to a secured real estate loan. The agreement required the agent to act as "trustee with fiduciary duties" in administering, servicing, monitoring borrower's financial condition, advising participant of adverse changes in financial condition, and establishing required impound and custodial accounts.

The agent failed to advise the participant of adverse changes and of various defaults, including the borrower's failure to maintain the required accounts. The agent even made junior secured loans to the borrower, and did not disclose this fact to its participant.

The Ninth Circuit held that the agent was a fiduciary which had committed four separate breaches of fiduciary duty:

- a. failure to establish and maintain impound and custodial accounts
- b. failure to monitor and report on borrower's financial condition
- c. failure to report defaults
- d. made junior loans without knowledge or consent of participant

The participant was entitled to rescind the participation agreement. The Circuit Court remanded the case to the District Court on the issue of disgorgement of profits on the junior loan.

F. Duress

1. Duress is the threat to do an act which a party has no legal right to do.
2. It occurs where the lender, through threats or coercion, overcomes the will of the borrower and induces the borrower to take detrimental action which it was not otherwise obligated to take.
3. Duress more commonly is employed as a defense to a claim than as an offensive weapon.
4. A valid claim for duress can arise even where lender's threatened actions might otherwise be legal if the lender's conduct is unduly coercive or his motivation is impure.
5. Mere pressure of business circumstances or hard bargaining stance does not automatically give rise to duress.

6. In Farah Manufacturing Company v. State National Bank, 678 S.W.2d 671 (Tex. 1984) lenders threatened use of management change clause if Farah was elected CEO.
7. In Pecos Construction Co. v. Mortgage Investment Co., 459 P.2d 843 (1969) The Supreme Court of New Mexico upheld a judgment of liability for duress where a lender refused to honor its commitment unless the borrower paid an additional financing fee.

G. Fraud

1. elements

- a. misrepresentation of material fact or material omission
- b. knowledge of falsity, or reckless disregard for the truth or falsity of the representation
- c. intent that person to whom the representation was made rely on the representation
- d. justifiable reliance
- e. resulting damages

2. promissory fraud

- a. promise made without present intent to perform
- b. in Illinois, must be a finding of a fraudulent scheme

3. circumstances giving rise to a fraud claim in lender-borrower context:

a. fraud upon borrower -

claim that lender made false threats or representations

- (1) In Stirling v. Chemical Bank, 382 F. Supp. 1146 (S.D.N.Y. 1974) aff'd, 516 F. 2d 1396 (2d Cir. 1975), a creditor who induced resignations of officers and directors of a borrower

with fraudulent promise not to call loan liable for resulting injury

- (2) In Sanchez - Corea v. Bank of America, 38 Cal. 3d 892, 701 P.2d 826 (1985), the court affirmed a \$2.1 million jury verdict against a lender based, in part, on the false representation that it would advance additional funds if the debtor assigned its accounts receivable to the lender.

b. fraud on other creditors

- (1) claim that lender committed fraud in responding to credit inquiry - There may be no legal obligation to respond to a credit inquiry. From a practical standpoint, however, it may be necessary to do so. Any response should be truthful and should not fail to state material facts.

- (2) In Central States Stamping v. Terminal Equipment Co., 727 F.2d 1405 (6th Cir. 1984), the appellate court affirmed a jury verdict against a bank which responded to a credit inquiry from the purchaser of a machine from the bank's borrower. The bank gave a generally positive response, noting only that the borrower was undercapitalized, and did not disclose the existence of loan defaults. Having undertaken to discuss the financial position of its borrower, the bank assumed a duty to disclose material information about the borrower.

c. fraud upon loan participants - The originating lender should make full disclosure to participants and should encourage each participant to make an independent credit investigation.

- (1) In Commercial National Bank of Peoria v. FDIC, 476 N.E.2d 809 (Ill. App. 1985), a jury verdict for fraud was affirmed by an appellate court

where the originating bank misled a participant by failing to advise the participant (1) that the "borrower had laid off employees, (2) that a potentially profitable contract did not exist and (3) that loan proceeds had been used to cover an overdraft.

H. Negligent Misrepresentation

1. elements

- a. misrepresentation or failure to state material fact
- b. resulting from failure to exercise standard of diligence or expertise reasonably expected of a competent lender
- c. reasonable reliance on misrepresentation or omission
- d. resulting damages

I. Constructive Fraud

1. This tort seems to be linked to breach of fiduciary duty/common law fraud.
2. It may be found where the lender is found to have a fiduciary duty to the borrower based upon a relationship of confidence and trust.
3. The existence of the fiduciary relationship seems to vitiate the requirement of fraudulent intent.
4. The missing element of intent is found to exist because of the fiduciary relationship.
5. Thus, even innocent misrepresentations may be deemed fraudulent under this legal theory.
6. See, Barrett v. Bank of America, 183 Cal. App. 3d 1362 (1986) (discussed above).

J. Negligence

1. elements

- a. duty of care

- b. breach
 - c. foreseeable, proximately caused damages
2. A claim of negligence generally arises in two places in the lender-borrower context:

a. application/processing stage

- (1) Courts are generally reluctant to find that a lender owes a duty of care to a loan applicant with whom the lender has no existing contractual relationship. In a few recent cases, however, courts have suggested that a lender that has received consideration for processing a loan application may have a duty of care to the potential borrower to process the application with due care, and not to deny credit because of negligence or unreasonable delay in the credit approval process.

(a) Jacques v. The First National Bank of Maryland, 307 Md. 527, 515 A.2d 756 (1986) - bank liable for failure to exercise due care in determining amount of loan for which borrowers qualified

(b) First Federal Savings & Loan Association of Hamilton v. Caudle, 425 So.2d 1050 (Ala. 1983) - bank may be held liable for negligent processing of HUD application

b. loan administration stage

Increasingly, courts hold that lenders owe a duty of care to borrowers to administer loans and borrowing and disbursement requests in a competent, nonnegligent manner.

Such holdings can be especially significant in certain specialized areas of lending, such as construction lending, asset-based lending, and factoring where the lender holds itself out as having special expertise or qualifications.

Columbia Plaza Corp. v. Security National Bank, 676 F.2d 780 (D.C. Cir. 1980)
(officer of bank accepted bribe, but bank was not liable for negligent administration)

Brunswick Bank & Trust Co. v. U.S., 707 F.2d 1355 (Fed. Cir. 1983) (bank precluded from collecting on government guarantee if government could prove that bank had negligently administered underlying loan)

- c. Depending upon the jurisdiction, contributory or comparative negligence may be valid defenses to a claim of negligence.

K. Defamation

- 1. libel
- 2. slander

A claim of defamation usually arises in connection with responses to credit inquiries.

L. Interference

- 1. three torts

- a. interference with contractual relationships

- (1) elements: See Restatement (Second) of Torts, §§766, 766A

- (a) existence of enforceable contract

- (b) actual knowledge by bank of existence of contract

- (c) intent to interfere - malice or intent to harm may not be required; mere intent to commit the act that foreseeably results in the interference may be enough

- (d) provable damages, proximately caused
- b. interference with prospective business advantage - This tort is comprised virtually the same elements as the tort of interference with contractual relationships except that: (1) a higher showing of malice or intent to harm is ordinarily required to establish this tort, and (2) this tort involves interference with, not an existing contractual relationship, but a business expectancy. Restatement (Second) of Torts §766B.
- c. negligent interference - not actionable. See Restatement (Second) of Torts §766C (1979)
- d. interference with corporate governance - For a succinct judicial description of this tort. See, Farah Manufacturing Company, Inc. v. State National Bank of El Paso, 678 S.W.2d 671, 690 (Tex. 1984):

FMC was entitled to have its affairs managed by competent directors and officers who maintain a high degree of undivided loyalty to the company...The evidence is factually sufficient that the interference compelled the election of directors and officers whose particular business judgment and inexperience and whose divided loyalty proximately resulted in injury to FMC. The interference by the lenders was done willfully, intentionally, and without just cause or excuse. As a matter of law, FMC has established a cause of action for interference.

M Racketeering

1. Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 - statutory elements

- a. a person (including an individual or entity);
 - b. employed by or associated with an enterprise engaged in interstate commerce (including individuals, partnerships, associations, and other legal and nonlegal entities);
 - c. conducts or participates in the conduct of the affairs of the enterprise
 - d. through a pattern (at least two acts within ten years of one another);
 - e. of racketeering activity (including many state and federal criminal acts involving fraudulent conduct, including mail fraud)
 - f. affects interstate commerce;
 - g. resulting injury to business or property
2. can recover treble damages and attorneys' fees

N. Instrumentality liability is the treatment of the lender as the agent, partner, joint venturer, or alter ego of the borrower. The result of imposition of instrumentality is that the claim of the lender against its borrower may be disallowed or treated as equity, or the lender may be held liable to other creditors of its borrower.

- 1. agency - In a Gay Jenson Farms, 309 N.W.2d 285 (Minn. 1981), a lender was held to be an agent of its borrower by the virtue of its interference with the internal affairs of the borrower, which owned a grain elevator. The factors giving rise to this finding were the lender's right of first refusal with respect to the purchase of grain, right of entry to conduct audits, and right to cut off financing.
- 2. alter ego - In Krivo Industrial Supply Co. v. National Distillers & Chemical Corp. 483 F.2d 1098 (5th Cir. 1973), the court held that influence arising from a lender's power and status as a major creditor did not make a lender liable to its borrower's creditors, absent the actual exercise of such control. In Krivo, the lender was a mandatory co-signer

of checks and had the power to decide which creditors were paid.

3. partner/joint venturer - In Connor v. Great Western Savings & Loan Association, 69 Cal. 2d 850 (1968), notwithstanding the fact that many of the elements of a joint venture were present, the court rejected the claim of home purchasers that a lender was a joint venturer of the developer and, hence, liable for the developer's negligence. The court held that a joint venture is an agreement between the parties under which they have a community of interest in a common business undertaking, a sharing of profits and losses, and a right of joint control. The fact that both profited from a successful development did not establish the existence of a joint venture.

O. Conversion

1. This tort involves the wrongful deprivation of a borrower's possession of property by a bank.
2. The primary circumstance in which a conversion claim is likely to arise is wrongful repossession.

In Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983), the Alaska Supreme Court affirmed an award of actual and punitive damages to a borrower whose collateral was repossessed without notice. Even though the loan agreement authorized repossession without notice, the court held the lender had waived the right to strictly enforce the agreement by accepting late payments and negotiating a workout.

P. Outrage/Intentional infliction of emotional distress

1. elements
 - a. extreme and outrageous conduct - conduct must shock the conscience - must be outside accepted community norms
 - b. intent to cause emotional distress - reckless disregard of the probability of causing emotional distress

- c. severe emotional distress
- d. actual and proximate causation of the emotional distress
- e. damages

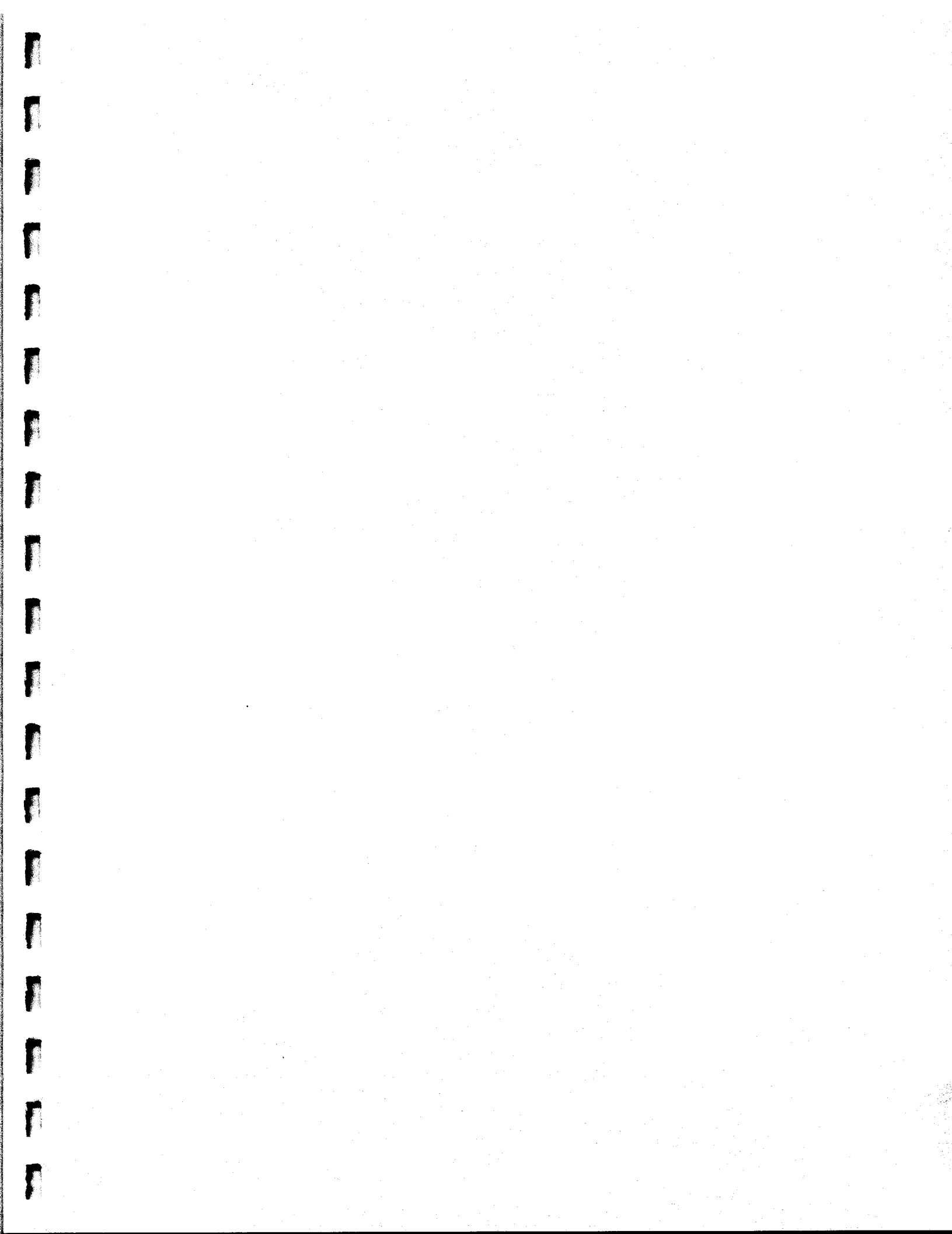
2. not available to corporations

Q. Prima Facie Tort

Restatement (Second) of Torts §870

One who intentionally causes injury to another is subject to liability for that injury, if his conduct is generally culpable and not justifiable under the circumstances. This liability may be imposed although the actor's conduct does not come within a traditional category of tort liability.

In Centerre Bank of Kansas City v. Distributors, Inc., 705 S.W.2d 42 (Mo. 1985) a court of appeals reversed a judgment on a \$7.5 million jury verdict against a bank based upon the allegedly wrongful acceleration of a demand note. The verdict was based in part on the prima facie tort. The appellate court found sufficient economic justification for the bank's action to defeat the claim because the borrower was losing money, the inventory figures supplied to the bank by the borrower were suspect, receivable delinquencies were high, and the bank was in a negative case position.

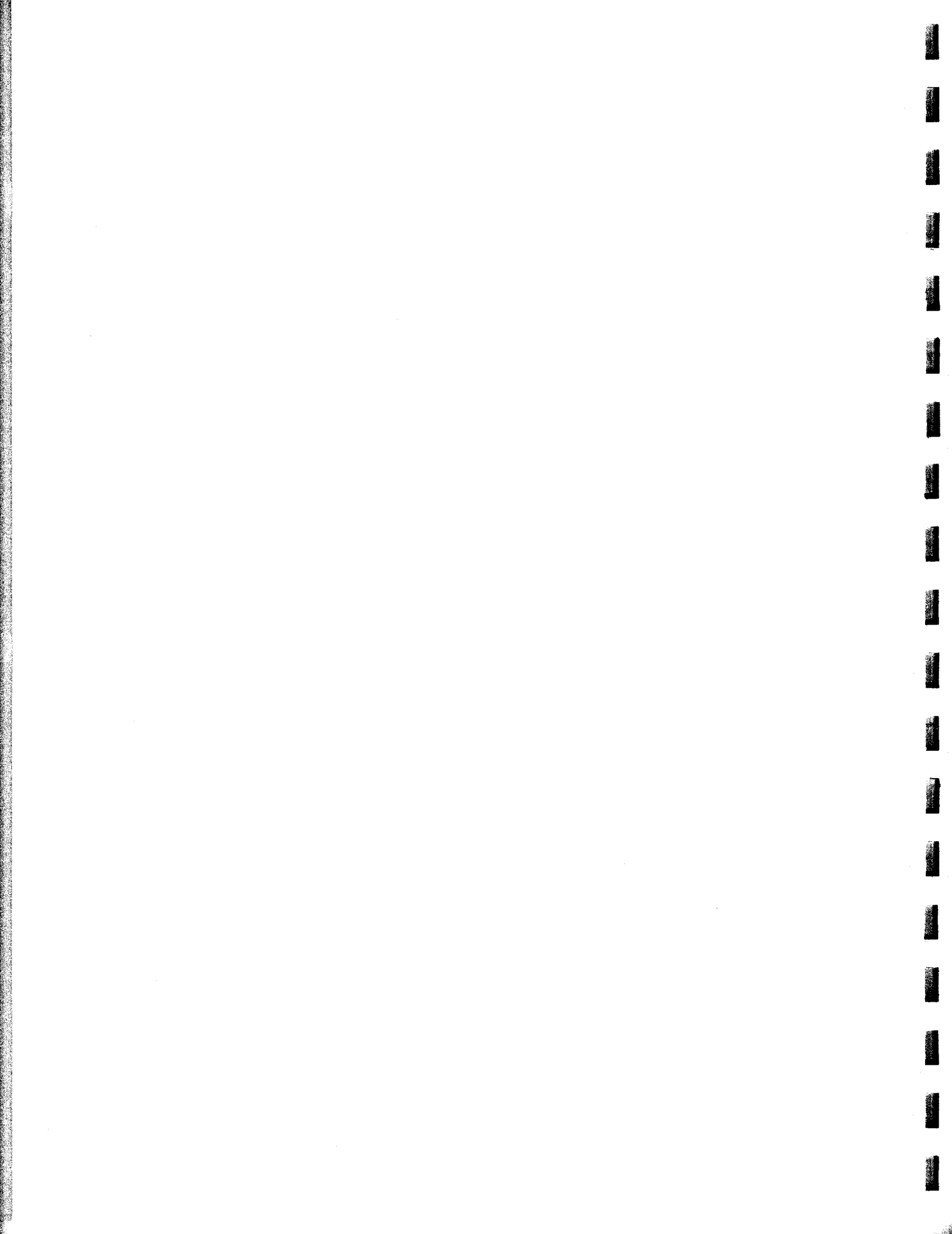


DEFENDING LENDER LIABILITY CASES

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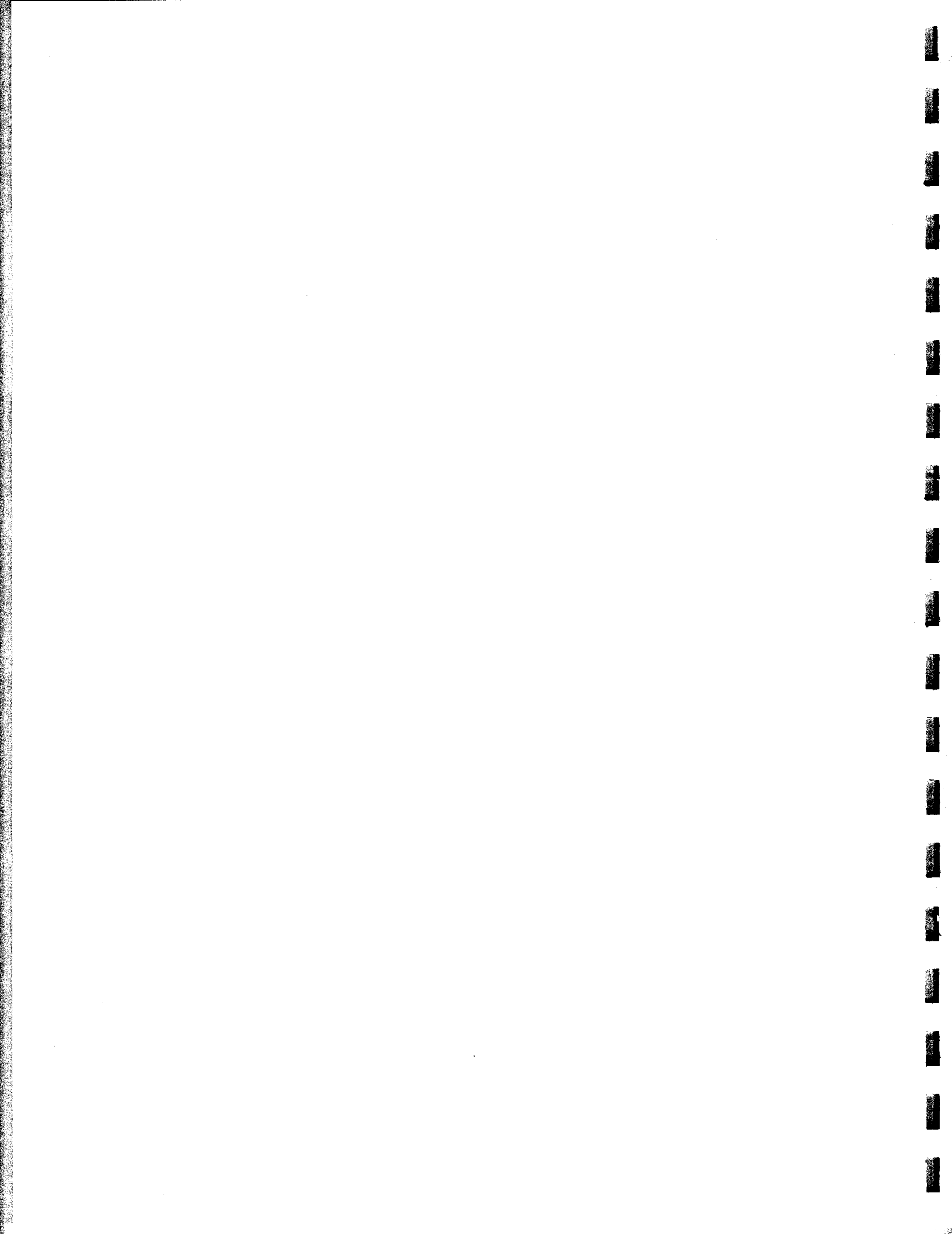
DEFENDING LENDER LIABILITY CASES

TABLE OF CASES

	<u>Page</u>
<u>Alford v. Frontier Enterprises, Inc.</u> , 599 F.2d 483 (1st Cir. 1979)	K-17
<u>Amoco Transport Company v. Bugsier Reederei and Bergrings, A.G.</u> , 659 F.2d 789, 794 (7th Cir. 1981).	K-4
<u>ARH Distributors, Inc. v. ITT Commercial Finance Corp.</u> , No. 87 C 00511, Slip. Op. (N.D. Ill. September 24, 1987)	K-18
<u>The Bank of California, N.A. v. Martin</u> , No. 37807 (Superior Court of Chelan County, Washington) . . .	K-26
<u>Benge v. Software Galeria, Inc.</u> , 608 F.Supp. 601 (E.D. Mo. 1985)	K-12
<u>Buschmann v. Professional Men's Association</u> 405 F.2d 659 (7th Cir. 1969)	K-17
<u>Clapper v. Commonwealth Realty Trust</u> , 85-686 (D. Del June 22, 1987)	K-17
<u>Continental Illinois National Bank & Trust Company of Chicago v. Stanley</u> , 585 F.Supp. 1385, 1388-89 (N.D. Ill. 1984)	K-16
<u>Continental Illinois National Bank & Trust Company of Chicago v. Windham</u> , 558 F.Supp. 578 (E.D. Tex. 1987)	K-19
<u>Cyclopedia of the Law of Private Corporations</u> , 5911 (rev. perm. ed. 1984)	K-17
<u>D'Antuono v. CCH Computax Systems, Inc.</u> , 570 F.Supp. 708, 713 (D. R.I. 1983)	K-13
<u>Dean W. Knight & Sons v. First Western Bank & Trust Co.</u> , 84 Cal., App. 3d 560, 148 Cal. Rptr. 767 (1978)	K-24
<u>In re Double TRL, Inc.</u> , 65 Bankr. 993 (Bankr. E.D. N.Y. 1986)	K-7
<u>FDIC v. Scharenburg v. Continental Illinois National Bank</u> , No. 84-2712-CIV-DAVIS; No. 87-0211-CIV-DAVIS; No. 87-0238-CIV-DAVIS (S.D. Fla. 1987)	K-26

	<u>Page</u>
F. Motion to dismiss tort claim for failure to state a claim	K- 17
G. Motion to dismiss specific claims for failure to state claims upon which relief may be granted and/or Motion for Summary Judgment or Partial Summary Judgment	K- 18
1. Motion to dismiss or for summary judgment on the ground that the claim is barred by the doctrine of res judicata	K- 19
2. Motion to dismiss or for summary judgment on the ground that the borrower has waived or released its lender liability case	K- 19
H. Motion to strike jury demand	K- 20
1. On grounds of untimeliness	K- 20
2. Contractual jury waiver	K- 20
I. Motion for summary judgment on collection claims	K- 23
J. Motions in Limine to preclude offer of prejudicial and clearly irrelevant facts . .	K- 23
1. Size of bank	K- 23
2. Ownership of bank	K- 23
3. Status of loan	K- 23
4. Termination of bank employee(s)	K- 23
II. Pre-trial Discovery	K- 23
III. Pre-trial Preparation	K- 23
IV. Trial	K- 23
- A. Personalization of bank	K- 23
B. Telling the whole story	K- 23
C. Motions for directed verdict	K- 24

	<u>Page</u>
1. Plaintiff's causes of action	K-24
2. Speculativeness of damages	K-24
D. Jury instructions	K-26



DEFENDING LENDER LIABILITY CASES

TABLE OF CONTENTS

	<u>Page</u>
I. Pre-trial Motions	K-1
A. Motion to dismiss complaint or stay civil litigation in favor of arbitration under the Federal Arbitration Act	K-1
1. Scope of the Federal Arbitration Act	K-1
2. Grounds for attacking validity of arbitration clauses	K-2
3. Relationship to waiver of right to jury trial	K-3
4. Applicability of arbitration clauses to non-contract issues and claims	K-3
5. The severability of arbitration clauses	K-5
6. Applicability of Federal Arbitration Act to adversary proceedings filed in Bankruptcy cases	K-7
B. Motion to compel arbitration under the Uniform Arbitration Act	K-7
1. Jurisdictions which have adopted the Uniform Arbitration Act	K-7
2. Scope and content of the Uniform Arbitration Act	K-8
3. Sample arbitration clauses	K-9
C. Motion to dismiss or stay based upon a contractual forum selection clause or to change venue on the grounds of forum non conveniens	K-9
1. Forum selection clauses	K-9
2. Forum Non Conveniens	K-12
D. Choice of law	K-13
E. Motion to dismiss for failure to state a claim on the ground that the plaintiff lacks standing to sue	K-15

	<u>Page</u>
<u>Handy Caddy, Inc. v. American Home Products Corp., 557 F.2d 136, 139 (8th Cir. 1977)</u>	K- 26
<u>In re Hart Ski Mfg. Co., Inc., 711 F.2d 845 (8th Cir. 1983)</u>	K- 7
<u>ITT Diversified Credit Corp. v. Kimmel, 508 F.Supp. 140 (N.D. Ill. 1981)</u>	K- 15
<u>John Deere Company of St. Louis v. Short, 378 S.W.2d 496, 503 (Mo. 1964)</u>	K- 17
<u>Johnson Controls, Inc. v. City of Cedar Rapids, 713 F.2d 370 (8th Cir. 1983)</u>	K- 1
<u>Judice's Sunshine Pontiac, Inc. v. General Motors, 418 F.Supp. 1212 (D. N.J. 1976)</u>	K- 17
<u>Kline v. Kawai American Corporation, 498 F.Supp. 868 (D. Minn. 1980)</u>	K- 11
<u>K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985)</u>	K- 23
<u>In re Knickerbocker, 827 F.2d 281, 288 (8th Cir. 1987)</u>	K- 25
<u>Lakota Girl Scout Council, Inc. v. Havey Fund-Raising Management, Inc., 519 F.2d 634, 640 (8th Cir. 1975)</u>	K- 25
<u>Leasing Service Corp. v. Crane, 804 F.2d 828 (4th Cir. 1986)</u>	K- 21
<u>M/S Bremen v. Zapata Off-Shore Company, 407 U.S. 1, 92 S.Ct. 1907, 32 L.Ed.2d 513 (1972)</u>	K- 9
<u>Mayer v. Oxidation Products Co., Inc., 110 N.J. Eq. 141, 146 (Ch. 1932)</u>	K- 16
<u>Merrill Lynch, Pierce Fenner & Smith v. Hovey, 726 F.2d 1286 (8th Cir. 1984)</u>	K- 4
<u>Midwest Mechanical Contractors, Inc. v. Tampa Constructors, Inc., 659 F.Supp. 526, 531 (W.D. Mo. 1987)</u>	K- 12
<u>Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985)</u>	K- 1

	<u>Page</u>
<u>Morgan v. Smith Barney, Harris Upham & Co.,</u> 729 F.2d 1163, 1165 (8th Cir. 1984)	K-3
<u>Moses H. Cone Memorial Hospital v. Mercury</u> <u>Construction Corp.,</u> 460 U.S. 1 (1983)	K-1
<u>N. Feldman & Son, Ltd. v. Cheeker Motors</u> <u>Corp.,</u> 572 F.Supp. 310, 313 (S.D.N.Y. 1983)	K-20
<u>N&D Fashions, Inc. v. DHJ Industries, Inc.,</u> 548 F.2d 722, 728 (8th Cir. 1977)	K- 2,4,6
<u>National Equipment Rental, Ltd. v. Hendrix,</u> 565 F.2d 255 (2d. Cir. 1977)	K-22
<u>Oneida Motor Freight v. United Jersey Bank,</u> 75 Bankr. 235 (D. N.J. 1987)	K-19
<u>Penthouse International, Ltd. v. Dominion</u> <u>Federal Savings & Loan Association,</u> 665 F.Supp. 301 (S.D.N.Y.)	K-26
<u>Pierson v. Dean, Witter, Reynolds, Inc.,</u> 742 F.2d 334 (7th Cir. 1984)	K-6
<u>Plum Tree, Inc. v. Stockment,</u> 488 F.2d 754, 757 (3rd Cir. 1983)	K-12
<u>Retama Nursing Centers, Inc. v. Cole,</u> 582 S.W.2d 196 (Tex. Civ. App. 1979)	K-25
<u>Ronco, Inc. v. Plastics, Inc.,</u> 539 F.Supp. 391 (N.D. Ill. 1982)	K-18
<u>Rouse Woodstock, Inc. v. Surety Federal</u> <u>Savings & Loan Association,</u> 630 F.Supp. 1004, 1008 (N.D. Ill. 1986)	K-13
<u>Ruth v. First National Bank of New Jersey,</u> 410 F.Supp. 1233 (D. N.J. 1976)	K-17
<u>Seligson v. Plum Tree,</u> 361 F.Supp. 748, 758 (E.D. Penn. 1973)	K-20
<u>Shearson/American Express, Inc. v. McMahon,</u> 107 S.Ct. 2332 (1987)	K-1,2,3
<u>Smith-Johnson Motor Corp. v. Hoffman Motors</u> <u>Corp.,</u> 411 F.Supp. 670, 677 (E.D. Va. 1975)	K-20

	<u>Page</u>
<u>Stark v. Shaw</u> , 155 Cal. App. 2d 171, 181, 317 P.2d 512, 517 (1974)	K- 25
<u>Truscott v. Peterson</u> , 50 N.W.2d 245, 257 (N.D. 1951)	K- 24
<u>Twohy v. First National Bank of Chicago</u> , <u>supra</u> , 758 F.2d at 1194 (7th Cir. 1985)	K- 16
<u>Unionmutual Stock Life Ins. Co. of America v.</u> <u>Beneficial Life Ins. Co.</u> , 774 F.2d 524, 528 (1st Cir. 1985)	K- 1
<u>Vickers v. Wichita State Univ.</u> , 213 Kan. 614, 620-621 518 P.2d 512, 517 (1974)	K- 24
<u>Wheeler v. St. Joseph Hospital</u> , 63 Cal. App. 3d 345	K- 3
<u>White v. First National Bank</u> , 252 Pa. 205, 97 A. 403 (1916)	K- 16
<u>Zimmerman v. Continental Airlines, Inc.</u> , 712 F.2d 55, 60 (3rd Cir. 1983), <u>cert. denied</u> 104 S.Ct. 998	K- 7

DEFENDING LENDER LIABILITY CASES

by Neal L. Wolf

I. Pre-trial Motions

A. Motion to dismiss complaint or stay civil litigation in favor of arbitration under the Federal Arbitration Act

1. Scope of the Federal Arbitration Act. Valid, written arbitration clauses in contracts involving transactions in, inter alia, interstate commerce, are enforceable in the Courts of the United States under the Federal Arbitration Act, 9 U.S.C. §1 et seq., (the "Act"), a complete copy of which is provided in Exhibit A hereto. The Act expresses a strong federal policy favoring arbitration. That policy has been articulated at all levels of the federal judicial system, including the United States Supreme Court. (See, e.g., Shearson/American Express, Inc. v. McMahon, 107 S.Ct. 2332 (1987); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985); Moses H. Cone Memorial Hospital v. Mercury Construction Corp., 460 U.S. 1 (1983). As the Court noted in Moses H. Cone:

[T]he Courts of Appeals have...consistently concluded that questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. We agree. The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.

460 U.S. at 24-25; see also, Unionmutual Stock Life Ins. Co. of America v. Beneficial Life Ins. Co., 774 F.2d 524, 528 (1st Cir. 1985) (dispute is arbitrable unless it "may be said with positive assurance" that the arbitration clause does not cover the dispute); Johnson Controls, Inc. v. City

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of Cedar Rapids, 713 F.2d 370, (8th Cir. 1983) ("The Court must also be guided by the 'liberal federal policy favoring arbitration....'").

Section 1 of the Act defines "commerce" to include, without limitation, "commerce among the several States." The Act is not applicable to transactions in intra-state commerce.

2. Grounds for attacking validity of arbitration clauses. Section 2 of the Act provides that written arbitration clauses in contracts evidencing transactions in commerce are "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contracts":

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

Grounds for revocation of arbitration clauses include such grounds as would permit revocation or rescission of contracts generally, including without limitation: fraud, unconscionability, and lack of capacity. See, e.g., Shearson/American Express, Inc. v. McMahon, 107 S.Ct. 2332 (1987):

Absent a well-founded claim that an arbitration agreement resulted from the sort of fraud or excessive economic power that "would provide grounds 'for the revocation of any contract,'" ibid., the Arbitration Act "provides no basis for disfavoring agreements to arbitrate statutory claims by skewing the otherwise hospitable inquiry into arbitrability." Ibid.

(citations omitted); N&D Fashions, Inc. v. DHJ Industries, Inc., 548 F.2d 722 (8th Cir. 1977) (in which the Court acknowledged that lack of authority by an alleged agent to bind the putative principal

under an arbitration clause would nullify the arbitration agreement, but found that the agent had apparent authority in the case at bar).

3. Relationship to waiver of right to jury trial. In essence, an agreement to arbitrate a dispute is a waiver of a party's right to a jury trial of the dispute. Thus, to the extent that, under applicable statutory or case law, a waiver of a right to jury trial will be effective only under certain defined circumstances, a person drafting an arbitration clause should consider the applicability of any rules, procedures, or guidelines concerning jury trial waivers. For a case recognizing the relationship between an arbitration agreement and a contractual waiver of the right to jury trial, and the requirement that, for the arbitration clause to be effective, a party to such agreement understand that he, she, or it is relinquishing jury trial rights, see Wheeler v. St. Joseph Hospital, 63 Cal. App. 3d 345 (1976).
4. Applicability of arbitration clauses to non-contract issues and claims. Section 3 of the Act requires the court, upon timely motion of one of the parties to the arbitration agreement, to stay trial of the action if it is satisfied that the issue is subject to arbitration under the agreement:

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

Courts have held that statutory and tort claims are subject to arbitration. See, e.g., Shearson/American Express, Inc. v. McMahon, 107 S.Ct. 2332 (1987) (claims brought under §10b of the Securities Exchange Act of 1934 and under the Racketeer Influenced and Corrupt Organizations Act were arbitrable under arbitration agreement between securities broker and its customer); Morgan v.

Smith Barney, Harris Upham & Co., 729 F.2d 1163, 1165 (8th Cir. 1984) (in which the Court, announcing that "when contract language is ambiguous or unclear, a 'healthy regard' for the federal policy favoring arbitration requires that 'any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration,'" held that certain prima facie tort and slander claims by an ex-account executive against its former employer were arbitrable under the Rules and Constitution of the New York Stock Exchange; in so holding, the court carved out one of the plaintiff's claims as not being subject to arbitration); N&D Fashions, Inc. v. DHJ Industries, Inc., 548 F.2d 722, 728 (8th Cir. 1977):

It is clear, first, that this dispute is within the terms of the arbitration agreement. The arbitration clause is applicable to "[a]ny controversy arising under, or in relation to, this contract." While N&D's claim is nominally based on fraud and misrepresentation rather than breach of contract, it plainly arises "in relation to" the contract, and so is within the scope of this broad arbitration clause.

Amoco Transport Company v. Bugsier Reederei and Bergrings, A.G., 659 F.2d 789, 794 (7th Cir. 1981):

Whether a particular claim is arbitrable depends not upon the characterization of the claim, but upon the relationship of the claim to the subject matter of the arbitration clause. Were the rule otherwise, a party could frustrate any agreement to arbitrate simply by the manner in which it framed its claims.

In the Amoco case, the Court held that tort claims arising out of the salvage of a tanker that was out of control, including but not limited to claims for negligence and breach of, an alleged warranty of seaworthiness, were arbitrable under an arbitration clause in the salvage agreement between the parties.

Courts have taken an expansive view of the kinds of claims which are arbitrable under arbitration clauses. In Merrill Lynch, Pierce Fenner & Smith v. Hovey, 726 F.2d 1286 (8th Cir. 1984) for instance, Merrill Lynch filed a District Court

lawsuit to enjoin five former employees from using company records and soliciting the business of Merrill Lynch clients. Relying upon the Federal Arbitration Act and New York Stock Exchange Rule 347, which provides for the arbitration of any controversy between a registered representative and any member or member organization arising out of the employment or termination of employment of the representative, the former employees sought to compel arbitration. Finding that the solicitation and duplication of records took place after the employment relationship had been terminated, the District Court granted the requested injunctive relief and refused to submit the dispute to arbitration. The Court of Appeal reversed, stating in part:

In contrast to a tort action, the factual circumstances presented here relate to a classic breach of contract situation. It is true that the alleged use of the records and solicitation of business occurred after the employees had resigned and thus after their employment contracts (and the agreement to arbitrate) had been terminated. However, the controversy itself arose out of, or because of, conditions that were imposed during the time the employment and arbitration agreements were in existence.

For the reasons discussed, we hold that the present controversy "arise[s] out of the employment or termination of employment." At least as to the construction and applicability of these conditions, we conclude that the arbitration agreement remains viable beyond the employment relationship of the parties.

5. The severability of arbitration clauses. Section 4 of the Act establishes a procedure by which a party to a dispute can obtain a district court order compelling arbitration when the other party fails, neglects, or refuses to arbitrate under the arbitration clause. Section 4 also establishes a procedure for the separate judicial, and perhaps jury, resolution of issues concerning "the making of the arbitration agreement or the failure, neglect, or refusal to perform the same":

If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed

summarily to the trial thereof. If no jury trial be demanded by the party alleged to be in default, or if the matter in dispute is within admiralty jurisdiction, the court shall hear and determine such issue. Where such an issue is raised, the party alleged to be in default may, except in cases of admiralty, on or before the return day of the notice of application, demand a jury trial of such issue, and upon such demand the court shall make an order referring the issue or issues to a jury in the manner provided by the Federal Rules of Civil Procedure, or may specially call a jury for that purpose. If the jury find that no agreement in writing for arbitration was made or that there is no default in proceeding thereunder, the proceeding shall be dismissed. If the jury find that an agreement for arbitration was made in writing and that there is a default in proceeding thereunder, the court shall make an order summarily directing the parties to proceed with the arbitration in accordance with the terms thereof.

A claim of fraud in the making of the underlying contract does not necessarily mandate a judicial determination on the issue of fraud. A few courts, including the United States Court of Appeals for the Eighth Circuit, have held that an arbitration clause is severable from the remainder of the contract and that, absent a claim of fraud in the inducement to enter into the arbitration clause itself, a fraud claim may be heard by the arbitrator:

...the fraud and misrepresentation claim is not one which would defeat the duty to arbitrate. At most, N&D claims fraud in the inducement to enter the contract of sale, rather than fraud in the inducement to enter the agreement to arbitrate. Fraud of the first type does not affect the duty to arbitrate.

N&D Fashions, Inc. v. DHJ Industries, Inc., 548 F.2d 722, 728 (8th Cir. 1977); e.g., Pierson v. Dean, Witter, Reynolds, Inc., 742 F.2d 334 (7th Cir. 1984).

6. Applicability of Federal Arbitration Act to adversary proceedings filed in Bankruptcy cases. Some courts have held that, notwithstanding the strong federal policy favoring arbitration, because of certain competing policies underlying the enactment of the Bankruptcy Reform Act of 1978, the grant or denial of a motion for a stay pending arbitration of a dispute between a debtor and its creditor under an arbitration agreement is within the sound discretion of the Bankruptcy Court. See, e.g., Zimmerman v. Continental Airlines, Inc., 712 F.2d 55, 60 (3rd Cir. 1983), cert. denied 104 S.Ct. 998:

Bankruptcy proceedings, however, have long held a special place in the federal judicial system. Because of their importance to the smooth functioning of the nation's commercial activities, they are one of the few areas where Congress has expressly preempted state court jurisdiction. See 28 U.S.C. §1334. While the sanctity of arbitration is a fundamental federal concern, it cannot be said to occupy a position of similar importance. Therefore, because of the importance of bankruptcy proceedings in general, and the need for the expeditious resolution of bankruptcy matters in particular, we hold that the intentions of Congress will be better realized if the Bankruptcy Reform Act is read to impliedly modify the Arbitration Act. Thus, while a bankruptcy court would have the power to stay proceedings pending arbitration, the use of this power is left to the sound discretion of the bankruptcy court.

e.g., In re Double TRL, Inc., 65 Bankr. 993 (Bankr. E.D. N.Y. 1986); but cf., In re Hart Ski Mfg. Co., Inc., 711 F.2d 845 (8th Cir. 1983) (in which the Eighth Circuit rejected a debtor's argument that, by filing a proof of claim, a creditor waived its contractual right to arbitrate).

B. Motion to compel arbitration under the Uniform Arbitration Act

1. Jurisdictions which have adopted the Uniform Arbitration Act. Thirty states and the District of Columbia have adopted the Uniform Arbitration Act since it was first drafted in 1955. Jurisdictions which have enacted the Uniform Arbitration Act include, without limitation, Delaware (1972), the

District of Columbia (1977), Illinois (1961), Maryland (1965), Massachusetts (1960), Pennsylvania (1980), Texas (1966), Vermont (1985), and Virginia (1986). New York and New Jersey are not among the states which have adopted the Uniform Arbitration Act. The legislatures and courts of a number of states which have not adopted the Uniform Arbitration Act have recognized the validity of such clauses, however. The General Assembly of California, for instance, enacted the California Arbitration Act (Code Civ. Proc., §1280 et seq.) A complete copy of the Uniform Arbitration Act and a list of those jurisdictions which have enacted it are provided in Exhibit B hereto.

2. Scope and content of the Uniform Arbitration Act. Like its federal counterpart, the Uniform Arbitration Act expresses a strong policy in favor of the recognition of arbitration agreements. Section 1 of the Uniform Arbitration Act provides as follows:

§1. Validity of Arbitration Agreement. A written agreement to submit any existing controversy to arbitration or a provision in a written contract to submit to arbitration any controversy thereafter arising between the parties is valid, enforceable and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract. This act also applies to arbitration agreements between employers and employees or between their respective representatives [unless otherwise provided in the agreement].

Section 2 of the Act provides a procedural mechanism by which a party to state court litigation of a dispute which is within the scope of an arbitration agreement may obtain an order compelling arbitration:

§2. Proceedings to Compel or Stay Arbitration.

(a) On application of a party showing an agreement described in Section 1, and the opposing party's refusal to arbitrate, the Court shall order the parties to proceed with arbitration, but if the opposing party denies the existence of the agreement to arbitrate, the Court shall proceed summarily to the determination of the issue so raised and shall

order arbitration if found for the moving party, otherwise, the application shall be denied.

(b) On application, the court may stay an arbitration proceeding commenced or threatened on a showing that there is no agreement to arbitrate. Such an issue, when in substantial and bona fide dispute, shall be forthwith and summarily tried and the stay ordered if found for the moving party. If found for the opposing party, the court shall order the parties to proceed to arbitration.

Subsequent sections of the Uniform Arbitration Act address the appointment of arbitrators (Section 3); the manner in which the arbitration shall be decided (Section 4); the scheduling and conduct of hearings before the arbitration panel or arbitrator (Section 5); right to counsel (Section 6); witnesses, subpoenas, and depositions (Section 7); the timing and form of any award (Section 8); and post-award matters such as judicial confirmation of an arbitration award (Section 11); vacating an award (Section 12); and modification or correction of an award (Section 13).

3. Sample arbitration clauses

A number of lenders today routinely insert arbitration clauses in their loan and workout agreements. The most carefully drafted clauses expressly extend to tort claims which arise between the parties and expressly exclude the lender's seizure and sale of collateral or foreclosure of its mortgage, deed of trust, or security interest from the ambit of the arbitration clause. Exhibit C contains a few such clauses.

C. Motion to dismiss or stay based upon a contractual forum selection clause or to change venue on the grounds of forum non conveniens

1. Forum selection clauses. The federal rule is that forum selection clauses are presumptively valid and enforceable. The leading case on the subject is M/S Bremen v. Zapata Off-Shore Company, 407 U.S. 1, 92 S.Ct. 1907, 32 L.Ed.2d 513 (1972), in which the Supreme Court held that, where Zapata, a Houston-based American company, contracted with Unterweser, a German company, to tow Zapata's drilling rig from Louisiana to Italy, and the contract required that

any disputes be litigated before the London Court of Justice, a neutral court, the forum selection clause was prime facie valid and enforceable in the absence of some compelling and countervailing reason making enforcement unreasonable. Although the Court was at least partially motivated by policy considerations relating to the expansion of American business abroad ("The expansion of American business will hardly be encouraged if, notwithstanding solemn contracts, we insist on a parochial concept that all disputes must be resolved under our laws and in our courts." Id. at 1912), it clearly announced the desire to break from a tradition under which such clauses were disfavored:

Forum-selection clauses have historically not been favored by American courts. Many courts, federal and state, have declined to enforce such clauses on the ground that they were "contrary to public policy," or that their effect was to "oust the jurisdiction" of the court. Although this view apparently still has considerable acceptance, other courts are tending to adopt a more hospitable attitude toward forum-selection clauses. This view, advanced in the well-reasoned dissenting opinion in the instant case, is that such clauses are prima facie valid and should be enforced unless enforcement is shown by the resisting party to be "unreasonable" under the circumstances. We believe this is the correct doctrine to be followed by federal district courts sitting in admiralty.

92 S.Ct. at 1913. In holding that such clauses are presumptively valid, the Court outlined some of the factors which might serve to prevent enforcement of a forum selection clause:

- a. "fraud, undue influence, or overweening bargaining power..." Id. at 1914.
- b. "if enforcement would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision." Id. at 1916.
- c. "if the chosen forum is seriously inconvenient for the trial of the action." Id.

With respect to inconvenience, the third listed factor, the Court noted that the party claiming such inconvenience must bear a very heavy burden of proof:

Of course, where it can be said with reasonable assurance that at the time they entered the contract, the parties to a freely negotiated private international commercial agreement contemplated the claimed inconvenience, it is difficult to see why any such claim of inconvenience should be heard to render the forum clause unenforceable. We are not here dealing with an agreement between two Americans to resolve their essentially local disputes in a remote alien forum. In such a case, the serious inconvenience of the contractual forum to one or both of the parties might carry greater weight in determining the reasonableness of the forum clause. The remoteness of the forum might suggest that the agreement was an adhesive one, or that the parties did not have the particular controversy in mind when they made their agreement; yet even there the party claiming should bear a heavy burden of proof.

Id., at 1916-17. The lower courts have followed Zapata in upholding choice of forum clauses. See, Kline v. Kawai American Corporation, 498 F.Supp. 868 (D. Minn. 1980). In Kline, a Minnesota-based piano and organ dealer, filed a Minnesota District Court lawsuit against its California-based distributor for breach of the dealership agreement, wrongful cancellation of the dealer's credit line, unlawful restraint of trade, and misrepresentation. The dealership agreement contained a choice of forum clause requiring the dealer to bring any suit arising out of or in connection with the agreement in a court located in Los Angeles County, California. The distributor moved to dismiss the complaint on the basis of the forum selection clause. Citing Zapata for the prima facie validity of the forum selection clause and the substantial burden which a party contesting the enforcement of such a clause must bear, the Court transferred the case to the United States District Court for the Central District of California. In doing so, the Court listed various factors which it would consider in determining the reasonableness of the parties' chosen forum:

A number of factors are relevant to this determination, including 1) which law governs the formation and construction of the contract; 2) the residency of the parties; 3) the place of execution and/or performance of the contract; 4) the location of the parties and witnesses probably involved in the litigation; 5) the inconvenience to the parties; and 6) whether the provision was equally bargained for.

498 F.Supp. at 871-2. Most of the listed factors are more relevant to a forum non conveniens analysis than a forum selection analysis. E.g., Benge v. Software Galeria, Inc., 608 F.Supp. 601 (E.D. Mo. 1985) (court transferred lawsuit alleging, inter alia, fraud in the inducement of franchise agreement containing forum selection clause).

2. Forum Non Conveniens. Even if the parties have entered into a forum selection agreement, a party may seek to transfer venue from the parties' selected forum to another forum in which venue is proper on the grounds of forum non conveniens.

a. The forum non conveniens doctrine is codified in 28 U.S.C. § 404(a):

For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought.

b. A court may transfer venue to a district other than that which the parties have chosen in an otherwise valid forum selection clause under the doctrine of forum non conveniens. The moving party has the burden of proving that the transfer will be to a more convenient forum. Midwest Mechanical Contractors, Inc. v. Tampa Constructors, Inc., 659 F.Supp. 526, 531 (W.D. Mo. 1987):

The Court is not prevented by the existence of a valid forum selection clause from considering a motion to transfer made pursuant to § 1404(a). In Plum Tree, Inc. v. Stockment, 488 F.2d 754, 757 (3rd Cir. 1973), the Court held that a forum selection clause whose

enforcement is not unreasonable does not preclude the selected forum from ordering a § 1404(a) transfer. The Court stated:

Congress set down in § 1404(a) the factors it thought should be decisive on a motion for transfer. Only one of these - the convenience of the parties - is properly within the power of the parties themselves to affect by a forum-selection clause. The other factors - the convenience of witnesses and the interest of justice - are third party or public interests that must be weighed by the district court; they cannot be automatically outweighed by the existence of a purely private agreement between the parties. Such an agreement does not obviate the need for an analysis of the factors set forth in § 1404(a) and does not necessarily preclude the granting of the motion to transfer.

Id. at 757-58.

E.g., Rouse Woodstock, Inc. v. Surety Federal Savings & Loan Association, 630 F.Supp. 1004, 1008 (N.D. Ill. 1986):

Typically, a valid venue clause is treated as a defendant's waiver of his right to assert his own inconvenience on a motion to transfer.

See also, D'Antuono v. CCH Computax Systems, Inc., 570 F.Supp. 708, 713 (D. R.I. 1983):

...the plaintiff, by consenting to inclusion of the forum designation in the agreements, has in effect subordinated his convenience to the bargain.

D. Choice of law.

Generally, the parties' choice of law will be honored unless the chosen law has no substantial relationship to the parties or the transaction or application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater

interest in the transaction. See, Restatement (Second) of Conflict of Laws, §187:

§187. Law of the State Chosen by the Parties

- (1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.
- (2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either
 - (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or
 - (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of §188, would be the state of the applicable law in the absence of an effective choice of law by the parties.
- (3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.

The legislature of at least one state, Texas, has enacted a statute governing the circumstances under which a choice of law or choice of forum clause choosing the law of a state other than Texas in a contract having a significant relationship to or involving residents of the state of Texas will be honored. That statute requires that such clause be set forth in "print." See, Texas Business & Commerce Code Ann. § 35.53:

- (a) This section applies to a contract only if any element of the execution of the contract

occurred in this state and a party to the contract is:

- (1) an individual resident of this state; or
- (2) an association or corporation created under the laws of this state or having its principal place of business in this state.

(b) If a contract to which this section applies contains a provision making the contract or any conflict arising under the contract subject to the laws of another state, to litigation in the courts of another state, or to arbitration in another state, the provisions must be set out in boldfaced print. If the provision is not set out in boldfaced print, the provision is voidable by a party against whom it is sought to be enforced.

- E. Motion to dismiss for failure to state a claim on the ground that the plaintiff lacks standing to sue.

Often, the shareholders of a corporate borrower which is insolvent or the debtor in a bankruptcy case, or which otherwise no longer exists assert direct damage claims against a lender. The lender's attorney should consider filing a motion to dismiss such claims on the ground that even if the allegations of the complaint are true insofar as they allege that the lender has breached a contract with the borrower or has committed torts against the borrower, the shareholders of the corporate borrower have not suffered any damages and do not have claims against the lender. See, e.g., ITT Diversified Credit Corp. v. Kimmel, 508 F.Supp. 140 (N.D. Ill. 1981), in which a lender brought an action against the president and sole shareholder of a corporation to enforce a guaranty of loans made to the corporation. The defendant counterclaimed, alleging that the lender had breached its agreement to continue funding the corporation and had engaged in other, commercially unreasonable behavior. The defendant-counterplaintiff alleged damages including lost income, decline in value of the stock of the corporation, resulting accumulation of personal liabilities, damage to reputation, emotional distress, and pain and suffering. In dismissing all claims, the court stated:

Illinois courts generally do not recognize an independent cause of action for damages by a plaintiff-shareholder suing in his own behalf rather than derivatively on behalf of the injured corporation where there is no showing that the

plaintiff himself has been injured in any capacity other than in common with his fellow shareholders as a consequence of the wrongful actions of a third party directed towards the corporation.

Id. at 144. E.g., Twohy v. First National Bank of Chicago, supra, 758 F.2d at 1194 (7th Cir. 1985) ("[U]nder general principles of United States corporate law, as well as under Illinois law, a stockholder of a corporation has no personal or individual right of action against third persons for damages that result indirectly to the stockholder because of injury to the corporation."); Continental Illinois National Bank & Trust Company of Chicago v. Stanley, 585 F.Supp. 1385, 1388-89 (N.D. Ill. 1984) (shareholder claims dismissed under "established rule that when the injury alleged is to the corporation, the cause of action accrues to the corporation, not the stockholders.")

The prohibition against corporate shareholders suing in their individual capacity recovering damages allegedly resulting from injury to the corporation is widely recognized. It is the law in both Pennsylvania and New Jersey. For example, in White v. First National Bank, 252 Pa. 205, 97 A. 403 (1916), a shareholder/guarantor of a corporate note sued the bank for damages sustained as a result of the bank's demand for payment of the note. The court held that the shareholder could not sue for damages allegedly sustained by the corporation. The court stated:

[W]hat right of action has he, the indorser of the note, against the defendant for the latter's breach of its agreement to extend the loan? We know of none. Such an action might be maintained by the principal debtor, but surely not by a mere indorser...

If, then, the right of action is in [the debtor company], how can the plaintiff also maintain an action for the same cause? If he can, the defendant will be compelled to pay twice for the same injury. There must, be something wrong with a proposition which leads to such a result. (Id. at 405.)

In Mayer v. Oxidation Products Co., Inc., 110 N.J. Eq. 141, 146 (Ch. 1932), the court stated that a cause of action for misuse of corporate assets "belongs primarily to the corporation itself" whether the defendants are strangers to the corporation or corporate officials. The Court noted that a stockholder who files such an

action asserts the right of the corporation. See also, Alford v. Frontier Enterprises, Inc., 599 F.2d 483 (1st Cir. 1979) (principal shareholder of corporation could not maintain individual action against defendant gasoline supplier where defendant's dealings were with the corporation); Judice's Sunshine Pontiac, Inc. v. General Motors, 418 F. Supp. 1212 (D. N.J. 1976); (acknowledging the general rule that action to redress injuries to a corporation cannot be maintained by a stockholder in his own name but must be brought in the name of the corporation, unless the wrong is a breach of duty to the stockholder personally); Ruth v. First National Bank of New Jersey, 410 F. Supp. 1233 (D. N.J. 1976) (if a valid claim against a bank existed on ground that the bank had misapplied funds credited to account of corporation, the right to assert such claim would belong to the corporation and not to an individual). See, e.g., 12B W. Fletcher, Cyclopedia of the Law of Private Corporations, §5911 (rev. perm. ed. 1984). A limited exception to that rule permits a shareholder to sue in an individual capacity where it is alleged that the defendant also breached a separate and distinct duty owing to the shareholder. E.g., Buschmann v. Professional Men's Association, 405 F.2d 659 (7th Cir. 1969). But, cf, Clapper v. Commonwealth Realty Trust, 85-686 (D. Del. June 22, 1987) (shareholders of a real estate investment trust have standing to sue for an injury to the trust under the Racketeer Influenced and Corrupt Organizations Act.)

F. Motion to dismiss tort claim for failure to state a claim.

Where the plaintiff complains of a breach of either a loan commitment or a loan agreement and, in effect, alleges that the facts giving rise to the alleged breach of contract also amount to a tort (for instance, negligence or breach of fiduciary duty), giving rise to a right to recover punitive as well as compensatory damages, the tort claims may be susceptible to a motion to dismiss.

As a general rule, the violation of a contract will not, as such, furnish a basis for liability in tort and for the recovery of punitive damages. John Deere Company of St. Louis v. Short, 378 S.W.2d 496, 503 (Mo. 1964):

Out of the contractual obligation a separate obligation or duty must arise before liability in tort will attach, i.e., breach of contract may be treated as a tort only "where the law casts its separate obligation." (Citations omitted) Here

there was no duty independent of contract to make loans, and therefore a breach of contract to make loans would not constitute a tort. (Emphasis supplied).

Id. In John Deere, defendant Short, a John Deere dealer, counterclaimed in tort against John Deere, alleging, among other things, that John Deere failed and refused to grant Short loans, implement and follow a financing plan, and make prompt and efficient delivery of its products and parts to Short. The court rejected Short's claim, noting that John Deere was not under any contractual obligation to grant cash or equipment loans to Short. The court stated that, even if there had been a contract to make a loan and John Deere had breached the contract, Short could not recover under a tortious misconduct claim. Because there was no duty independent of contract to make loans, any breach of the contract to make loans would not constitute a tort.

E.g., Ronco, Inc. v. Plastics, Inc., 539 F.Supp. 391, (N.D. Ill. 1982). In Ronco, a United States District Court dismissed negligence and fraud claims on his own motion, stating that the law of contract was the appropriate vehicle for relief:

Plaintiff's negligence claim, however, is meritless. Under Illinois law, which all parties agree controls in this diversity case, one who suffers purely economic losses from an alleged breach of contract may not maintain a separate cause of action sounding in tort. The law of contract, not tort, is the appropriate vehicle for relief. (citations omitted).

Ronco, supra, 539 F.Supp. at 394-95 n. 4. See, also ARH Distributors, Inv. v. ITT Commercial Finance Corp., No. 87 C 00511, Slip Op. (N.D. Ill. September 24, 1987).

- G. Motion to dismiss specific claims for failure to state claims upon which relief may be granted and/or Motion for Summary Judgment or Partial Summary Judgment.

In addition to filing a motion to dismiss tort claims which, in essence, constitute recast contract claims, bank counsel should consider possible bases for attacking the specific claims which have been asserted by the plaintiff borrower. These bases may rise because the plaintiff has not properly pled the elements of the alleged cause of action, because the factual allegations of the alleged cause of action do not state a claim, or because the undisputed facts belie the existence of the

alleged claim. In the latter case, because the motion would require the bank to direct the court's attention to matters outside the pleadings, the appropriate motion would be a motion for summary judgment or partial summary judgment.

1. Motion to dismiss or for summary judgment on the ground that the claim is barred by the doctrine of res judicata. In two recent cases, federal courts have barred the assertion of lender liability claims where prior adjudications in bankruptcy court had established the validity of the debt owed to the lenders. In Continental Illinois National Bank & Trust Co. v. Windham, 558 F.Supp. 578 (E.D. Tex. 1987), a lender asserted the defenses of judicial estoppel and res judicata based on a guarantor's prior admissions concerning his corporation's underlying obligation and the entry of an order for relief, recognizing the validity of the lender's claim, in an involuntary bankruptcy case involving the corporation. The lender had been a petitioning creditor in the prior involuntary bankruptcy. The court dismissed the guarantor's 23 counterclaims.

The court held that, under Section 303(b) of the Bankruptcy Code, the bankruptcy court's order for relief necessarily entailed a finding that the claims of the petitioning creditors were not subject to bona fide dispute. Because the guarantor was a principal and thus in privity with the debtor corporation, the bankruptcy court's order for relief precluded the guarantor from relitigating the validity of the lender's claim. See also, Oneida Motor Freight v. United Jersey Bank, 75 Bankr. 235 (D. N.J. 1987) (prior bankruptcy court determinations establishing validity of bank's claim in automatic stay context precluded debtor from litigating breach of contract and fraud claim against bank in subsequent proceeding).

2. Motion to dismiss or for summary judgment on the ground that the borrower has waived or released its lender liability claim. Often as a part of a loan extension, forbearance, or workout agreement, the lender requires the borrower to release any existing, known or unknown, lender liability claim which the borrower may have against the lender. A form of one such release is attached hereto as Exhibit D. In preparing a defense of a lender liability case, counsel for the lender should

review all applicable documents and consider all relevant facts to determine if there has been an express or implied waiver by the borrower of any claims it may otherwise have had against the lender.

One drafting tip: under the laws of at least one state, California, a general release does not extend to claims of which the releasing party is unaware at the time of executing the release, unless the release expressly covers such unknown claims. Cal. Civ. Code, Section 1542 (West _____).

H. Motion to strike jury demand.

1. On grounds of untimeliness. See Rule 38(b) of the Federal Rules of Civil Procedure: "Any party may demand a trial by jury of any issue triable of right by a jury by serving upon the other parties a demand therefor in writing at any time after the commencement of the action and no later than ten days after the service of the last pleading directed to such issue. Such demand may be indorsed upon a pleading of the party."

2. Contractual jury waiver. The legislative bodies of a number of states have enacted statutes governing the right of a party to waive his, her, or its right to trial by jury and, if a party has such right, the manner in which such waiver must be exercised. Hence, a lawyer seeking to insert an express waiver of the right to a jury trial or an arbitration clause into a loan agreement or to enforce such a provision should examine applicable state law. As a general rule, however, courts have recognized the right of a party contractually to waive the right to a jury trial in a civil case. Seligson v. Plum Tree, Inc., 361 F.Supp. 748, 758 (E.D. Penn. 1973). Contractual jury waiver provisions are neither illegal nor contrary to public policy. Smith-Johnson Motor Corp. v. Hoffman Motors Corp., 411 F.Supp. 670, 677 (E.D. Va. 1975). A court will uphold a contractual waiver of the right to jury trial if the waiver is voluntarily, intelligently and knowingly made. N. Feldman & Son, Ltd. v. Checker Motors Corp., 572 F.Supp. 310, 313 (S.D.N.Y. 1983).

In N. Feldman & Son, Ltd. v. Checker Motors Corp., plaintiff, an importer of equipment, brought an action against Checker, a manufacturer of taxicabs,

and GM, a manufacturer of diesel engines. Plaintiff alleged breach of contract, breach of express and implied warranties, fraud, negligence, strict liability in tort, and conspiracy.

Checker moved to strike plaintiff's demand for a jury trial, contending that plaintiff had waived a jury trial by executing an agreement which contained the following provision:

Checker and dealer both acknowledge and agree that any controversy which may arise under this agreement or the relationship established hereby would be based upon difficult and complicated issues, and therefore, the parties agree that any lawsuit growing out of any such controversy will be tried in a court of competent jurisdiction by a judge sitting without a jury.

The Court granted Checker's motion, based upon plaintiff's voluntary and informed consent to a jury trial waiver. 572 F.Supp. at 313. The court noted that the waiver provision was clearly visible and was located directly above the signatures of the contracting parties; the plaintiff did not fit into the category of an individual with "no real choice" but to sign the waiver provision; and the plaintiff had previously entered into a similar agreement with Checker which contained the same jury waiver provision. Id.

Similarly, the Fourth Circuit recently upheld a contractual jury waiver in a commercial setting. In Leasing Service Corp. v. Crane, 804 F.2d 828 (4th Cir. 1986), plaintiff, the lessor of a drill rig, sought damages and repossession of a leased drill rig because of defendants' breach of the lease. The defendants could not read or write. During a meeting between the defendants and a representative of plaintiff, one of the defendants had his wife review the proposed equipment lease agreement, which contained a jury waiver provision. Defendant's wife crossed out certain language in the printed lease agreement and prepared a handwritten amendment to the document. The parties then executed the equipment lease agreement, as amended. Defendants subsequently filed a jury demand, which plaintiffs moved to strike, based upon the contractual jury waiver.

The District Court granted plaintiff's motion to

strike defendants' demand for jury trial, holding that defendants had waived their right to jury trial by executing the equipment lease agreement. The Fourth Circuit affirmed, stating that a right to jury trial can be knowingly and intentionally waived by contract. Id. at 832.

The jury waiver provision in Leasing Service Corp. was situated on the reverse side of a two page, standardized, fine print contract provided by plaintiff. Furthermore, the waiver was not set off in a paragraph of its own, was in the 90th line of print, and was in the middle of a 38-line paragraph. Id. at 833. In holding that defendants knowingly and voluntarily waived their right to a jury trial, the Fourth Circuit noted:

The lease agreement was only two pages long. The parties were not manifestly unequal in bargaining positions. Despite their lack of formal education, the Crane brothers [the defendants] were manifestly shrewd businessmen who had been in a generally successful drilling business for sixteen years. Fred Crane had held a dealer's and salesman's license for the purchase and the sale of equipment. The circumstances surrounding the lease negotiations in fact reveal both the specific understanding of the Equipment Lease Agreement Fred Crane's wife reviewed the two-page document agreement closely enough to locate, object to, and have lined out the provision in the middle of the document which granted the lessor a security interest in all other assets belonging to the lessee. Finally, the Crane's insistence on the execution of the handwritten agreement which limited the lessor's remedies in the event of a default indicate their understanding of the situation and of their interests. Id. at 833.

Although, generally, courts have recognized the theoretical validity of contractual provisions waiving the right to jury trial, they have been reluctant to enforce such waivers in circumstances in which the waiver is not knowing and voluntary, or when the parties have substantially unequal bargaining power. See, e.g., National Equipment Rental, Ltd. v. Hendrix, 565 F.2d 255 (2d Cir. 1977) in which the Second Circuit affirmed a judgment on a jury verdict dismissing a lawsuit by an equipment lessor to collect the balance due

under an equipment lease. The Second Circuit rejected the lessor's claim that, because of a clause in the lease under which the lessee waived his right to jury trial, the District Court improperly granted the lessee's demand for a jury trial. In doing so, the court focused on the inconspicuousness of the waiver and the inequality of bargaining power of the parties. See also, K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) in which the court held that a contractual waiver of a right to a jury trial was not knowing and voluntary, and hence invalid, where the president of the borrower testified that he was told by a representative of the lender, prior to signing the loan agreement, that the jury waiver provision would not be enforced, absent fraud.

I. Motion for summary judgment on collection claims.

Although bank counsel may be inclined to seek entry of partial summary judgment on the bank's claim under its promissory note or credit agreement, where substantial lender liability counterclaims exist, and cannot be disposed of upon summary judgment, it may be inadvisable for the bank to seek summary judgment on its affirmative claims. If the bank succeeds, it may lose the opportunity to open and close at trial and, perhaps more importantly, to put into evidence its good acts and resulting damages.

J. Motions in Limine to preclude offer of prejudicial and clearly irrelevant facts.

1. Size of bank
2. Ownership of bank
3. Status of loan
4. Termination of bank employee(s)

II. Pre-trial Discovery

III. Pre-trial Preparation

IV. Trial

- A. Personalization of bank
- B. Telling the whole story

C. Motions for directed verdict

1. Plaintiff's causes of action
2. Speculativeness of damages

In the past, a new business or a business which had been experiencing losses could not recover damages for lost profits. Courts would not allow parties to go to the jury on lost profits claims where the very fact, as distinguished from the amount, of such lost profits was speculative. This developed into a rule of substantive contract law rather than a mere evidentiary matter. See, e.g., Truscott v. Peterson, 50 N.W.2d 245, 257 (N.D. 1951):

To come within the rule, it must be made to appear that the business which is claimed to have been interrupted was an established one which had been successfully conducted for such a length of time and had such a trade established that the profits thereof were reasonably ascertainable. The prospective profits of a new business or enterprise are generally regarded as being too remote, contingent, and speculative to meet the legal standard of reasonable certainty applicable in determining the elements of recoverable damages in an action for breach of contract or for a tort.

Recently, however, some courts have treated proof of lost profits as an evidentiary matter and have permitted a business to recover such damages notwithstanding an unprofitable history. Generally, they have permitted recovery of lost profits by a start-up or historically unprofitable company under the following two circumstances:

(a) where there is an evidentiary basis, e.g., by expert testimony, that a "start-up" period of loss was the foundation for a profitable operation. See, e.g., Dean W. Knight & Sons v. First Western Bank & Trust Co., 84 Cal. App. 3d 560, 148 Cal. Rptr. 767 (1978) ("The fact that the development had not yet generated a profit at the time that First Western committed its fraud does not of itself prevent recovery of damages for loss of profits so long as there is an evidentiary basis establishing that the loss period was a foundation for profitable operation."); and Vickers v. Wichita State Univ., 213 Kan. 614, 620-621 518 P.2d 512, 517 (1974):

Certainly the televising of conference basketball games and the selling of advertising in connection

therewith is not a new or untried business. There are techniques available in the advertising and television business by which profits can be calculated with reasonable certainty to justify a contractual relationship.

It might well take two or three years to build such an enterprise into a profitable business. It would be manifestly unjust to permit a breach of a contract covering such a business after two or three years promotional operation and thus permit the contractor to take advantage of the promotion without liability because the particular operator could not show a profit during the promotional period.

(b) where there is an evidentiary basis for finding that, although plaintiff may not have been profitable in general, the breached contract would have produced a profit. See, e.g., Stark v. Shaw, 155 Cal. App. 2d 171, 181, 317 P.2d 182, 188:

The problem is not whether the roofing company has made profits in the past, or whether as a business, it will produce profits in the future; rather, the issue to be determined is whether the company was reasonably certain to make a profit under this particular contract.

See, also, Retama Nursing Centers, Inc. v. Cole, 582 S.W.2d 196 (Tex. Civ. App. 1979):

In the present case, however, we are dealing with a single contract covering one transaction in which both parties were committed to a definite price in exchange for certain materials and service. Consequently, the potentiality for profits is not nearly as speculative as in Owen, supra, and lost profits can be measured by the difference between the contract price and what it would have cost the contractor to perform the contract in accordance with the plans and specifications.

For other cases applying the modern rule, see, e.g., In re Knickerbocker, 827 F.2d 281, 288 (8th Cir. 1987), citing, Lakota Girl Scout Council, Inc. v. Havey Fund-Raising Management, Inc., 519 F.2d 634, 640 (8th Cir. 1975):

An award for lost profits may not be based on pure conjecture or speculation...However, this rule does not require that data regarding a plaintiff's

actual performance be employed in every case. In Lakota, we upheld the jury's award of lost profits for breach of a fund-raising contract based on expert testimony regarding similar fund-raising in other areas ... we observed that the decision to submit expert testimony of this nature to the jury to assist in the calculation of damages is a matter resting with "the sound discretion of the trial court ..."

See, also, Handy Caddy, Inc. v. American Home Products Corp, 557 F.2d 136, 139 (8th Cir. 1977);

It does not follow ... that a so-called "new business can never recover lost profits as an item of damages for breach of contract. In the final analysis, the question is primarily a problem of proof. Each case must rest upon the evidence adduced and it is for the trial judge in the first instance to determine whether the complaining party has produced the quantum and quality of evidence sufficient to submit the issue to a jury.

In two recent, well-publicized lender liability cases, borrowers or prospective borrowers recovered substantial damages for lost profits notwithstanding the "start-up" nature of the borrowers' respective operations. Penthouse International, Ltd. v. Dominion Federal Savings & Loan Association, 665 F.Supp. 301 (S.D.N.Y. 1987) (\$112,083,583 in damages for lost profits sustained by uncompleted hotel/casino); FDIC v. Scharenburg v. Continental Illinois National Bank, No. 84-2712-CIV-DAVIS; No. 87-0211-CIV-DAVIS; No. 87-0238-CIV-DAVIS (S.D. Fla. 1987) (\$105 million jury verdict based in part upon damages suffered by a start-up real estate development).

- D. Jury instructions. See Jury Instructions given in The Bank of California, N.A. v. Martin, No. 37807 (Superior Court of Chelan County, Washington), attached hereto.