



3-13-1987

## Seventh Annual Seminar on Legal Issues for Bank Counsel

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

M. Brooks Senn  
*Senn, Miller & Keith*

C. Christopher Trower  
*Brown, Todd & Heyburn*

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**Authors**

Office of Continuing Legal Education at the University of Kentucky College of Law, M. Brooks Senn, C. Christopher Trower, William D. Roberts, Richard S. Holt, David C. Pottinger, Carl R. Page, Sherry F. Hardy, John T. McGarvey, William R. Mapother, Bankers Training and Consulting Company, and Gregg Neal

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CLE**

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**SEVENTH ANNUAL  
SEMINAR  
ON  
LEGAL ISSUES FOR  
BANK COUNSEL**

**MARCH 13-14, 1987**



# **UK CLE**

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**SEVENTH ANNUAL  
SEMINAR  
ON  
LEGAL ISSUES FOR  
BANK COUNSEL**

**MARCH 13-14, 1987**

**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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UNIVERSITY OF KENTUCKY  
COLLEGE OF LAW  
OFFICE OF CONTINUING LEGAL EDUCATION

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

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

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SEVENTH ANNUAL SEMINAR ON  
LEGAL ISSUES FOR BANK COUNSEL

Office of Continuing Legal Education  
University of Kentucky College of Law

-- in cooperation with --  
Kentucky Bankers Association  
and  
Section on Corporation, Banking and Business Law  
of the  
Kentucky Bar Association

March 13 & 14, 1987

Friday, March 13, 1987

- 8:00 - 8:50 a.m. Late Registration, Courtroom, College of Law, University of Kentucky
- 8:50 - 9:00 a.m. Welcome, Todd B. Eberle, Associate Dean and Director of Continuing Legal Education, University of Kentucky
- Moderator, William J. Parker, Harlin, Parker & Rudloff, Bowling Green, Kentucky
- Opening Remarks, Nelson D. Rodes, Attorney-Banker, Danville, Kentucky, President, Kentucky Bankers Association
- 9:00 - 9:45 a.m. RECENT LEGISLATIVE AND JUDICIAL DEVELOPMENTS IN BANKING - M. Brooks Senn, Senn, Miller & Keith, Louisville, Kentucky
- 9:45 - 10:30 a.m. 1986 TAX DEVELOPMENTS AND 1987 TAX STRATEGIES FOR BANKS AND BANK HOLDING COMPANIES - C. Christopher Trower, Brown, Todd & Heyburn, Louisville, Kentucky
- 10:30 - 10:45 a.m. BREAK
- 10:45 - 12:00 noon CHANGES IN EMPLOYEE BENEFIT LAW AFFECTING THE BANKING INDUSTRY
- 10:45 - 11:25 a.m. A. Individual Retirement Account Changes After The Tax Reform Act - William D. Roberts, Greenebaum Doll & McDonald, Louisville, Kentucky
- 11:25 - 12:00 noon B. Other Employee Benefit Law Changes - Richard S. Holt, Greenebaum Doll & McDonald, Lexington, Kentucky
- 12:00 - 1:30 p.m. LUNCH (on your own)
- 12:10 ADDRESS BY THE PRESIDENT OF THE AMERICAN BAR ASSOCIATION  
Eugene C. Thomas, Moffatt, Thomas, Barrett & Blanton,  
Chtd., Boise, Idaho.

- 1:30 - 2:55 p.m. **CONSUMER REGULATORY UPDATE AND REVOLVING CREDIT INVOLVING HOME EQUITY.** . .New Amendments and cases re: Reg. Z, Reg. B, Reg. E, Reg. AA, and ARM Regs. . .Open end line of credit secured by Mortgages - David C. Pottinger, Morgan and Pottinger, Louisville, Kentucky
- 2:55 - 3:10 p.m. **BREAK**
- 3:10 - 4:40 p.m. **NON-CONSUMER REGULATORY PROBLEMS.** . .State lending limits. . . National lending limits. . .Transactions with affiliates - Section 23a. . .Currency Transaction Reporting: regulations, forms, procedures, and dealing with the Treasury Department - Carl R. Page, Executive Vice President and House Counsel, Liberty National Bank and Trust Company, Louisville, Kentucky and Sherry F. Hardy, Vice President and Assistant Counsel, Liberty National Bank and Trust Company, Louisville, Kentucky
- 5:00 - 7:00 p.m. **COCKTAIL RECEPTION** 27th Floor, Lexington Financial Center, Main at Mill and Upper  
Hosted by Brown, Todd & Heyburn

Saturday, March 14, 1987

- 9:00 - 9:45 a.m. **UCC CHANGES TO ARTICLE 9; AND THE FEDERAL FOOD SECURITY ACT OF 1985.** . .Adoption of 1972 Amendments of UCC. . .New legislation regarding security interests in farm goods - John T. McGarvey, Morgan and Pottinger, Louisville, Kentucky
- 9:45 - 10:35 a.m. **FARM BANKRUPTCY.** . . New Chapter 12: The Family Farmer Reorganization Act of 1986. . .Chapter 11 farm reorganizations - William R. Mapother, Mapother and Mapother, Louisville, Kentucky
- 10:35 - 10:45 a.m. **BREAK**
- 10:45 - 11:30 a.m. **LENDER LIABILITY - PART I: Videotape Sue the Lender.** . . Control and interference. . .Good faith and fair dealing. . . Misrepresentation and fraud - Bankers Training and Consulting Company, St. Louis, Missouri
- 11:30 - 12:00 noon **LENDER LIABILITY - PART II: "Banks in Litigation".** . . Commentary on videotape. . .Analysis of lender liability issues for Kentucky - Gregg Neal, Neal & Davis, Shelbyville, Kentucky

RECENT LEGISLATIVE AND JUDICIAL DEVELOPMENTS  
IN BANKING

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

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M. Brooks Senn

Section A





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I.

LEGISLATIVE DEVELOPMENTS

A. 1986 KENTUCKY GENERAL ASSEMBLY

The 1986 Kentucky General Assembly enacted the following new sections or amendments to the Kentucky Revised Statutes which affect the banking industry. All legislation is listed by KRS section amended or added and, unless otherwise noted, became effective on July 15, 1986.

KRS 36.085 and 36.086 - DEPOSITS BY NATIONAL GUARD ARMORIES - SB 229 created new sections of KRS Ch. 36 to authorize the Department of Military Affairs to establish installation management fund accounts in local banks for national guard armories and deposit in such accounts funds derived from the use of buildings and grounds by local civic and non-military organizations for receptions, meetings and other events.

KRS 205.835 - REPORTS OF ACCOUNTS OF PUBLIC ASSISTANCE RECIPIENTS - HB 135 created a new section of KRS Ch. 205 requiring banks, savings and loan associations, credit unions, insurance companies and other financial institutions to disclose information to the Kentucky Cabinet for Human Resources concerning accounts of applicants and recipients of public assistance if written consent to such disclosure is given by the applicant or recipient. The bill also amended KRS 205.175 to prohibit unauthorized use of such information and imposes a fine upon any financial institution for refusing to comply with a request for information.

KRS 271A.270 and 273.247 - CORPORATIONS - SB 337 amended various sections of KRS Chs. 271A and 273, relating to the business and non-profit corporations, to require, among other things, that the articles of incorporation of such corporations contain the address (including street and number, if any) of the corporations' principal office which is defined to mean the place (in or out of Kentucky) where the principal executive offices of the corporations are located.

KRS Ch. 287 - DEPARTMENT OF FINANCIAL INSTITUTIONS' BILL - HB 709 was a comprehensive revision to a number of sections of KRS Ch. 287 enacted at the request of the Kentucky Department of Financial Institutions. The bill's provisions are discussed in detail in EXHIBIT A to this Outline.

KRS 287.013 - FINANCIAL INSTITUTIONS BOARD - HB 213 increased from 10 to 12 the number of persons serving on the Financial Institutions Board and reduced the terms of office of the board's members.

KRS 287.100 - BANK INVESTMENTS - SB 370 authorized a bank, in addition to the investments already permitted by KRS 287.100, to invest in the shares of a mutual fund registered under the Securities Act of 1933 if the fund's investments include any obligations in which a national bank is permitted to invest in directly.

KRS 287.105 - MOTOR VEHICLE LEASING - SB 156 amended KRS 287.105 to authorize state banks to lease motor vehicles as well as other personal property to their customers. Prior to the amendment, KRS 287.105 prohibited a state bank from entering into lease transactions covering motor vehicles; bank holding companies and national banks were, however, permitted to enter into such transactions.

KRS 287.280 and 287.100 - LENDING LIMITS AND REAL ESTATE INVESTMENTS - HB 202 amended KRS 287.280, relating to a bank's lending limits, and KRS 287.100, relating to bank investments. The amendment to KRS 287.280 deleted the provision prohibiting bank directors or officers from becoming indebted or obligated as a guarantor or surety to the bank in an amount exceeding 10% of the bank's capital stock without securing the excess by collateral double in value of the amount of the excess and substituting in its place provisions permitting an executive officer or director to become indebted to the bank or obligated as guarantor or surety in the same amount as other customers. However, the bill required extensions of credit to directors and executive officers be approved by the noninterested members of the bank's board and not be preferential or contain terms more favorable than those available to the public.

The amendment to KRS 287.100 authorized a bank to invest in real estate in the bank's generally accepted banking market so long as each investment does not exceed 10% of the bank's actual paid-in capital and surplus and to permit investment and improvements in real estate acquired in satisfaction of a debt previously contracted so long as such investment does not exceed 10% of the bank's paid-in capital and surplus.

Provisions similar to those in HB 202 were also contained in the Department of Financial Institutions' bill (HB 709) discussed in EXHIBIT A. The statute reviser reconciled the two acts, and the reconciliation is now contained in KRS 287.280.

KRS Ch. 355 - AMENDMENTS TO UNIFORM COMMERCIAL CODE - SB 28 adopted the 1972 amendments to Article 9 (relating to secured transactions) of the Uniform Commercial Code and the 1977 amendments to Article 8 (relating to investment securities) of the Code. The bill also amended various sections of KRS Chs. 186 and 186A, relating to perfection of security interest in motor vehicles, so as to intergrate the procedure for perfecting such security interests with the motor vehicle title law. The amendments become effective on July 1, 1987.

KRS 365.205 - CHECKS - HB 417 created a new section of KRS Ch. 365 requiring that checking accounts opened after the effective date of

the bill have the numerical month and year in which the account was opened printed on the face of the checks.

KRS 371.065 - GUARANTY AGREEMENTS - HB 286 required that guaranty agreements not incorporated in the debt instrument specify the maximum liability of the guarantor thereunder and the date on which the guaranty terminates. The termination does not, however, affect extensions of credit in existence on the date of termination.

KRS 382.365 - RELEASE OF REAL PROPERTY LIENS - HB 622 amended KRS 382.365 by reducing the time within which a lien on real property must be released from 60 to 30 days after the date of satisfaction of the obligation secured by the lien and providing that a lien holder who fails to do so is liable to the owner of real property for the actual expenses incurred in securing the lien release.

KRS 382.530 - FUTURE ADVANCE CLAUSE - HB 246 amended KRS 382.520, relating to future advance clauses in real estate mortgages, to provide that a mortgagor or his agent or attorney, may request a mortgagee to release the amount of a mortgage lien securing an additional unadvanced indebtedness by delivering to the mortgagee a written request specifying the mortgage containing the future advance clause and the nature, amount and holder of the lien or encumbrance which the mortgagor intends to place upon the property. If the mortgagee does not release the future advance clause within ten days after receipt of the written request, the mortgagor may record the request in the appropriate county clerk's office. After recording, any advance made by the holder of the mortgage containing the future advance clause is subordinate to the lien or the encumbrance described in the written request except that a "line of credit" is not subordinate unless the written request specifically, and not by implication, describes the line of credit by account or other identifying number and states that any advance thereafter made pursuant to such plan is intended to be subordinated.

KRS 385.012 to 385.242 - TRANSFERS TO MINORS - HB 466 repealed the Uniform Gifts to Minors Act and substituted in its place the Uniform Transfer to Minors Act approved by the National Conference on Uniform State Laws in July, 1983.

KRS 386.030 and 287.230 - INVESTMENT IN MUTUAL FUNDS AND IN AFFILIATED TRUST FUNDS - HB 807 amended KRS 386.030, relating to investments by fiduciaries, and KRS 287.230, relating to common trust funds. The amendment to KRS 386.030 permits fiduciaries, including banks and trust companies, to invest in securities of an open-end or closed-end management type investment company or investment trust registered under the federal Investment Company Act of 1940, i.e. mutual funds, irrespective of the fact that the fiduciary also provides services to the mutual fund as an investment advisor, custodian, transfer agent, registrar or otherwise. The amendment to KRS 287.230 (which was originally introduced as a separate bill) permits investments of funds held by a bank acting in a fiduciary

capacity in common trust funds established by itself or an affiliated bank. As used in the bill, an "affiliated bank" means a bank in an affiliated group within the meaning of Section 1504 of the Internal Revenue Code relating to filing of consolidated tax returns by corporations connected by stock ownership with a common parent corporation.

KRS 286.023 - INVESTMENTS IN MUTUAL FUNDS - HB 700 added a new section to KRS Ch. 386 to provide that if an instrument establishing a fiduciary relationship requires, directs or authorizes the fiduciary to invest in obligations of, or guaranteed by, the United States government and does not contain an express provision to the contrary, the fiduciary may invest in a mutual fund registered under the Investment Company Act of 1940, the portfolio of which is limited to obligations of, or unconditionally guaranteed by, the United States government or repurchase agreements fully collateralized by such obligations.

KRS 434.655 - FRAUDULENT USE OF CREDIT OR DEBIT CARD - HB 642 amended KRS 434.655 to increase the penalty for fraudulently using a credit or debit card to obtain money, goods or services by reporting a card as lost, stolen or never received from a fine of not more than a \$1,000 or imprisonment of not more than one year, or both, to a fine of not more than \$3,000 or confinement in a penitentiary for not more than five years, or both, if the money, goods or service furnished or received exceeds \$300 in any six month period. If the value of the money, goods or services is \$300 or less in any six month period, then the penalty remains a fine of not more than a \$1,000 or imprisonment of not more than one year, or both.

KRS 514.040 - THEFT BY DECEPTION - Hb 772 amends KRS 514.040, relating to theft by deception, to permit a county attorney to impose a \$5 fee for giving notice to the issuer of a bad check that the drawee has refused payment and requiring the holder of the check to pay such fee if the check is subsequently paid.

B. LEGISLATIVE PROPOSALS FOR 1988 GENERAL ASSEMBLY

1. Multibank Holding Company Issues:

- (a) Removal of 15% deposit limit [KRS 287.900(3)]
- (b) Ability to convert holding company affiliated banks to branches, with county-wide branching rights.
- (c) Ability to purchase thrift institutions and convert to banks; and to purchase newly converted thrifts.

2. Increased Powers:

- (a) Underwriting of revenue bonds, commercial paper and corporate securities.
- (b) Underwriting and sale of life insurance.
- 3. Electronic Funds Transfer Legislation
- 4. Revolving Credit Rate Limitations
- 5. Guaranty Statute (KRS 371.065) - Amend to clarify ambiguities concerning listing of maximum indebtedness and termination date.
- 6. Equity Lines of Credit: Clarify the relevant statutes with respect to (i) future advances; (ii) exemptions for business loans; (iii) the ability to charge "points" and fees; and (iv) how the \$15,000 usury limit relates to unfunded or partially funded lines of credit.
- 7. Lending Limits: Clarify KRS 287.290 regarding the exemption of loans secured by government securities.
- 8. Establish central filing system for perfection of security interests in farm products.
- 9. Miscellaneous:
  - (a) Amend KRS 355.3-106(e) regarding the negotiability of notes that provide for the collection of attorney fees.
  - (b) Clarify KRS 376.390 regarding rights of consumers to refinance consumer loans, especially those over \$15,000.
  - (c) Provide for a system to register security interests in boats, similar to that used for automobiles.
  - (d) Clarification of bank's right to move trust assets among affiliates.
  - (e) Elimination of usury limitations on extensions of credit (other than revolving credit) by banks.
- 10. Department of Financial Institutions Proposals

C. FEDERAL LEGISLATION

- 1. Food Security Act of 1985 (P.L. 99-198) - effective December 24, 1986.

Section 1324 entitled "Protection for Purchasers of Farm Products" preempts the "farm product" exception of UCC 9-307. See EXHIBIT B attached to this outline.

2. Family Farmer Bankruptcy Act of 1986 (P.L. 99-554) - effective November 26, 1986.

Creates a new Chapter 12 of the Bankruptcy Code - entitled, "Adjustment of Debts of a Family Farmer with Regular Annual Income" - modeled after existing Chapter 13 of the Code with modifications

3. Money Laundering Control Act of 1986 (Title H of P.L. 99-570) - generally effective October 27, 1986.

Among other things, the Act:

- (a) Establishes civil and criminal penalties for individuals who launder money and attempt to evade federal currency reporting requirements set forth in the 1970 Bank Secrecy Act, under which financial institutions must report cash transactions of at least \$10,000 to the Internal Revenue Service.
- (b) Makes illegal the evasive structuring of cash transactions by individuals in order to avoid reporting requirements, the so-called "smurfing" practice. "Smurfing" is the name given a practice through which criminals evade bank currency reporting rules by dividing illegally earned sums of money into parcels of less than \$10,000 before laundering those crime proceeds.
- (c) Allows for the seizure of cash and property of "smurfers" and would require financial institutions to adopt procedures to comply with the law. The Treasury is granted summons authority, under the Act, to improve enforcement of the Bank Secrecy Act.
- (d) Permits limited good-faith disclosure of identifying information such as names and account numbers, in cases of suspected criminal activity, and allows courts to direct financial institutions to delay notifying customers of subpoenas or of information being furnished to a grand jury. Notification currently is required by the 1978 Right to Financial Privacy Act.

Financial institutions will be protected from customer-initiated lawsuits, under the Act, for volunteering information to law enforcers in cases of suspected money laundering activity by customers.

4. Bank Bribery Amendments Act of 1985 (P.L. 99-370) - effective September 3, 1986.

The amendment now defines the crime of bank bribery to require specific rather than general intent. A thing of value must be "corruptly" offered to or accepted by a financial institution's officers or personnel for the offense to occur. The law also



specifically does not apply to "bona fide" salary, wages, fees, other compensation, and expenses paid or reimbursed. Under prior law, some bankers' salaries were technically bribes.

The amendment gave the financial institution regulators wide authority to establish enforcement criteria. They are directed to "jointly establish such guidelines as are appropriate to assist an officer, director, employee, agent, or attorney . . . to comply with this section."

5. Section 1521 of the Tax Reform Act of 1986 (P.L. 99-514) - effective for transactions closed after December 31, 1986.

The new section requires a new Form 1099-B to be filed in connection with certain real estate transactions closed after December 31, 1986. See EXHIBIT C attached to this Outline.

## II.

### REGULATORY DEVELOPMENTS

#### 1. CREDIT PRACTICE RULE (FRB REG. AA) - CONTINUING GUARANTEES:

Effective November 1, 1986, the Federal Reserve Board updated its guidelines under Regulation AA - the Credit Practice Rule.

Under the rule a natural person who guarantees an extension of consumer credit must be furnished with the cosigner notice prescribed by the rule. The answer to Question 14(b)-13 of the revised guidelines, among other things, makes it clear that where a cosigner executes a continuing guaranty, a bank should modify the cosigner notice to accurately reflect the extent of the guarantor's obligation. If, for example, the guaranty applies to all future debts, the first sentence of the notice should indicate that the cosigner is being asked to guarantee not only the first loan, but also the future debts of the borrower (up to a certain date or amount, if appropriate).

Thus, if, for example and in order to comply with KRS 371.065 (enacted by the 1986 General Assembly), a bank's continuing guaranty agreement terminates on December 31, 1987, and the maximum liability is \$50,000, the first sentence of the cosigner notice should be modified to read:

"You are being asked to guaranty this debt, as well as all future debts of the borrower entered into with this bank through December 31, 1987, up to a maximum liability of \$50,000."

#### 2. SEC RULE 14b-2 - SHAREHOLDER COMMUNICATIONS BY BANKS ACTING AS FIDUCIARIES:

The Securities and Exchange Commission has adopted a new Rule 14b-2 prescribing the obligations of a bank in connection with the forwarding of proxy materials to beneficial owners and communications by registered companies (under the 1934 Act) with beneficial owners of securities registered in the bank's name. The rule implements the Shareholder Communications Act of 1985 (P.L. 99-222) which gave the SEC authority to require banks exercising fiduciary powers to perform tasks with respect to proxy voting and the distribution of proxies. The new rule parallels Rule 14b-1, which governs similar obligations of brokers and dealers, and is intended to insure that the beneficial owners of securities held in street name timely receive proxy material and other corporate communications.

Generally, the system for forwarding proxy materials to beneficial owners whose securities are held by banks will require registered companies to ask each bank for the number of proxies and other proxy soliciting material or annual reports needed by the bank for forwarding to beneficial owners. After receiving a request, the bank must respond within seven business days, indicating the number of sets of proxy materials and annual reports needed. The company will supply the bank with sufficient copies for forwarding to beneficial owners, and the bank will be required to forward such materials directly to beneficial owners on whose behalf it holds securities within five business days after they are received. However, a bank is not required to forward proxy materials nor provide the beneficial owner information referred to below unless it receives assurances that its reasonable expenses will be reimbursed by the company.

Under the direct communications system, a bank will be required, on request, to provide a registered company with the names, addresses and securities positions of certain beneficial owners of the company's securities on whose behalf the bank holds securities. The beneficial owners of accounts opened on or before December 28, 1986, must affirmatively consent to disclosure of their identities. However, for accounts opened after that date, the beneficial owner will be deemed to have consented to the disclosure if the owners have not affirmatively objected to the disclosure. Accordingly, it will be necessary that a bank solicit the consent of beneficial owners on whose behalf it holds securities to determine whether disclosure is appropriate.

New Rule 14b-2 generally became effective on December 28, 1986. However, the provisions of the rule which prescribe a bank's duties in connection with obtaining and forwarding proxy materials do not take effect until July 1, 1987.

### 3. NOMINATION OF NATIONAL BANK DIRECTORS:

In Banking Bulletin 86-21, effective September 25, 1986, the Comptroller of the Currency rescinded Part 17 of Title 12 of the Code of Federal Regulations which provided that a national bank may require any shareholder who intends to nominate a candidate to its

board of directors, other than the candidate proposed by the bank's management, to notify the bank and the Comptroller of the Currency at least 14 and not more than 50 days in advance of the shareholder meeting called for the election of the directors.

In rescinding the regulation, the Comptroller determined that no significant regulatory purpose was served by Part 17 and it was not required in order for national banks to have notification requirements. Moreover, the rescission of the regulation did not, the Comptroller stated, affect existing notification requirements in a bank's Articles of Association or Bylaws nor would it prevent a bank from adopting reasonable notification requirements in the future.

#### 4. EXPANDED NONBANKING ACTIVITIES:

Effective December 15, 1986, six new activities were added to the list of nonbanking activities generally permissible for bank holding companies. The list was issued as part of Regulation Y enumerating the nonbanking activities that the Federal Reserve Board has determined to be generally permissible for the BHCs under Section 4(c)(8) of the Bank Holding Company Act.

The added activities are: personal property appraisals; commodity trading and futures commission merchant advice; consumer financial counseling; tax preparation and planning; check guaranty services; and operation of a collection agency and credit bureau.

#### 5. SECURITY INTEREST IN FARM PRODUCTS

In Banking Circular 221, issued December 22, 1986, the Comptroller of the Currency has explained the conditions under which loans involving farm products collateral will be considered to be secured by national bank examiners. Under the Comptroller's new policy, such loans will be considered secured only if two things have occurred: First, the bank's security interest has been perfected in accordance with applicable state law and, secondly, the bank has made reasonable efforts to satisfy the notice requirements of the Food Security Act of 1985 discussed in Section I.C1 above.

According to the Comptroller, perfection pursuant to applicable state law alone is no longer sufficient to protect the bank's security interest in farm products. Reasonable efforts to comply with Section 1324 include, according to the Comptroller, either registration with a qualifying state central filing system or, (if, as is true in Kentucky, a qualifying state central filing system has not been established) notification of local buyers of farm products and prospective buyers designated by the borrower. The Banking Circular also advises banks to consider other available options to perfect their security interests in farm product collateral and encourages consultation with legal counsel.

### III.

#### JUDICIAL DEVELOPMENTS

##### A. FEDERAL COURT DECISIONS

###### 1. DISCOUNT BROKERAGE OFFICES - MCFADDEN ACT RESTRICTIONS

On January 14, 1987, the United States Supreme Court upheld the Comptroller of the Currency's determination that national bank offices offering only discount brokerage services are not "branches" subject to the geographic restrictions of the McFadden Act. Clark v. Securities Industry Association; Security Pacific National Bank v. SIA, \_\_\_ U.S. \_\_\_ Nos., 85-971 and 85-972. (1987)

The majority opinion, written by Justice Byron White, holds that "the operation of a discount brokerage is not a core banking function" subject to the McFadden's Act geographic restrictions. In so doing, the Court upheld the 1982 ruling by the Comptroller to the effect that the McFadden Act only covers activities like deposit taking, checking accounts and lending. This could leave almost the entire realm of other financial services available to national banks without branching restrictions.

###### 2. NATIONAL BANKS CAN BRANCH LIKE S&Ls

On February 9, 1987, the U.S. Court of Appeals for the Fifth Circuit in New Orleans rendered a decision which, if upheld, could have a substantial impact upon branch banking. Department of Banking and Consumer Finance of Mississippi v. Clarke, \_\_\_ F.2d \_\_\_ (5th Cir. 1987), No. 85-4722. In that case, the court upheld the Comptroller of the Currency's approval of a national bank branch in a location which would have been permitted under Mississippi law for a savings and loan association but not for a commercial bank. Mississippi savings and loan associations have state wide branching rights. On the other hand, Mississippi banks are permitted to branch only within 100 miles of the bank's main office.

In the Mississippi case, the Comptroller of the Currency had approved a national bank's branch located 160 miles from its main office. The Court of Appeals upheld the Comptroller's decision and agreed that savings and loan associations "are engaged in the banking business" and banks should be accorded equal treatment for branching purposes. In so doing, the court compared the services and products offered by both banks and savings and loan associations and upheld the Comptroller's decision as being "neither arbitrary nor compricious. It is patently correct."

Preliminary indications are that the U.S. Supreme Court will be asked to review the decision. If upheld, the decision is

significant and could stimulate further interest in branch banking laws.

### 3. NONBANK BANKS

On January 22, 1986, the U.S. Supreme Court rejected the Federal Reserve Board's attempt to regulate so-called nonbank banks under the Bank Holding Company Act by attempting to redefine the term "bank" in Regulation Y so as to include institutions offering NOW accounts and purchasing money market instruments. Federal Reserve Board v. Dimension Financial Corp., \_\_\_\_ U.S. \_\_\_\_ (1986).

Writing for a unanimous court (Justice Byron White not participating), Chief Justice Warren Burger declared that the Fed's definition of "bank" under Regulation Y differed from the Bank Holding Company's definition at 12 USC 1841(c) in a way that exceeded the Board's authority. Although both the statute and the regulation had defined a bank as an institution that offered demand deposits and engaged in the business of making commercial loans, Regulation Y has included NOW accounts (on the ground that they were "withdrawable on demand as a matter of practice") and money market activities such as certificates of deposit or commercial paper (on the ground that they are "commercial loan substitutes"). The Supreme Court found that NOW accounts are simply not "deposits that the depositor has a legal right to withdraw on demand" under 12 USC 1841(c)(1), and that money market activities do not fit under the generally accepted definition of "commercial loans."

Although the decision is important in the long standing nonbank bank controversy, what may prove more important, however, is the Supreme Court's apparent rejection of the principle of "functional regulation" in the face of contrary statutory language. The Board had argued that the Bank Holding Company Act's plain purpose" required that it regulate nonbanks; it further cited 12 USC 1844(B), which permits the Board to issue regulations "necessary to enable it to administer and carry out the purposes of [the Bank Holding Company Act] and prevent evasions thereof."

The court opined that the "plain purpose" approach "takes no account of the processes of [legislative] compromise and, in the end, prevents the effectuation of congressional intent."

### 4. SEC BANK BROKERAGE RULE INVALID

In July, 1985, the Securities and Exchange Commission issued the Rule 3b-9 (effective January 1, 1986) requiring certain banks engaging in the discount brokerage business to register as broker-dealers. On November 4, 1986, the U.S. Court of Appeals for the District of Columbia Circuit held that the Commission exceeded its authority in issuing the rule, saying (American Bankers Association v. Securities and Exchange Commission, \_\_\_\_ F.2d \_\_\_\_ (D.D. Cir. 1986):

"Whatever regulatory coherence Rule 3b-9 would bring to the field of securities brokerage, we conclude the SEC has no authority to regulate banks as broker-dealers, and Rule 3b-9 is invalid.

"Here, as in Dimension Financial [discussed in Paragraph 3 above], the 1934 Act may be imperfect in not allowing SEC regulation of banks that engage in discount brokerage activities, but here, as in Dimension Financial, the statutory definition of 'bank' precludes the agency from issuing a regulation fundamentally altering that imperfect definition."

## B. KENTUCKY DECISIONS

### 1. INTEREST AND USURY

On March 18, 1986, the Kentucky Supreme Court upheld the practice of Kentucky banks of making installment loans in excess of \$15,000 free of any usury or other limitations. Duff v. Bank of Louisville & Trust Co., Ky., 705 S.W. 2d 920 (1986). In that case, the bank had made precomputed interest installment loans which contained interest, fees, charges and penalties in excess of those permitted by KRS 287.215. Plaintiffs asserted that in making the loans, the bank was limited to only those changes permitted by KRS 287.215, while the bank defended on the ground that since the original principal amount of the loans exceeded \$15,000, it could, under KRS 360.010, change any rate of interest and impose such charges and fees as were agreed to by the borrowers. In upholding the position of the bank, the Court, adopted the Circuit Court's opinion saying id. 925:

"Therefore, it is this court's finding that under the statutes and authorities cited, based on the amendments referred to herein, banks are authorized to execute loans under either KRS 287.215 or KRS 360.010. On over \$15,000.00 loans, banks may structure their loans under KRS 360.010, including provisions for charges, rebates and fees, similar to those provided for and required under KRS 287.215, if it so elects and the parties agree thereto.

"It is the court's finding that KRS 287.215 does not bar parties by contract from including any of its provisions in a loan over \$15,000.00 structured outside of its statute."

### 2. EXTENSION/NOVATION - RELEASES OF MORTGAGE

In Nolin Production Credit Association v. Citizens National Bank, Ky. App., 709 S.W. 2d 466 (1986), decided on May 9, 1986, a husband and wife borrowed \$98,000 from the Nolin PCA secured by a mortgage containing a future advance clause "opened ended to \$120,000" covering farms in Nelson and three other counties. The borrowers were subsequently divorced and the husband thereafter executed a new \$314,506 note (which included the \$65,700 unpaid

balance of the previous loan to him and his former wife) secured by a new mortgage covering the farms in the three counties but not the Nelson County farm. Following bankruptcy of the husband, a controversy developed between a subsequent mortgagee of the Nelson County property and the Nolin PCA as to who was entitled to the sale proceeds of the Nelson County farm. The subsequent mortgagee contended the first loan was satisfied by the execution of the \$304,506 note, and its mortgage thereby released even in the face of its future advance provision. On the other hand, Nolin PCA's position was that the first note was not paid off but was extended and consequently the future advance provision protected Nolin PCA as to the Nelson County property.

The court found that Nolin PCA intended a novation by execution of the second note and applied the well settled rule that a renewal note will not extinguish an obligation. However, a renewal note that is a novation which operates to extinguish an original debt is to be distinguished. Whether a second note is a renewal of an original obligation or a novation thereof, depends upon the intentions of the parties. As a result, the court held:

" . . . that if the new note extinguished the old debt, the mortgage securing it also fails as to the first debt and the future advances protection with it, since there is no obligation upon which to base an advance."

The decision is important because of the court's holding as to the effect of the novation upon the future advance clause in the first mortgage - particularly as applied to revolving credit transactions secured by real estate mortgages. If the revolving credit account is paid down to "zero", is the mortgage securing the account released? The Nolin PCA case appears to say it is.

### 3. LOCATION OF SIGNATURES

Although not directly involving banking law, the decision by the Kentucky Court of Appeals in Consolidated Aluminum Corporation v. Krieger, Ky. App., 710 S.W. 2d 869 (1986) could have an impact upon the preparation of loan and other bank documents. In that case, a sale contract contained twenty-two "terms and conditions" of sale on the reverse side of the document. While the front side of the document was signed and contained language incorporating by reference the terms and conditions on the reverse side, the incorporation language appeared below the signature line. In holding that the terms and conditions on the reverse side were not a part of the contract because the language incorporating them was below the signature line, the Kentucky court said:

"In Kentucky, a writing 'shall not be deemed to be signed unless the signature is subscribed at the end or close of the writing.' KRS 446.060(1). Kentucky courts consistently hold that the Uniform Commercial Code does not displace KRS

446.060(1) . . . . Therefore, any part of a commercial writing appearing below the signature line does not become a part of the contract . . . .

"We do not mean to suggest the KRS 446.060(1) abolishes incorporation of terms and conditions by reference in commercial contracts. That is clearly not the case . . . . However, any incorporating language must appear above the signature line of the contract in order to be valid and enforceable in the courts."

#### 4. FUTURE ADVANCE CLAUSES

Many security agreements contain a provision to the effect that the security interest granted in the collateral secures not only the obligation incurred at the time the security agreement is entered into but also secures obligations thereafter incurred by the debtor. This is the so-called future advance or "spreader" clause. The decision is Dalton v. First National Bank of Grayson, Ky. App., 712 S.W. 2d 954 (1986) casts some question upon the effectiveness of these clauses.

In that case, the bank had been granted a purchase money security interest in mobile home trailer. As characterized by the court:

"On the back of the security agreement was a boilerplate future advance clause which purported to agree that the trailer would also secure any other debt owned by the [debtors] then or thereafter to the bank."

Subsequently, one of the debtors had an overdraft at the bank which then asserted that its security interest in the trailer also secured repayment of the overdraft. In subsequent litigation, the bank's claim was rejected, the court saying:

"We hold, therefore, that broad, boilerplate future advance clauses in adhesion contracts are not enforceable as to future transactions which are of different type or class than the original secured transaction. Specifically, such clauses in purchase money security agreements for consumer goods will be enforceable only where the latter transaction concerns a similar purchase money loan for consumer goods."

#### 5. DISPOSITION OF COLLATERAL

Under the Uniform Commercial Code, a secured party, after obtaining possession of collateral, must do one of two things: either retain possession of the collateral in satisfaction of the debt (KRS 355.9-505), or sell the collateral at a commercially reasonable public or private sale and apply the sale proceeds against the debt (KRS 355.9-504)



A recent decision by the Kentucky Court of Appeals in Owens v. First Com. Bank of Prestonsburg, Ky. App., 706 S.W. 2d 414 (1986) has held, however, that a judicial sale is available to the lender as a third non-code remedy.

Under the facts of the decision, the bank elected to adopt a procedure akin to a real estate foreclosure by suing on the debt and then obtaining an order from the court directing the court commissioner to sell the collateral at public auction. After the sale, the trial court entered judgment for the deficiency between the debt and the amount raised at the auction. On appeal the Court of Appeals held that the judicial sale was an "appropriate" alternative method of disposing of the collateral.

The decision is also important because, even though the bank purchased the collateral at the commissioner's sale for \$50,000 and later sold it for \$65,000, the court held that the \$15,000 "profit" on the second sale belonged to the bank and the debtor was not entitled to credit the same against the bank's deficiency.

#### 6. STRICT COMPLIANCE WITH TERMS OF LETTERS OF CREDIT

If it becomes final, the January 23, 1987, decision of the Kentucky Court of Appeals in Utica Mutual Insurance Company v. Walker, \_\_\_ K.J.S. \_\_\_ (although decided under New York's Uniform Commercial Code) again emphasizes that a bank issuing a letter of credit is not obligated to honor a sight draft drawn upon the credit unless the letter's beneficiary strictly complies with the terms of the letter of credit.

In holding that valid policy reasons exist for adhering to the strict compliance rule, the Kentucky court quoted with approval from the decision of the United States Court of Appeals for the Fifth Circuit in Philadelphia Gear Corp. v. Central Bank, 717 F.2d 230, 236 (5th Cir. 1983):

"the rejection of strict compliance as a doctrine would vitiate the economic value of a credit transaction; for not only would the issuer be compelled to assume the risks of the underlying contract's nonperformance, it would also be required to assume the additional risks of judicial realignment of its obligations under the credit:

"[T]he peculiar values of the letter of credit are (1) that they provide the assurance of payment, (2) that they can provide that assurance in respect to any transaction, and (3) that they are inexpensive. These values will be lost if performance of the letter of credit is to be infected by the nonperformance of the underlying transaction because when that happens the letter of credit is not an assurance of payment and because if that happens the cost of a letter of credit must include the issuer's problematic litigation expense."



EXHIBIT A



# Legislative Bulletin

## KENTUCKY BANKERS ASSOCIATION

600 PORTLAND BUILDING, SECOND & BROADWAY, LOUISVILLE, KENTUCKY 40202

(502) 582-2453

February 28, 1986

NUMBER 4

TO: Members, KBA

FROM: Willis G. Moremen, Executive Vice President

### ANALYSIS OF DEPARTMENT OF FINANCIAL INSTITUTIONS' BILL (HB 709)

As reported in Legislative Bulletin No. 3, Representative Bruce has introduced House Bill 709 on behalf of the Department of Financial Institutions. The bill makes numerous revisions to KRS Ch. 287 relating to banks and a section by section analysis of the major substantive provisions of HB 709 follows.

The bill has been reported out of the House Banking and Insurance Committee and could be voted on by the full House as early as Monday, March 3, 1986. Your Association has gone on record in support of the bill. If you concur in the Association's position, please ask your legislator to support House Bill 709. Your immediate action is needed.

1. Collateral for Loans. KRS 287.030 currently prohibits a bank from making a loan on the security of shares of the bank's stock. The bill amends this section by providing that such loans can also not be secured by the shares of stock of the bank holding company which controls the bank to the extent that the loan "exceeds the amounts permitted by Section 23(A) of the Federal Reserve Act (12 USC Sec. 371c)". Since national banks, state member banks and state nonmember insured banks are already subject to the provisions of Section 23A, and thus are already prohibited from making loans secured by holding company stock in excess of the amounts and under the circumstances prescribed by Section 23A, the amendment to KRS 287.030 would not appear to require any substantive changes in the loan practices currently followed by banks in Kentucky.

2. Number of Directors. The bill amends KRS 287.040 to require that banks, trust companies and combined banks and trust companies have a minimum number of directors. Under the amendment, a bank would be required to have a minimum of five directors while trust companies and combined banks and trust companies would be required to have a minimum of seven directors.

3. New Banks. KRS 287.050 currently requires that before the Articles of Incorporation of a newly organized bank, trust company or combined bank and trust company can be filed and recorded, a copy of the articles must be submitted to the Commissioner of Financial Institutions who shall, in approving the organization of the new bank, "investigate the financial standing, moral character and capability of each of the incorporators." The amendment to KRS 287.050 would require that the Commissioner also investigate the financial standing, moral character and capability of each of the bank's "proposed executive officers and directors, if known." In addition, a new section is added to KRS 287.050 requiring that amendments to the Articles of Incorporation of a bank, trust company or combined bank and trust company be approved by the Commissioner of Financial Institutions before filing with the Secretary of State. This new section merely codifies the existing regulatory requirement.

4. Directors' Qualifying Shares and Duties. Presently, KRS 287.065 requires that a director's qualifying shares have an aggregate value of at least \$500. The bill amends KRS 287.065 to require that the qualifying shares have a book value of at least \$1,000. The bill also adds a new subsection 3 to KRS 287.065 requiring that (a) each director "exercise such ordinary care and diligence as necessary and reasonable to administer the affairs of the bank in a safe and sound manner," (b) the bank furnish each director with a copy of an appropriate publication outlining the duties of the director and an updated copy of Kentucky's banking laws and that the bank maintain updated copies of Federal banking laws. The appropriate publication and what constitutes Kentucky banking laws and Federal banking laws are to be determined by administrative regulation.

5. Bank Capital. KRS 287.080 is amended to make it clear that none of the original minimum capital of a financial institution may be designated as undivided profits.

6. Permitted Investments. KRS 287.100, relating to the investment of a bank's funds, is amended to specifically authorize a bank to:

(a) Invest in bonds or other interest bearing obligations of the United States; bonds or other obligations issued or guaranteed by any instrumentality incorporated by authority of an act of congress; and general obligation or revenue bonds issued or guaranteed by any state, county or municipal government.

(b) Invest in real estate in the bank's generally accepted banking market so long as each investment does not exceed 10% of the bank's actual paid-in capital and surplus calculated at the time such investment is made.

(c) Invest in improvements to real estate acquired in satisfaction of a debt previously contracted so long as each such investment does not exceed 10% of the bank's paid-in capital and surplus calculated at the time such investment is made. Any real estate so improved must be disposed of within five (5) years of the date of acquisition with the Commissioner being authorized to extend the period of such disposition on a year to year basis not exceeding five (5) additional years.

(d) Own or operate a discount brokerage service either through the bank or a bona fide bank subsidiary.

(f) Own or operate a travel agency either through the bank or a bona fide bank subsidiary.

The newly authorized investments specified in subsection (a) above are subject to the lending limit provisions of KRS 287.280 and 287.290 and in computing the maximum investment in bonds, notes or other such investments, book value is required to be used. Accreted book value is required to be used for discount or zero coupon bonds.

Finally, the amendment to KRS 287.100 requires that a bank which acquires real estate in satisfaction of a debt previously contracted shall write down the acquisition at 10% per year.

7. Branches. The bill amends KRS 287.180, relating to establishment of branches, to require that the Commissioner, in approving or disapproving an application to establish a branch, must determine that there is a reasonable probability of the successful operation of such branch "based upon the financial and managerial impact of the branch on the bank establishing the branch." In addition, the amendment specifies that such application must be approved or disapproved by the Commissioner based upon the facts existing at the date of the filing of the application except for the financial condition of the bank purposing to establish the branch office, which condition is subject to a review until an order ruling on the application is made. Finally, the amendment makes it clear that in connection with a merger of banks in the same county, the charter of the bank which does not survive the merger must be surrendered.

8. Lending Limits. Presently, KRS 287.280 provides that if a loan to a director or officer exceeds 10% of the bank's paid-in capital, the excess must be secured by collateral double in value the amount of the excess. The bill would amend KRS 287.280 to delete this double collateral requirement with the result that a bank's lending limits applicable to any person are also applicable to loans to the bank's directors and executive officers. However, the amendment further provides that loans to the directors and executive officers must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions by the bank with other persons and

cannot involve more than the normal risk of repayment or present other unfavorable features. Moreover, each loan or extension of credit to a director or executive officer must be approved in advance by a majority of the board of directors with the interested party abstaining from participating directly or indirectly in the voting.

Finally, KRS 287.280 is also amended to provide that, in computing the indebtedness of any person to the bank, the liability of any partnership in which the person acts as general partner shall be included.

9. Examination Reports. Presently, KRS 287.470 prohibits an officer or employee of the Department of Financial Institutions from releasing any information contained in an examination report except so far as necessary in performance of his official duty as provided by law. The bill amends KRS 287.470 to specifically provide that reports of examination are considered confidential information and no officer or director of a bank or trust company as well as any officer or employee of the Department of Financial Institutions shall release such report or any information contained in the report except (a) when required in a proper legal proceeding in which a subpoena and protective order insuring confidentiality has been issued by a court of competent jurisdiction, or (b) the information is referred to a prosecuting attorney for possible criminal proceedings, or (c) the information is referred to outside persons providing professional services to the bank or for the purpose of evaluating the bank for possible acquisition. Before a report can be released to an outside person as aforesaid, a written request must be submitted by such outside person and release of the information approved by the board of directors or an executive committee of the bank.

10. Reports to Commissioner. The bill would add a new subsection to KRS 287.490 requiring any officer, director or the board of directors of a bank or trust company to immediately notify the Commissioner of Financial Institutions concerning any information relating to the institution of which they have personal knowledge involving fraud, defalcation, misfeasance or violation of KRS Chapter 287. Failure to do so is grounds for officer or director removal pursuant to KRS 287.690.

11. Multi-bank Holding Companies. Currently, KRS 287.900, relating to multi-bank holding companies, prohibits, until July 13, 1989, an individual or bank holding company from acquiring control of a bank or bank holding company in Kentucky if as a result the individual or company would acquire control of more than three banks in Kentucky during any twelve month period. The bill would amend this provision to permit a holding company to acquire control of a holding company in Kentucky controlling more than three Kentucky banks if such acquisition is approved by the Commissioner of Financial Institutions so long as (a) such acquisition only occur once; (b) the banks acquired by such acquisition in excess of the three bank per year limitation be counted against future



acquisitions occurring prior to July 13, 1989; and (c) the total banks in Kentucky acquired by the holding company not exceed 15 banks during the five year period ending July 13, 1989.

12. Approval of Multi-bank Holding Company Acquisitions. KRS 287.905, relating to approval by the Commissioner of Financial Institutions of acquisitions by multi-bank holding companies, currently requires the Commissioner to approve such acquisitions within 60 days after acceptance of a completed application unless he finds that the terms of the acquisition are not in accordance with Kentucky law or the financial condition, competence, experience or integrity of the holding company or its principals are such as will jeopardize the financial stability of the bank or holding company to be acquired or the public convenience and advantage will not be served by the acquisition.

The bill amends these requirements by extending the time within which the Commissioner shall act on the application from 60 to 90 days and adding to the criteria for approval of the acquisition the requirement that no federal regulatory authority, whose approval is required, has disapproved the transaction because it would result in a monopoly or substantially lessen competition. In addition, the bill authorizes the Commissioner to, among other things, enter into cooperative agreements with federal or state regulatory authorities to examine an out-of-state bank that is controlled by a Kentucky bank holding company or by a bank holding company which includes a state chartered bank and to exchange confidential information and reports of examinations relating to interstate acquisitions of banks and bank holding companies.

13. Non-bank Bank Prohibition and Director/Officer Disqualification. The bill adds two new sections to KRS Chapter 287. The first would prohibit the operation of non-bank banks in Kentucky by making it illegal for an individual, corporation or bank holding company to acquire, control, hold, charter, convert or operate any bank in Kentucky which is an FDIC "insured bank" or eligible to make application to become an "insured bank" and which does not both accept demand deposits and actively engage in the business of making commercial loans. The second new section prohibits any bank officer or director who has been removed from office pursuant to KRS 287.690 from serving as a officer or director of any other Kentucky state bank without the prior written approval of the Commissioner of Financial Institutions.

14. Penalties. The bill amends the penalty section of KRS Chapter 287 (KRS 287.990) by increasing the fines for engaging in private banking in Kentucky, for failing to submit reports required by law or for submitting false reports or failing to submit to an examination. In addition, new fines are imposed on a bank for failing to comply with the new provisions of KRS 287.065 (paragraph 4 above) and for exceeding the real estate investment limitations of the new section to KRS 287.100 (paragraph 6 above). Finally, any officer or director who violates the provisions of KRS 287.280

relating to the bank's debt limit is subject to a fine of not less than \$100 nor more than \$500 for each violation and any officer or director who violates KRS 287.280(2), relating to prior approval of loans to directors or executive officers, is subject to fine of not less than \$500 nor more than \$2,000 for each violation.

15. Repeal. The bill repeals KRS 287.120 requiring one-half of the capital stock of a combined bank and trust company to be invested for the institution's trust business and KRS 287.500 making examination and other reports concerning a bank or trust company prima facie evidence of the facts stated in the report. The provisions of KRS 287.500 are, however, re-enacted by the bill and made a part of KRS 287.470.

EXHIBIT B

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# Legal Bulletin

## KENTUCKY BANKERS ASSOCIATION

600 PORTLAND BUILDING, SECOND & BROADWAY, LOUISVILLE, KENTUCKY 40202

(502) 582-2453

March 27, 1986

TO: Members, KBA  
FROM: M. Brooks Senn, General Counsel  
RE: Enforcement of Security Interests Against Purchasers of Farm Products

Section 9-307 of the Uniform Commercial Code (KRS 355.9-307) provides that a buyer in ordinary course of business, other than a purchaser of farm products from a farmer, takes free of a security interest created by his seller. This has the effect of permitting a lender having a security interest in farm products to enforce that interest against the purchaser or selling agent if the farmer/debtor does not apply the proceeds of sale of the farm products in payment or reduction of the debt. This is the so-called "farm products exception."

Kentucky long ago recognized that this exception creates a problem for the buyer of farm products as well as the farmer and his commission merchants and agents. As a result, Kentucky has amended KRS 355.9-307 of the Code in an attempt to accommodate all competing interests. Essentially, the Kentucky amendments require a lender, desiring to preserve its security interest in tobacco, livestock, grain, soybeans or race horses sold through or to a licensed warehouse, stockyard or an organization engaged in the business of selling race horses at auction, to give notice of its security interest to the warehouse, stockyard or horse auctioneer prior to the sale of the collateral. If such notice is not given, a bona fide purchaser as well as the warehouse, stockyard or auctioneer takes free of, and is not liable to the lender for the value of, its security interest.

Section 1324 of the Food Security Act of 1985 (P.L. 99-198) which becomes effective on December 24, 1986, and is entitled "Protection for Purchasers of Farm Products," preempts state law in this area and provides that a buyer, commission merchant or selling agent of farm products is not subject to a security interest in the products unless one of two alternative approaches are followed by which lenders can continue to enforce their farm product liens against purchasers. A copy of Section 1324 is attached to this Bulletin. It should be carefully examined since it defines a number of the terms used in the federal act and this memorandum.

In short, the federal act provides in Sections 1324(d) and 1324(g)(1) that, notwithstanding conflicting state law, farm product buyers, commission merchants and selling agents "take free of" a security interest in farm products created by the farmer/seller unless (a) the secured party/lender or the farmer prenotifies - much like the present practice in Kentucky - the farm product buyer, commission merchant or selling agent of the existence of the lender's security interest or (b) the state in which the farm products are produced has established a central filing system for filing financing statements covering farm products on a state wide basis.

Kentucky does not presently, and will not on December 24, 1986, have a central filing system. Thus, farm products lenders in Kentucky must, on the effective date of the federal act, comply with the prenotification provisions of the act in order to preserve their security interests in farm products against the claims of buyers, commission merchants or selling agents of such products. In order to do so, written notice of such security interest must be received by the buyer, commission merchant or selling agent within one year before the sale of the farm products. If, after receipt of such notice, the buyer, commission merchant or agent fails to comply with the payment obligations imposed by the lender as a condition for waiver or release of the security interest specified in such notice, then the lender's security interest remains unaffected by the sale and the lender can recover the value of the collateral from the buyer, commission merchant or selling agent if the farmer fails to remit the sale proceeds to the lender.

The federal act provides that what constitutes receipt of such notice is determined by state law. KRS 355.1-201(26) provides that a person receives a notice when (a) it comes to his attention; or (b) it is duly delivered at the place of business through which the contract was made or at any other place held out by him as the place for receipt of such communications.

The contents of the notice required by the federal act is somewhat more elaborate than required by present Kentucky law in that the notice must be organized according to farm products and contain:

1. The name and address of both the debtor and the secured party;
2. The social security (or taxpayer identification) number of the debtor; and
3. A description of the farm products subject to the security interest, including the amount of such products where applicable, the crop year, and a reasonable description, including county, of the property.

In addition, the notice must specify any payment obligations imposed upon the buyer, commission merchant or selling agent by the

lender as a condition for waiver or release of the security interest. For example, the lender could require that the check for the sale proceeds be made to the joint order of the lender and the farmer.

While the federal act provides that the notice lapses on the earlier of the expiration period of the financing statement or the transmission date of a notice signed by the secured party that the statement has lapsed, the requirement that the notice be received within one year before the sale of the farm products limits the effective duration of the notice. For example, if a lender finances the purchase of feeder calves which farmer does not intend to sell for two years, a notice given at the time of the financing would not appear to be effective for a sale of the calves at the end of the two year period. In addition, the notice must be amended within three months of any material changes in the information included in the original notice.

Finally, the federal act provides that the security agreement signed by the farmer and granting the security interest in the farm products may require the farmer to furnish a list of buyers, commission merchants and selling agents to or through whom the farmer may sell the farm products. If the products are sold through a person not included on the list, the farmer may be fined the greater of \$5,000 or 15% of the value or benefit received from the farm products described in the security agreement unless the farmer notifies the lender of the identity of the buyer, commission merchant or selling agent at least seven days prior to the sale or accounts to the lender for the proceeds of the sale not later than ten days thereafter.

As indicated above, the federal act becomes effective on December 24, 1986. Sales before that date will be subject to the Kentucky notice requirements of KRS 355.9-307 while sales after that date will be subject to the notice requirements of the federal act. Since it is believed that a certified mail, return receipt requested, notice satisfying the federal requirements will also satisfy existing Kentucky law requirements, farm product lenders find it desirable and feasible to send federal notices prior to the effective date of the federal act. Banks are urged to consult with their legal counsel in this connection.

To assist banks and their counsel in redesigning the required notice, the requirements of the federal notice and the present Kentucky notice are indicated in the following table:

<u>Kentucky Notice</u>	<u>Federal Notice</u>
Required for tobacco, grain, soybeans, livestock and race horses	Required for <u>all</u> farm products
Notice required to be mailed certified mail, return receipt requested	No specific requirement (certified mail, return receipt requested is advised)

PROTECTION FOR PURCHASERS OF FARM PRODUCTS

SEC. 1324. (a) 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) The purpose of this section is to remove such burden on and obstruction to interstate commerce in farm products.

(c) 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 in 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 section 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, including 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 subparagraph 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) Except as provided in subsection (e) 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) 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.

(g)(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) 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)(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) The Secretary of Agriculture shall prescribe regulations not later than 90 days after the date of enactment of this Act to aid States in the implementation and management of a central filing system.

(j) This section shall become effective 12 months after the date of enactment of this Act.



EXHIBIT C



# Legal Bulletin

## KENTUCKY BANKERS ASSOCIATION

600 PORTLAND BUILDING, SECOND & BROADWAY, LOUISVILLE, KENTUCKY 40202

(502) 582-2453

December 31, 1986

TO: Members, KBA  
FROM: M. Brooks Senn, General Counsel  
RE: New Reporting Requirement for Real Estate Transactions  
Closed after 1986

The Tax Reform Act of 1986 added a new section 6045(e) to the Internal Revenue Code requiring that certain information be reported to the Internal Revenue Service in connection with real estate transactions closed after December 31, 1986.

While the IRS has not yet issued any regulations specifying what transactions must be reported and what data must be collected, a newly issued revised Form 1099-B indicates that the names, addresses and federal identification numbers of the buyer and seller, the gross proceeds of sale and a description of the real estate involved will be required to be reported by the person (including any attorney or title company) responsible for closing the transaction. However, if there is no person responsible for closing the transaction, then the mortgage lender must file the report. Thus, depending upon how the closing is handled, banks financing a real estate sale or their attorneys, if any of them "close" the sale, may be required to file the new report.

Until IRS regulations are issued, banks financing a real estate sale should be sure that the following information is collected at the closing of the transaction:

1. The date of the sale;
2. The seller's gross proceeds;
3. The name and address of the seller;
4. The name and address of the buyer;
5. The taxpayer identification numbers of both the buyer and seller (social security number of individuals and federal I.D. numbers of corporations or partnerships); and
6. A brief description of the property sold (including whether it is a principle residence).

As soon as regulations are issued by the IRS, a supplemental bulletin will be issued to KBA members.

The subject of this Bulletin involves legal principles or requirements, the applicability of which may vary depending upon the circumstances. Accordingly, legal counsel should be consulted in applying the same.

Revision of Form 1099-B, Statement for Recipients of Proceeds From Real Estate, Broker, and Barter Exchange Transactions

Announcement 86-115

Form 1099-B has been revised to provide for the reporting of real estate trans-

actions closing after 1986, as required by the Tax Reform Act of 1986, which added section 6045(e) to the Internal Revenue Code.

New Box 1b "Real estate" has been added for reporting gross proceeds from a real estate transaction, and two check-

boxes have been added to Box 5 to identify the nature of the property involved in the transaction. Other minor changes have also been made to the form.

A copy of the revised form, which will be available in Internal Revenue Service offices in early January, appears below.

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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	Proceeds From Real Estate, Broker, and Barter Exchange Transactions
		1b Real estate \$	1987 Statement for Recipients of	
		2a Stocks, bonds, etc. \$	<input type="checkbox"/> Gross proceeds <input type="checkbox"/> Gross proceeds less com accounts 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



1986 TAX DEVELOPMENTS  
AND  
1987 TAX STRATEGIES  
FOR BANKS AND BANK HOLDING COMPANIES

C. Christopher Trower  
Brown, Todd & Heyburn  
Louisville/Lexington, Kentucky

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C. Christopher Trower

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1986 TAX DEVELOPMENTS AND 1987 TAX  
STRATEGIES FOR BANKS AND BANK  
HOLDING COMPANIES

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1986 TAX DEVELOPMENTS AND 1987 TAX  
STRATEGIES FOR BANKS AND BANK  
HOLDING COMPANIES

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I. INCOME TAX RATES

A. Individuals.

In 1987, individual taxpayers will be subject to a maximum rate of 38.5% on ordinary income and 28% on capital gains. The highest rate of 38.5% will apply to marginal taxable income as follows.

Tax Rates for 1987

<u>Tax Rate</u>	<u>Married, Filing Joint Returns</u>	<u>Heads of Household</u>	<u>Single Individuals</u>
38.5%	Over \$90,000	Over \$80,000	Over \$54,000

For tax years beginning in 1988, the tax rates for individuals will be condensed into two rate brackets of 15% and 28%, applied to taxable income as follows.

Tax Rates Beginning in 1988

<u>Tax Rate</u>	<u>Married, Filing Joint Returns</u>	<u>Heads of Household</u>	<u>Single Individuals</u>
15%	\$ 0-\$29,750	\$ 0-\$23,900	\$ 0-\$17,850
28%	Over \$29,750	Over \$23,900	Over \$17,850

Congress eliminated the benefit of the 15% bracket for taxpayers with substantial income, by placing an additional 5% surcharge on upper bracket taxable income beginning at approximately \$72,000 for married taxpayers and approximately \$43,000 for single individuals. Income above these levels

will be taxed at a marginal rate of 33% (up to approximately \$190,000 for married taxpayers and \$100,000 for single individuals), but the effective rate of tax will never go above 28%.

B. Corporate Tax Rates.

For taxable years beginning on or after July 1, 1987, corporations will be subject to the following rates on taxable income:

<u>Taxable Income</u>	<u>Tax Rate</u>	
	<u>Current Law</u>	<u>New Law</u>
\$25,000 or less	15%	15%
\$25,001-\$50,000	18%	15%
\$50,001-\$75,000	30%	25%
\$75,001-\$100,000	40%	34%
\$100,000-\$335,000	46% *	39%
over \$335,000		34%

\* An additional 5 percent tax up to \$20,250 is imposed on taxable income in excess of \$1,000,000. Corporations with taxable income of at least \$1,405,000 pay a flat rate of 46 percent.

For tax years beginning before and including July 1, 1987 (e.g., 1987 calendar year returns), a blended rate will apply. The blended rate is calculated by prorating the tax calculation based on the number of months before and after July 1, 1987. For a calendar year corporation, the top rate for 1987 will 40 percent (6 x 46% plus 6 x 34% = 480% divided by 12 = 40%).

C. Planning Points.

A number of strategies are suggested for 1987 by the change in individual and corporate tax rates.



1. Capital Gain Preference. For 1987 only, capital gains are still taxed at a rate which is a little over 70% of the ordinary income rate (28% max vs. 38.5 max). Careful attention should therefore be paid to 1987 transactions to maximize capital gain elements and minimize ordinary income/-recapture elements. This will be particularly true in

\* Asset sales -- depreciation recapture.

\* Stock redemptions -- dividend/capital transaction.

2. Installment Sales. In an installment sale, the entire amount of ordinary income recapture must be reported in the first year, regardless of the amount of cash received. Don't be misled into thinking that an installment sale will push ordinary income out of 1987 (at the 38.5% rate) and into 1988 (at the 28% rate). Rather, by careful planning it is possible to structure the sale so that it does not close for tax purposes until 1988.

3. Hump Planning. The additional 5% tax which is added to the maximum individual and corporate taxes to phase out the effect of the lower brackets means that a premium will be placed upon planning between tax years to stay out of the 5% surcharge area.

4. Choice of Business Entity. As more fully explained below, the inversion of the corporate and individual rates - so that for the first time in tax memory corporate rates are higher than the individual rates - will mean that almost all new business ventures should be structured as S corporations or partnerships.

## II. CAPITAL GAINS AND LOSSES

The new law essentially eliminates the preferential treatment for capital gain. But the distinction between capital and ordinary income is still retained in the Code, and has several significant impacts.

### A. Individuals.

In 1987, when the top individual rate on ordinary income will be 38.5%, the top capital gain rate is 28%.

For 1988, capital gain income will be taxed at the same rate as other income - including the 33% marginal rate for income and gain between approximately \$72,000 and \$200,000.

However, the concept of capital gain is preserved. Thus, capital losses will be allowed as a deduction in full against capital gains as under prior law, and against up to \$3,000 per year of ordinary income to the extent capital losses exceed capital gains.

It will therefore be important, for example, to continue to make sure that regular corporations qualify for § 1244 (capital gain/ordinary loss) treatment on their stock. It will also be very important in transactions where an economic loss will be suffered to try to structure the loss as an ordinary loss rather than a capital loss. Otherwise, the taxpayer will suffer a significant economic detriment without a corresponding tax offset, except to the limited extent that capital losses can offset ordinary income.

#### B. Corporations.

The Act eliminates the preferential tax rate for corporate capital gains. For gains includable in income on or after January 1, 1987, corporate net capital gain is taxed at the regular corporate rate, with a maximum tax rate of 34%. Capital losses are still deductible only against capital gains.

#### C. Changes in Strategies.

Advance planning designed to produce capital assets and capital gains will be beneficial under the law only for taxpayers who have, or anticipate having, capital losses. The overriding incentive under prior law to always plan to create capital assets and capital gains to achieve lower tax rates no longer exists. If a particular transaction ultimately produces a loss, taxpayers will continue to be motivated to avoid capital asset classification in order to avoid the limitation on deductibility of capital losses.

1. Downside Protection. Since the incentive to produce capital gains will apply only to selected taxpayers, most initial tax planning for conventional business transactions is likely to focus on the avoidance of capital asset status as insurance against the omni present possibility (albeit unintended) that the transaction will ultimately produce a loss which, if a capital asset is involved, cannot be deducted against ordinary income to any significant extent. Planning of this sort will, however, be overshadowed in many situations by other considerations: primarily, the need to deal with the new, tougher alternative minimum tax, the new limit on passive activity losses, the increased restrictions on the deductibility of interest expense, and, in the short

run, the effect of the multitude of transition rules in the Act and the possibility of future legislation reinstating a preferential rate for capital gains.

2. Impact Areas. We see immediate and drastic effects on the following types of transactions and related planning: depreciation and other recapture provisions; collapsible corporation strategies; partnership hot assets and § 736 redemption strategies; § 1239 restrictions on related party sales; restricted property and § 83(b) elections for employees; and incentive stock option plans.

3. Acquisitions and Business Entity Choices. The elimination of preferential treatment of corporate and shareholder capital gains, and the imposition of a double tax on corporate liquidation sales and distributions will drastically change planning strategies for the purchase and sale of closely held corporations, and for the choice of business form.

### III. DEPRECIATION AND TAX CREDITS

The investment tax credit is eliminated, retroactive to January 1, 1986. Depreciation schedules will be lengthened, with a resulting increase in the net after tax cost of purchasing equipment.

#### A. Depreciation.

The Act provides eight classes of depreciable property, each having a prescribed recovery period and depreciation method; several other types of property will be individually treated for depreciation purposes. Residential real property (apartments) will be depreciable over 27-1/2 years, and non-residential real property (office buildings and shopping centers) will be depreciable over 31-1/2 years, each using the straight line method.

Personal property is assigned a recovery period of 3, 5, 7, 10, 15 or 20 years, based upon the current ADR midpoint life. Property in the 3-year, 5-year, 7-year, and 10-year classes will be depreciated using the 200% declining balance method. Automobiles and light trucks will be in the five-year class; seven-year class property will include furnishings and fixtures used in apartments, offices, motels, and hotels. Property in the 15-year and 20-year classes will be depreciated using the 150% declining balance method.

One element which will have to be included in the depreciable basis of property is construction period interest incurred after December 31, 1986. Rather than being amortized over 10 years as under current law, construction period interest will have to be capitalized and depreciated over the depreciable life of the property as a construction cost. Interest paid after December 31, 1986 will qualify for present law treatment if substantial construction occurred before March 1, 1986.

B. Investment Tax Credit.

The general investment tax credit for equipment is repealed for all property placed in service on or after January 1, 1986. Property placed in service on or after that date, but which was subject to a written binding contract to construct or acquire as of December 31, 1985, will be eligible for a reduced credit if it was placed in service by January 1, 1987 for property with a class life of 5 to 7 years, or by July 1, 1986 for property with a class life of less than 5 years.

If property is eligible for the investment tax credit under the transition rule, the amount of the allowable credit is reduced by 17.5% for taxable years beginning in 1987 and 35% for taxable years thereafter. The reduction in credit also applies to any credits carried forward from prior taxable years. A full basis adjustment for the credit claimed will be required.

A modified investment credit was, however, retained for historic rehabilitation expenditures and low income housing expenditures.

IV. MAJOR CHANGES IN ACQUISITION AND SALE  
OF BUSINESS STRATEGIES

A. Frame of Reference.

Tax planning for the acquisition or disposition of corporate businesses has historically focused on the following techniques.

\* If the purchaser was buying stock, the purchaser would consider making a § 338 election to get a tax basis for the assets equal to the price paid for the stock.

\* If the purchaser was buying assets, the selling corporation would make a § 337 election to avoid tax on the sale of assets at the corporate level. Shareholders of the

selling corporation would pay tax only at capital gain rates on the liquidating distribution.

\* If an individual purchased stock of a corporation, results similar to the § 338 election (available only to corporations) could be achieved by liquidating the acquired corporation and operating as a partnership or sole proprietorship. The liquidation would be taxable, but no liability would be generated because the price paid for the stock would ordinarily equal the fair market value of the assets distributed.

\* If a corporate business was to be divided among shareholders, and tax-free reorganization treatment for a split-off under § 355 was not available, the preferred strategy was to use a one-month liquidation under § 333 to avoid tax at the corporate and individual levels.

The 1986 Tax Act repeals or undercuts all these rules, and, subject to certain exceptions for closely held corporations which will expire at the end of 1988, requires that all acquisition strategies and activities be immediately reviewed. In addition, corporations which expect to be acquired or liquidated at any time in the future must seriously consider shifting to partnership or S corporation status now, or accelerating plans for acquisition or liquidation prior to the end of 1988.

#### B. New Law Provisions.

Under the new law (and subject to the exceptions noted below), the following changes are made.

\* A corporation which distributes assets in kind to its shareholders is taxed at the corporate level as if it sold the assets for their fair market value. In addition, the shareholders pay a tax on the value of the assets received.

\* The favorable provisions of § 337, permitting a tax-free sale of corporate assets as part of a liquidation, are repealed.

\* The favorable provisions of § 333, permitting an in-kind distribution with no tax at corporate or at individual levels, are repealed.

The effect of these changes is that (assuming maximum rates), a dollar of income or gain at the corporate level will be subject to corporate and individual taxes of 52.5% (as opposed to a maximum individual rate of 28%) before it reaches

the shareholders' hands. In other words, there will almost always be a double tax on the build up in value of a closely held corporation which is not currently siphoned off by salaries or other compensation. This requires all closely held businesses to completely rethink their strategies and plans for the future. This is true for three basic reasons.

\* Earnings can no longer be accumulated at the corporate level with lower tax rates than at the individual level.

\* Preferential treatment for capital gains on the sale of corporate stock (versus ordinary income) has been repealed.

\* The technical ways of avoiding the double tax in the sale of a business have been eliminated.

It is true that a sale of stock will still only be taxed at one level. But that's too easy. Buyers of stock will know that they cannot get a stepped up basis for the underlying assets without payment of the second tax; we therefore expect to see stock sales at substantial discounts to reflect the true economic difference to the buyer (versus an asset sale).

### C. Converting to S Status: A Loophole?

Converting to S status will avoid the double tax on appreciation in value at the corporate level, but only on increases in value that occur after the conversion. Under the new law, even if a corporation shifts to S status, a corporate level tax will be imposed on any gain that arises prior to conversion (so-called built-in gain) which is recognized by the S corporation, through sale or distribution, within ten years after the date of the S election.

Gains on sale or distributions of assets by S corporations will be presumed to be built-in gains, except to the extent that the taxpayer can establish that the appreciation accrued after the conversion. Built-in gain will be taxed at the maximum corporate rate applicable to the particular type of income for the year in which the disposition occurs.

Planning Point - if a corporation converts to S status, there should be an adequate contemporaneous record of assets and valuation to determine built-in gain for future planning purposes. Such adequate documentation will be invaluable if a later significant asset value increase occurs and the business is sold. Allocation among assets in future acquisitions will also be important.

D. Exceptions - Closely Held Corporations.

Closely held corporations are entitled to present law treatment with respect to liquidating sales and distributions (and therefore may use § 333, § 336, and § 337) for transactions occurring before January 1, 1989, provided the liquidation is completed before that date.

To be eligible for the special transitional rule for closely held corporations, a "closely held corporation" is a corporation whose value which does not exceed \$10,000,000 and more than 50% of its stock must be owned by ten or fewer individuals who have held their stock for five years or longer. If a corporation's value does not exceed \$5,000,000, full relief is available. If the value is between \$5,000,000 and \$10,000,000, the relief is phased out 20% for each \$1,000,000 of value.

Corporations which qualify as closely held under the exception provisions may also make an S election prior to January 1, 1989, without becoming subject to the special S corporation built-in gain rules under the new law.

For purposes of the transition rule, a corporation's value will be the higher of the value on August 1, 1986 or its value as of the date of the adoption of a plan of liquidation.

Although the exceptions are available until the end of 1988, the transaction involved will require major economic and tax choices to be made by the owners of closely held businesses. Every closely held corporation should be carefully reviewed and consideration for an S election, conversion to partnership status, or a complete liquidation should be carefully explored and analyzed well before the end of 1987, leaving 1988 to implement the strategies (which may include structuring family redemptions, ESOPs, third party purchases, or other corporate financing transactions).

V. PLANNING FOR THE INVERSION OF  
CORPORATE AND INDIVIDUAL RATES

When the Act is fully effective, the maximum corporate rate will be 6% higher than the top individual rate: 34% (39% including the phase-out) versus 28% (33% including the phase-out). The combined effective rate on corporate income which is distributed to individual shareholders will be 52.5% under the Act (34% plus 28% of 66%, without regard to the phase-out).

The elimination of the capital gain preference means that the time-honored gambit of retaining the maximum possible earnings at the corporate level with a view towards reducing the tax ultimately paid by shareholders is no longer available. An individual shareholder who realizes the value of his interest in retained corporate earnings through a sale of his shares or the receipt of distributions in liquidation of the corporation will be subject to the same rate of tax as if he had simply received a fully taxable dividend.

Moreover, inasmuch as the General Utilities doctrine will be repealed, along with Sections 333, 336 and 337, the shareholder's ability to have corporate earnings reinvested in property which appreciates, followed by a sale of stock or assets with only one level of taxation, will be eliminated. Under the Act, the deferral of the distribution of corporate earnings can only defer, rather than reduce, the second tax ultimately paid by a shareholder. For individual shareholders, the only true escape from double taxation, as under present law, is to die while still owning the shares.

The substantial rate differential in favor of individuals and the advent of a purer form of double taxation of corporate earnings, combined with the many other provisions of the Act which are unfavorable to corporations (such as the new corporate alternative minimum tax which includes an adjustment for 50% of the excess of pre-tax financial statement over alternative minimum taxable income), creates substantial incentives for new businesses to be structured in a noncorporate (or S corporation) form and for existing C corporations to consider shifting to either S corporation or partnership status.

A. Incentives to Form New Businesses as Partnerships.

Under the Act, partnerships are likely to become the preferred form of business organization for Kentucky clients, except for those businesses where protection from tort liability is essential. Many new businesses should be organized initially as partnerships and should retain the partnership form throughout their existence. Existing incorporated businesses which can be liquidated without great tax cost should be liquidated into partnerships. For closely held corporations with a value of less than \$5,000,000, the liquidation needs to be accomplished by the end of 1988.

The advantages of the partnership form over the more traditional corporate form of business organization are numerous and substantial. The major benefits are as follows.



1. Avoiding Double Tax. If all taxpaying entities are in the maximum tax brackets, the effective current rate on the earnings of the business will be six percentage points lower if a partnership rather than a corporation is used. If any of the earnings of the business are distributed to shareholders, or if the corporation is subject to the accumulated earnings or personal holding company tax, the differential will be even larger. Moreover, the true differential over time will be even larger because of the shareholder-level tax that will ultimately be paid in most situations on a sale of the business, and because of the compounding effect of net after tax investment. Use of the partnership form completely avoids, as a practical matter, any double tax in connection with distributions of earnings to the equity owners of the business.

2. Flow Through of Losses. Tax losses generally flow through directly to the equity owners as current deductions of a partnership, but not of a corporation (subject, however, to the new limitation on the deductibility of passive activity losses).

3. No Double Tax on Sale or Liquidation. No double tax occurs on the sale or liquidation of a partnership business.

B. Possible Tax Disadvantages of Conversion.

The foregoing tax advantages of the partnership form are so substantial that, in most situations, they should overwhelm the following tax and business arguments against utilization of the partnership form.

1. No Reorganization Treatment. There are no provisions comparable to the Section 368 reorganization rules which would generally allow corporations to acquire partnerships in tax-free transactions. This problem can be overcome through careful planning in many situations.

2. Familiarity. The corporate vehicle is better known and understood by investors and their advisers, and the law relating to corporations is more developed and better defined than the law relating to partnerships.

3. Employee Benefits and State Law. Generally, the quantity and quality of tax-favored retirement benefits and other fringe benefits that can be made available to an employee are the same under federal law regardless of whether the employer is a corporation or a partnership. But there may be

some distinctions under state law in favor of corporate employees.

4. Liability. Use of a corporation generally insulates its shareholders from the debts and liabilities of the corporate business, but in closely held corporations this invariably applies only to trade creditor debts and most types of tort liability. Bank financing or any significant credit arrangements invariably require shareholder guaranties, which as a practical matter cut deeply into the limits on liability provided by a corporation.

Although a partnership does not automatically offer limited liability to its partners, reasonable protection against creditors of the business often can be achieved through the formation of a limited partnership, possibly with a corporation as its sole general partner, or the judicious use of insurance.

C. Exceptions.

There will, of course, continue to be some situations in which it will be desirable to operate businesses in the corporate form. The owners of a small business which has no real growth potential may find it desirable to form a corporation to take advantage of the 15% corporate rate on the first \$50,000 of annual income. The 15% rate is sufficiently lower than the 28% individual rate so that deferral of the shareholder-level tax for a reasonable period of time (six to eight years) will reduce the present value of the entire double tax to less than a current 28% rate.

Similar considerations may apply in other situations where all or most of the owners of the business will be active in the management and control of the business, thereby jeopardizing their status as limited partners for state law purposes. Similarly, there will be situations in which the need to insulate the owners of a business from its liabilities dictates that the maximum protection afforded by the corporate form be availed of. On balance, however, it seems clear that many fewer businesses should be incorporated than under prior law.

D. New and Old Businesses: The S Election.

Utilization of an S corporation will be less attractive under the Act than the formation of a partnership, but more attractive than staying in a regular C corporation.

1. Limits on Shareholders. The 35-shareholder limit, as well as restrictions on the types of shareholders that an S corporation (no corporate or partnership shareholders; no 80% subsidiaries) may have, prevent an S election in many situations. The 35 shareholder limit is particularly troublesome for closely held-corporations which aspire to public ownership, since it will eventually force them to choose, in connection with public ownership, between a potentially expensive liquidation and the termination of their S election in favor of conventional, tax-disfavored C corporation status.

2. Limits on Losses. The ability of S corporation shareholders to deduct entity losses is more limited than that of partners.

3. State Taxes. Although Kentucky recognizes and respects S corporation status, many other states do not. A corporation which is organized as an S corporation but operates in states other than Kentucky must consider this potential problem.

4. Special Allocations. A partnership can, subject to certain limitations, make special allocations of taxable income and loss among its partners. An S corporation cannot.

5. Contributions of Appreciated Property. A partnership takes account of pre-contribution appreciation or depreciation in the value of property in allocating taxable income and losses among its partners. An S corporation cannot.

6. Distributions of Appreciated Property. An S corporation cannot distribute assets in-kind to its shareholders tax-free. A partnership can.

7. Limits on Stock. Only one class of stock can be issued.

## VI. ESOP LOANS AND SECURITIES SALES

The Code contains four major incentives for the use of ESOP's for corporate financings and acquisitions.

### A. Lower Costs of Capital.

A properly structured loan to an ESOP, the proceeds of which are used to purchase employer securities, entitles a financial institution lender to exclude from income 50 percent of the interest received.

This benefit to the lender results in a lower interest rate for the borrower. Typically, negotiations between the lender and borrower will produce an interest rate somewhere between the institution's tax-free lending rate (on IDB's) and its taxable lending rate (on regular obligations).

B. Deferral of Gain.

The second major benefit under current law is that a seller of stock to an ESOP is, assuming certain regulatory requirements are met, entitled to defer income tax entirely on gain from the sale, provided sale proceeds are reinvested in a portfolio of United States operating companies. Gain is deferred until the portfolio is liquidated. This is an excellent deferral device for senior executives ready to sell their companies whose intention is to retire and live off the earnings from their stock portfolio.

C. Deductible Principal Payments.

Because company contributions to an ESOP to enable the ESOP to make principal and interest payments are deductible, the technique can produce major real dollar savings: in effect, the purchase price of stock (the classic capital investment) can be deducted. For a seller of stock qualifying for deferral treatment, the ability to reinvest the entire sales proceeds in a stock portfolio (without first having to pay taxes to the IRS) dramatically increases the rate of return and the real dollar return.

D. New Law: Estate Benefits.

Under the new law, these important benefits are retained and, in some cases, expanded. The new law expands the 50 percent interest income exclusion to loans made to the employer corporation as well as to the ESOP if securities are transferred to the ESOP within 30 days and the term of the loan is no greater than seven years. An estate tax exclusion for 50 percent of the proceeds from the qualified sale of employer securities to an ESOP has also been added to the new law.

VII. TAX SHELTERS, PASSIVE LOSSES AND INVESTMENT INTEREST

Essentially, the new law - through a complex network of rules - eliminates the use of tax shelter such as real estate, oil and gas, and equipment leasing, to shelter ordinary income from business activities. Interest paid to carry a tax shelter investment is included within the passive loss, and may not be deducted against other income. Investment

interest - interest paid to carry stocks, bonds, and other investment property - will be deductible only to the extent of investment income. Personal interest is nondeductible.

A. Passive Losses.

Any tax losses from a "passive activity," which is defined as any business activity (regardless of what type of entity is utilized) in which the taxpayer does not "materially participate" (which is defined as actual involvement in operations), may not be utilized to offset salary income or income from stocks, bonds or other portfolio items. This essentially eliminates the use of multiple writeoff tax shelters to indefinitely defer tax on current income from positive sources.

Losses from tax shelters can be utilized to shelter income from other tax shelters. But economically this simply puts shelters on the same footing as other investments. Tax shelter losses can also be utilized to offset ordinary income, but only when the tax shelter investment is completely terminated. Since at the end of the tax shelter investment there will normally be substantial recapture, the effect of this rule is that tax shelter "losses" won't be available to offset ordinary income unless the investor actually lost money on the tax shelter.

B. Interest.

Under pre-1986 law, all personal interest (such as interest on credit cards, car loans, and similar matters) was fully deductible. Investment interest incurred to purchase or carry stocks or similar assets was deductible up to the amount of investment income, plus an additional \$10,000.

The new law repeals the deduction for personal interest entirely. With the exception of interest paid on a first or second home (limited to the amount of the cost of the home as opposed to its value), nonbusiness interest will not be deductible at all. Investment interest will be fully deductible, but only to the extent of investment income.

The general effect of the limitations on use of passive losses and the nondeductibility of personal and investment interest will be that taxpayers can no longer count on a federal income tax subsidy for particular types of investments or spending choices. Those investments and spending choices will have to be made with after tax dollars rather than borrowed money carried by interest at pre-tax dollar rates.

VIII. SPECIAL 1986 TAX CHANGES APPLICABLE TO BANKS  
AND BANK HOLDING COMPANIES

The Tax Reform Act of 1986 included a number of provisions specifically applicable to banks and other financial institutions, and several other provisions which will have significant impact on banks.

A. Net Operating Loss Carryovers/Carrybacks.

Under the new law, a corporation will be permitted to utilize net operating losses following a change in ownership only to the extent of the "applicable Section 382 limitation." This amount is determined by multiplying (i) the value of the loss corporation on the day of the acquisition, by (ii) the applicable federal long term rate.

For example, if the value of the loss corporation is \$3 million, and the applicable federal long term rate is 6 percent, then the "applicable Section 382 limitation" will be \$180,000 per year. Regardless of the size of the loss corporation's NOL, no more than \$180,000 per year may be utilized to offset post-acquisition income. Given the maximum 15-year carryforward, the maximum NOL which could be utilized would be \$2,700,000 (15 times \$180,000), even if the loss corporation's NOL was \$5 million prior to the change of ownership.

Prior law permitting financial institutions to carry NOLs back ten years and forward five was repealed by the 1986 Act for losses incurred in taxable years beginning after December 31, 1986. Such losses will be eligible for a three-year carryback and a fifteen-year carryforward. The ten-year carryback is retained for NOL's incurred before 1994 to the extent a loss is attributable to commercial bank bad debts. These losses will be available as carryforwards to the succeeding five years.

B. Elimination of Bad Debt Reserves for Large Banks.

If a bank is a "large bank," i.e., one with an average adjusted tax basis of all assets in excess of \$500,000,000 for any year after December 31, 1986, the bank may not use the reserve method of computing its bad debt deduction. Rather, the bank must charge off and deduct bad debts under the specific chargeoff method. A bad debt deduction will be allowed only in the year in which a loan is determined to be wholly or partially worthless.

In addition, "large" banks will be required to recapture existing bad debt reserves beginning in the "year of

disqualification," i.e., the year in which the adjusted basis of the bank's assets exceeds \$500,000,000, under one of the following two methods.

\* Fixed percentage recapture - 10%/20%/30%/40% over four years, or at the bank's election an amount greater than 10% the first year and then 2/9's, 3/9's and 4/9's in succeeding years.

\* Cutoff-method recapture - chargeoffs and recoveries on loans in the portfolios as of the end of the taxable year preceding the disqualification year would be treated as adjustments against the reserve; additional deductions or income would be taken/reported only when the reserve is reduced to zero.

Careful planning to document the worthlessness or partial worthlessness of a bad debt will be necessary for large banks.

#### C. TEFRA Disallowance.

Under § 291(e)(1)(B), 20 percent of a financial institution's interest expense allocable to indebtedness incurred to carry tax-exempt obligations is treated as a "preference item" for which no deduction is allowed. Under prior law, § 291(e) applied to obligations acquired after December 31, 1982.

Under § 265(b) of the new law, no deduction is allowed for the portion of a financial institution's interest expense which is allocable to tax-exempt obligations, determined by multiplying the gross interest expense by a ratio the numerator of which is the average adjusted basis of tax-exempt obligations acquired after August 7, 1986, and the denominator of which is the average adjusted basis for all assets of the financial institution.

The increase in the TEFRA disallowance from 20 percent to 100 percent will have a major impact on the structuring of acquisitions. Taxable acquisitions will be treated as purchases of obligations after August 7, 1986, with an attendant 100 percent TEFRA disallowance for the target's tax-exempt interest expense. Nontaxable acquisitions structured as reorganizations will permit a carryover basis and a carryover of the 20 percent TEFRA disallowance.

#### D. Accrual Accounting Required.

Under prior law, a bank may use the cash receipts and disbursements method of accounting for tax purposes as opposed

to the accrual method of accounting. The cash method generally permits a bank to control its income by accelerating payment of expenses and deferring collection of income items at year end, and to benefit from the cash flow generated by tax deferral.

Under the new law, banks and other taxpayers with average annual gross receipts greater than \$5 million for taxable years beginning in 1987 and thereafter must change their method of accounting for tax purposes to the accrual method, subject to an election to remain on the cash basis with respect to certain real property transactions, any loan or lease, or any transaction with a related party, entered into on or before September 25, 1985.

Average annual gross receipts are computed by dividing the sum of the gross receipts for as many of the previous three taxable years (not including the current taxable year and including only taxable years beginning after December 31, 1985) that the bank conducted business, by the number of such taxable years. For purposes of the \$5 million test, gross receipts for any taxable year of less than 12 months are annualized. Thus, for an existing calendar year bank, the annual gross receipts test for 1987 will be based solely on calendar year 1986.

The net adjustment from the change in accounting method will generally be included in income over four years. Timing for recognition of the net adjustment is determined under a complex series of alternative rules, but it is possible in certain circumstances that the entire adjustment would have to be taken into effect in the first year that a bank's gross receipts exceed \$5,000,000.

#### E. NOL Planning Opportunities.

Three situations exist where a § 338 election, or a liquidation and sale pursuant to § 337, may be valuable to an acquiring entity notwithstanding the repeal of the General Utilities doctrine.

\* The first situation is where the seller bank has NOL carryforwards. An election can be made with the consent of the seller to use the seller's NOLs to offset the taxable income generated immediately from the step-up in tax basis of the acquired bank's assets. This method of utilizing NOL carryovers may be particularly advantageous where the NOLs would otherwise be limited by the new change of ownership rules. § 338(h)(10).



\* The second situation in which a § 338 election may be advantageous is when the acquired bank has NOL carryovers that will be subject to the consolidated return separate return year limitation rules. These rules limit the utilization of NOL carryovers to the post-acquisition taxable income of the acquired bank. A § 338 election step-up in the tax basis would create increased future tax deductions not subject to the SRLY rule. The tax liability resulting from the step-up can be offset by the acquired bank's NOL carryovers. Thus, with minimal additional tax costs, SRLY deductions can effectively be converted into future deductions that can be used without limitation to offset future taxable income of other members of the group.

The third situation is where small, closely held corporations qualify for an exception from the repeal of General Utilities. Banks which qualify for this exception would generally not recognize gain or loss upon distribution of assets in liquidation occurring prior to January 1, 1989, where the liquidation (or stock purchase in the case of a § 338 election) is completed by that date. Gain or loss would be recognized, however, for ordinary income assets and capital assets held for less than six months. Investments will probably be classified as ordinary income assets. A small closely held corporation is defined as any corporation whose value does not exceed \$5,000,000 and more than 50 percent of whose stock is owned for a substantial period of time by 10 or fewer individuals. There is a partial exception (a phase out) for closely held corporations whose value is between \$5,000,000 and \$10,000,000.

F. Intangible Assets and Goodwill Allocations.

Under prior law, the Service and taxpayers fought a running battle as to whether a premium paid for assets in excess of the fair market value of tangible and identifiable intangible assets (such as core deposit premiums, trust department customer lists, and the like) could be allocated in a second tier across all assets, including goodwill (the value of which would normally be determined by appraisal). The Service took the position that no second tier allocation was permissible, and that the entire amount of any premium had to be allocated to nonamortizable goodwill or going concern value.

The 1986 Act requires that any premium be allocated using the "residual" method to nonamortizable goodwill rather than being allocated ratably among all assets, effective for all direct asset purchases, including purchases pursuant to § 337, effective for any acquisition occurring after May 6, 1986.

Regulations currently in effect require the use of the residual method in § 338 deemed asset purchases.

Note that the new law does not require that any premium in excess of book be allocated to nonamortizable goodwill. Rather, the law requires that any premium paid for assets which are not tangible assets or identifiable intangible assets must be allocated to goodwill. Negotiations on future acquisitions should therefore focus on the identification of additional intangible assets which may not currently be on the target's books.

G. Trust Department Changes.

The 1986 legislation creates a number of new rules which will significantly alter traditional trust and estate planning techniques used by families to reduce their overall income, gift and estate tax burdens.

1. Unearned Income of Minor Children. Unearned income in excess of \$1,000 of a child under 14 will be taxed at the parents' rates. Current techniques used to transfer income tax burden to children under 14 will be significantly affected. Tax savings on the first \$1,000 of income (representing, perhaps, \$10,000 to \$15,000 of property) will still be available, and there is no such income restriction for children 14 years of age or older.

In practice, the new law encourages shifts from custodial accounts to § 2503(c) trusts which permit accumulation of income. If the trust income is not required to be distributed, and is not in fact distributed, the unearned income on trust property will not be reportable by the child, and thus will be outside the scope of the new law. When the dependent reaches age 14, the trust can make discretionary distributions to equalize the tax brackets of the trust and the beneficiary. Investments which defer recognition of income until after age 14 will also be encouraged under the new law.

2. Taxable Years of Trusts and Estates. Both existing and newly created trusts (other than charitable trusts) must now take taxable years ending on December 31, effective for 1987. If a trust has a fiscal year, the trust will have two tax years for 1987: its regular year, plus a short period return ending December 31, 1987. The taxable income to a beneficiary attributable to any short taxable year must be spread ratably over a four-year period beginning with the year of the change.

3. Rate Schedule of Trusts and Estates. The tax rate schedule for trusts and estates will be revised effective for taxable years beginning in 1988. The first \$5,000 of taxable income will be taxed at 15 percent, and any taxable income in excess of \$5,000 will be taxed at 28 percent. The benefit of the 15 percent bracket will be phased out where taxable income is between \$13,000 and \$26,000.

4. Clifford and Spousal Remainder Trusts. The new law eliminates the benefits of Clifford trusts and spousal remainder trusts by treating a trust in which the grantor or his spouse has retained a reversionary interest in excess of 5 percent as a "grantor trust." A "grantor trust" is ignored for income tax purposes, and the grantor is treated as the owner of the trust property, so that all income is taxed directly to him. The change applies to transfers made to trusts after March 1, 1986.

Trust departments will have a double recordkeeping responsibility for grantor trusts, Clifford trusts and spousal remainder trusts for at least 10 years. The necessity for the double recordkeeping is for transfers made to the entities before and after March 1, 1986, which is the trigger date for the new provisions.

5. Generation Skipping Transfer Tax. The new law amends the present generation skipping transfer tax retroactive to the Tax Reform Act of 1986, to impose a flat-rate tax not only on transfers involving a sharing in benefits by more than one generation, but also on direct transfers that skip generations. A \$1,000,000 per transferor specific exemption is provided, with transfers in excess of that amount being subject to tax at a rate equal to the maximum gift and estate tax rate. In addition, the new law provides an additional exemption of \$2,000,000 per donee on direct skips to grandchildren until January 1, 1990. The provision is effective for testamentary transfers made after the date of enactment and for inter-vivos transfers made after September 25, 1985.

Since the current law is repealed retroactive to 1986, banks will generally have to amend any reported generation skipping tax return where a tax was paid. The change in the generation skipping tax will not affect completely the taxation of trusts, because trusts for different generations can still be used to reduce the overall tax burden: direct skips will be taxed on a net-of-tax basis, while taxable distributions and terminations will be taxed on a tax-inclusive basis. Direct skips will be required for the use of the grandchild exemption.

#### H. Current Inclusion of Discharge of Debt Income.

Pre-1987 law generally provided that gross income includes income from the discharge of indebtedness. Exceptions were provided, however, for (i) discharges in Title 11 cases, (ii) discharges where the taxpayer was insolvent outside the bankruptcy, and (iii) discharges of "qualified business indebtedness" of a solvent taxpayer, provided that an election was made to apply the amount excluded to reduce the basis of the taxpayer's depreciable property.

The 1986 Act eliminates the exclusion for discharge of "qualified business indebtedness" of solvent taxpayers. The effect of the change is to require that any discharge of debt, other than in a Title 11 case or where the taxpayer is insolvent outside bankruptcy, results in the immediate recognition of income in the amount of the discharge. The amount of the discharge will be equal to the difference between the face amount of the debt and any consideration (which may be none) given by the debtor to effect the discharge.

An exception is provided for "qualified farm indebtedness" so that a solvent farmer may avoid current recognition of discharge of debt income and reduce the basis of assets instead.

#### I. Bankruptcy Exception to NOL Limitation Rules.

The 1986 Act creates an exception to the § 382 limitation rules if (i) the loss corporation, before the ownership change, is in Title 11, and (ii) the shareholders and creditors of the loss corporation (determined immediately before the ownership change) own, immediately after, stock of the corporation that has at least 50 percent of the total combined voting power and 50 percent of the value of the stock of the loss corporation.

If the exception applies, then pre-change losses and excess credits that can be carried to a post-change year are computed as if 50 percent of the amount which would have been includable in gross income from an exchange of stock or debt (but for the bankruptcy exception of § 108) had been so included. In making the determination, NOL carryforwards to any post-change year are determined as if no deduction was allowed for interest paid or accrued by the loss corporation on debt that was converted into stock under the Title 11 case. If during the two years immediately following an ownership change to which the bankruptcy exception applies, a second ownership change occurs, the § 382 limitation amount with respect to the second change will be zero.

A loss corporation may elect not to have the bankruptcy exception apply. A new loss corporation should consider making this election if the § 382 limitation is large enough to make it likely that the loss corporation will be able to use up substantially all of its carryforwards within a reasonable time. While making the election will cause the new loss corporation to be subject to the § 382 limitation, it will keep the corporation from having to reduce the amount of its available carryforwards for discharge of debt income and interest paid to creditors who exchange their debt for stock. In some situations, it may be better to have the § 382 limitation on utilization apply to the full amount of carryforwards, rather than to have no utilization limitation apply to a lesser amount of carryforwards (due to the 50 percent rule).

#### J. Corporate Minimum Tax.

Under the new law, the present add-on corporate minimum tax is replaced with an alternative minimum tax. In general, AMT will be computed by applying a rate of 20 percent to the corporation's alternative minimum taxable income, determined by increasing regular taxable income by certain specified tax preferences and adjusting that amount for special items. Corporate taxpayers will in effect pay the greater of the AMT or the regular tax.

The AMTI will be reduced by a \$40,000 exemption on a controlled group basis before the 20 percent tax is applied. But this exemption is reduced by 25 percent of the amount by which AMTI exceeds \$150,000. Therefore, no exemption will be allowed if alternative minimum taxable income is more than \$310,000.

An AMT credit carryforward is available, and will be equal to the lesser of the AMT paid or 20 percent times the deferral (as opposed to permanent) preference items. This credit, subject to limitations, may be carried over to future years to offset regular tax.

Tax preference items which will affect AMT calculations for banks will include (i) deductions for losses and bad debts of financial institutions in excess of an amount computed under the experience method, (ii) accelerated depreciation on real property in excess of straight line for pre-1987 acquisitions, (iii) for real or personal property placed in service after 1986, the difference between ACRS depreciation and depreciation calculated under the alternative depreciation system of 40 years straight line for real property and ADR midpoint life with 150 percent declining balance for personal property, (iv) tax-exempt interest on specified private activity bonds

issued after August 7, 1986, and (v) one-half of the excess of the adjusted net book income of the taxpayer over the alternative minimum taxable income computed without regard to this preference item.

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CHANGES IN EMPLOYEE BENEFIT LAW  
AFFECTING THE BANKING INDUSTRY

Individual Retirement Account Changes After the  
Tax Reform Act of 1986 Section C

Changes in Employee Benefit Law Affecting the  
Banking Industry Under the 1986 Tax Reform Act  
(Other than IRA's and SEPP's) Section D

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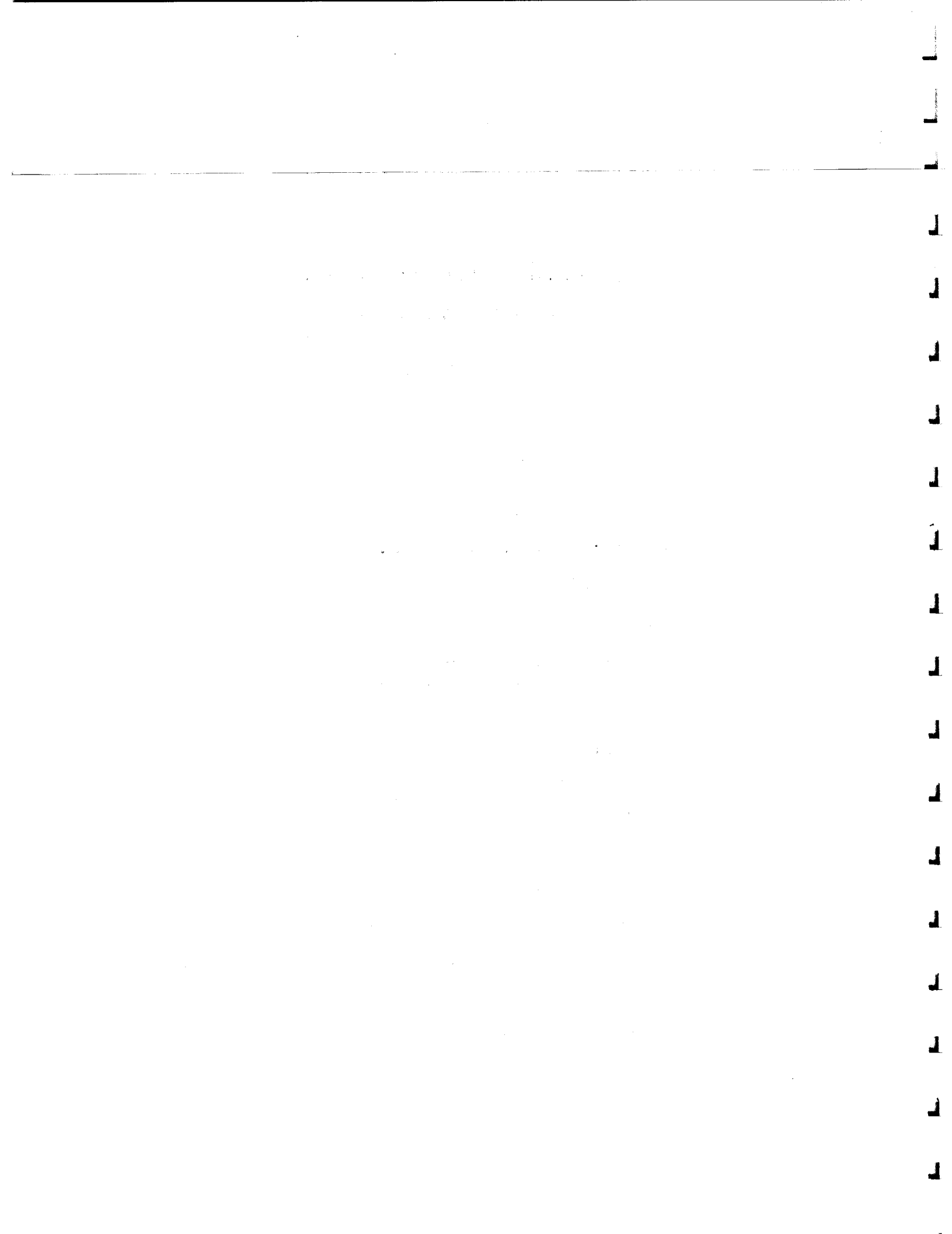


INDIVIDUAL RETIREMENT ACCOUNT CHANGES  
AFTER THE 1986 TAX REFORM ACT

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**INDIVIDUAL RETIREMENT ACCOUNT CHANGES  
AFTER THE TAX REFORM ACT**

**William D. Roberts**

**I. Introduction.**

- A. The Tax Reform Act of 1986 (the "Act") has substantially changed many of the provisions of the Internal Revenue Code ("IRC") which affect individual retirement accounts ("IRAs"). Many changes have been made to simplified employee pensions ("SEPs"), too. In the case of IRAs, the changes make IRA contributions less attractive for those who are more highly compensated. The SEP changes may make these programs more attractive for small companies although the effect on retirement savings throughout the country is not likely to be large in the short run.
  
- B. The changes in the law reflect the apparent attitude of the drafters of the Act that a tax advantage should be given to encourage only a basic level of retirement benefits. Middle and low income taxpayers should be provided incentives to increase retirement savings because absent these incentives, these groups are less likely to save for retirement. High income taxpayers should not receive incentives to save for retirement because they are more likely to be able to adequately provide for themselves without incentives. The new rules will result in a lower level of benefits being provided from individual retirement plans at a higher administrative cost.

**II. Eligibility.**

- A. The Act generally leaves the rules governing eligibility unchanged. An individual must have compensation (or earned income in the case of a self-employed individual) and, for all practical purposes, not have attained age 70-1/2 in the year in which the contribution is made.
  
- B. The Tax Reform Act does make sweeping changes to the rules which govern the deductibility of contributions to IRAs.

### III. Deductibility of Contributions.

- A. The general rule has not changed. An individual may make a deductible contribution to an IRA up to the lesser of \$2,000 or 100% of the participant's compensation (earned income in the case of a self-employed individual) for a taxable year.
- B. If an individual or the individual's spouse is an **active participant** in a **qualified retirement plan**, the dollar limit on the amount of the deduction for a taxable year may be reduced (but never below zero). IRC Section 219(g)(1).
  - 1. The qualified plans which prevent an individual from receiving a full deduction include: pension, profit sharing or stock bonus plans qualified under IRC Section 401(a); annuity plans described in IRC Section 403(a); plans established for federal, state or local government employees by an agency or an instrumentality of such governmental bodies (excluding, however, deferred compensation plans described in IRC Section 457); annuity contracts or custodial accounts described in IRC Section 403(b); SEPs as described in IRC Section 408(k); or a trust described in IRC Section 501(c)(18).
    - a. Participation in the Social Security or Railroad Retirement (Tier 1 or Tier 2) system is not active participation which would preclude a deductible contribution. IRS Notice 87-16, A-7. See Appendix A.
    - b. A U.S. Armed Forces reservist who has less than 90 days of active duty during a taxable year is not considered to be an active participant in a qualified plan. IRS Notice 87-16, A-12. IRC Section 219(g)(6)(A).
    - c. A volunteer firefighter who has accrued an annual benefit not in excess of \$1800 under a plan based upon his or her volunteer firefighting efforts is not considered an active participant. IRC Section 219(g)(6)(B).
  - 2. What is active participation? Different rules will apply depending upon whether the plan is

a defined benefit plan or a defined contribution plan, but the following generally apply.

- a. Retired employees who are receiving pension payments are not considered active participants. IRS Notice 87-16, A-8. Individuals who make employee contributions to qualified plans are considered active participants. IRS Notice 87-16, A-10. Active participation is determined without regard to the extent to which an individual is vested in his benefit, if at all. IRS Notice 87-16, A-14.
- b. For a plan which begins in 1986 and ends in 1987, a special "overlap plan year" rule applies. These plans are considered to have two short plan years, one ending December 31, 1986 and the other beginning January 1, 1987. Actions attributable to the 1986 short plan year that would normally make an individual an active participant for the year will not make an individual an active participant for the 1987 taxable year. In addition, employer contributions or forfeitures allocated during the 1987 portion of the overlap plan year will be treated as allocated on December 31, 1986, to the extent the contributions are attributable to compensation that would have been paid (but for a deferral of salary) in 1986, was actually paid before January 1, 1987, or was attributable to services performed before January 1, 1987. Therefore, it may be possible to terminate a non-calendar tax year plan and make an allocation based on 1986 compensation. This rule would also benefit those employees who retired or terminated service on or before December 31, 1986 and who will receive an allocation based on compensation during that portion of the year. IRS Notice 87-16, A-11.
- c. Married individuals filing separate returns are not affected by the active

participation of their spouses. IRS Notice 87-16, A-3. Note, however, the deductibility limits for married individuals filing separate returns, infra. page 6. Marital status is determined as of the last day of the taxable year. Therefore, if an individual is not married at the end of this taxable year, the active participation of his or her former spouse is irrelevant. If an individual marries during the year and the individual's spouse is an active participant, the individual will be treated as an active participant if a joint tax return is filed. IRS Notice 87-16, A-4.

- d. The surviving spouse of a deceased taxpayer who was not an active participant for the taxable year is not treated as an active participant even if a joint return is filed for the taxable year of death. However, the applicable dollar limitation for adjusted gross income ("AGI") purposes is \$40,000 (see discussion, infra. page 6). Subsequent taxable years are unaffected by the participant's death and active participation insofar as the surviving spouse is concerned except that the \$40,000 AGI limitations may continue to apply. See IRC Section 2(a). IRS Notice 87-16, A-5.
3. For defined benefit plans, an individual is an active participant if he or she is not excluded under the eligibility provisions of the plan for the plan year ending with or within the individual's taxable year. Participation for any portion of a plan year, even one day, may preclude an individual from making a fully deductible contribution. IRS Notice 87-16, A-17.
    - a. If a participant declines to participate, he is still considered to be an active participant. The same rule applies if the individual fails to make mandatory contributions or if the individual has failed to perform the minimum service required to accrue a benefit under the plan. IRS Notice 87-16, A-15.

- b. But if the plan is a "frozen" defined benefit plan, the individual is not considered an active participant. IRS Notice 87-16, A-16. That is, if benefit accruals under the plan have ceased, the individual is not an active participant. But if the individual's compensation increases and the compensation could increase the amount of benefit he or she receives, the plan will not be considered frozen.
  - c. Distribution in a year of a benefit accrued in prior years is not active participation so long as the individual was excluded under the eligibility provisions for the plan year in which the distribution is made. IRS Notice 87-16, A-18.
4. In the case of a defined contribution plan, an individual is considered an active participant if employer contributions, employee contributions or forfeitures are allocated to his or her account with respect to a plan year ending with or within the individual's taxable year.
- a. Individuals who do not meet the requirements of a plan for performance of a specified number of hours (most often, 1,000 hours of service in a plan year) or employment on a given date (most often, the last day of the plan year) so as to receive a contribution or allocation are not considered active participants. IRS Notice 87-16, A-20.
  - b. An individual may receive allocations of earnings on an existing account balance without becoming an active participant, so long as the individual is not eligible for an allocation of forfeitures or contributions. IRS Notice 87-16, A-19. If the individual is eligible for an allocation of forfeitures or contributions, but the sponsoring organization fails to make a contribution, the individual is an active participant. IRS Notice 87-16, A-21.

c. Those who receive a contribution as required by IRC Section 416, Special Rules for Top Heavy Plans, are active participants. Any amount contributed or allocated (other than earnings), even if it is only \$1, will result in active participation. See IRS Notice 87-16, A-22 and A-13. Likewise, those individuals who defer compensation under Cash or Deferred Arrangements ("CODAs") under IRC Section 401(k) are considered active participants. IRS Notice 87-16, A-23, A-24 and A-25.

B. The amount an individual may deduct depends upon marital status and AGI as well as active participant status.

1. Individuals who are not active participants in qualified plans or whose spouses are not participants in qualified plans may make a fully deductible IRA contribution.
2. No deduction is allowed if an active participant's AGI exceeds a specified amount. The amount depends on the individual's filing status as follows:

FILING STATUS	AGI
Single	\$35,000
Married filing jointly	\$50,000
Married filing separately	\$10,000

3. If an individual is an active participant and if his AGI is less than a specified dollar amount, he or she will be able to make a fully deductible IRA contribution. The applicable amount is determined as follows:

FILING STATUS	AGI
Single	\$25,000
Married filing jointly	\$40,000
Married filing separately	\$ 0

4. For individuals whose adjusted gross income falls between the upper and lower applicable amounts as outlined above, the deductible



dollar limit is phased out. For each \$1,000 of compensation above the lower limit, a participant loses \$200 of deduction on a full \$2,000 contribution.

- a. To estimate the deduction an individual may take, IRS Announcement 86-121 provides a table. See Appendix B.
- b. The announcement also provides a formula by which the exact amount of the deduction limit may be calculated. Presumably, the formula will be used on the individual's 1040 Form.
- c. Special Rules may apply.
  - i. The deduction limit is not reduced below \$200 until the deduction for active participants reaches \$0. IRC Section 219(g)(2)(B).
  - ii. If the deduction limit is calculated and is not a multiple of \$10, it must be reduced or rounded down to the next lowest multiple of \$10. IRC Section 219(g)(2)(C).
  - iii. AGI is calculated after taking into account any passive loss limitations under IRC Section 469 and any taxable Social Security benefits under IRC Section 86. Therefore, adjusted gross income is calculated first for the purposes of passive loss limitations; second, for purposes of determining the Social Security benefits that are taxable; and third, for purposes of the limit on IRA deductions.
  - iv. In determining the adjusted dollar deduction limit for married individuals filing a joint return, the couple's adjusted gross income is aggregated. IRS Notice 87-16, B-1.

#### IV. Nondeductible Contributions.

- A. To restate the obvious, a taxpayer may now make a non-deductible IRA contribution to the extent of the excess of the lesser of \$2,000 (\$2,500 in the case of a spousal IRA) or 100% of compensation offset by the amount of the IRA contribution which is deducted. IRC Section 408(a)(1). Nondeductible contributions may be made in lieu of deductible contributions. Earnings on contributions, whether deductible or nondeductible, are not taxed until the income is distributed.
- B. In order to make a nondeductible contribution, the contribution must be designated as such on the individual's tax return for the appropriate taxable year. If the taxpayer overstates the nondeductible portion of a contribution on his tax form, he or she may be subject to a \$100 penalty for each overstatement. An exception is provided if the overstatement is due to a reasonable error and the taxpayer has taken action to correct the overstatement. See IRC Section 6693(b).
- C. Both deductible and nondeductible contributions may be made to the same IRA. The individual is not required by the Internal Revenue Code to distinguish between deductible and nondeductible contributions to the institution holding the IRA. IRS Notice 87-16, C-1.
- D. Amounts contributed to an IRA, whether deductible or nondeductible, may be treated as excess contributions and withdrawn by April 15th of the year following the year for which the contribution was made. Any earnings on the excess contribution which must be distributed as required by IRC Section 408(d)(4)(C) will be subject to the 10% additional income tax imposed by IRC Section 72(t). IRS Notice 87-16, C-2. Although no additional contributions may be made after April 15 of the year following the year for which contributions are made, a designation of a contribution as deductible or nondeductible may be changed by amending the tax return prior to the expiration of the statute of limitations. IRS Notice 87-16, C-3.
- E. An individual may not roll over employee contributions from a qualified plan into an IRA even though

the character of nondeductible IRA contributions is similar to nondeductible contributions.

- F. Distribution rules with respect to IRAs which contain only deductible contributions have not changed.
- G. To determine what portion of a distribution including nondeductible contributions is deductible, the Service provides the following formula:

$$\frac{\text{Total Nondeductible Contributions}}{\text{All IRA Balances + Distribution + Outstanding Rollovers}} \times \text{Distribution Amount}$$

1. An outstanding rollover is a distribution received in one taxable year from an IRA (but not rolled over in that year) which may still be rolled over into another IRA in the following taxable year. This is a distribution for which the 60 day rollover period begins in one taxable year and ends in another.
2. For purposes of the formula, an individual must treat all individual retirement accounts, individual retirement annuity contracts, SEP account balances, and rollover IRAs as a single IRA. Qualified voluntary employee contributions are not aggregated.
3. The total IRA account balance is the fair market value, including realized and unrealized appreciation, of all IRA vehicles, determined as of the last day of the taxable year in which the distribution is made. IRS Notice 87-16, D-1. Distributions for one taxable year are aggregated and valued as of the day of distribution.
4. Excess contributions returned pursuant to IRC Section 408(d)(4) of the Code do not enter the calculation.
5. Individuals may not designate a distribution as coming from nondeductible contributions. Each withdrawal is treated as a pro rata recovery of both non-taxable and taxable portions. IRS Notice 86-17, D-2. These rules

may not be avoided by taking a total withdrawal from an IRA and rolling over an amount equal to the portion which would otherwise be taxable, but for the rollover. In such a case, the amount withdrawn, less the amount rolled over, is the amount actually distributed. Again, the pro rata distribution rule will apply to this portion. IRS Notice 87-16, D-3. Therefore, nondeductible IRA contributions not only may, but must be rolled over from one IRA to another in the same manner as deductible contributions.

6. Loss on an IRA may be recognized only when all amounts have been distributed and when amounts distributed are less than the individual's unrecovered basis. IRS Notice 87-16, D-6.
7. IRAs belonging to a participant's spouse are not aggregated for the purposes of determining the individual's account balance.

V. Administrative Issues for Custodians and Trustees.

- A. IRS Announcement 86-121 provides a "non-technical explanation" of the provisions of the Act as they affect IRAs. The announcement **may and should** be used by master and prototype IRA sponsors to update disclosure statements. The announcement is designed to meet the requirements of Treasury Regulation Section 1.408-6.
  1. Note, however, that the disclosure need not be provided to those who are making contributions for the 1986 tax year.
  2. The regulations imply and Treasury officials unofficially agree that the disclosure would be necessary only in the case of contributions made for tax years beginning after December 31, 1986.
- B. An IRA trustee or custodian has no duty under the Act to differentiate between deductible and nondeductible contributions. That is, the trustee need

not maintain records which account for the basis, if any, that a contributor has in an IRA. The taxpayer is responsible for calculating the taxable amount on an IRA distribution. IRS Notice 87-16, D-11.

- C. For purposes of withholding on distributions from IRAs, the payor is required to assume that the entire amount of an IRA distribution is taxable. IRC Section 3405(d)(1)(B).
- D. An individual's employer or former employer must inform the individual as to whether he or she is an active participant for each taxable year. Active participation status will be reported on the form W-2. IRS Notice 87-16, A-1.
- E. The Treasury will promulgate regulations which will detail trustee and custodian reports to the IRS concerning IRAs. Copies will be furnished to depositors no later than January 31 of the calendar year following the calendar year to which the reports relate. IRC Section 408(i)(1).

#### VI. Spousal IRA.

- A. The Act has made a change in the spousal IRA rules of which some taxpayers may be able to take advantage. Under prior law, spousal IRAs could be established for a participant and his spouse if they filed a joint return and if the spouse had no compensation. The deductible amount increased from \$2,000 to \$2,250, although only \$2,000 could be contributed into one account. If one spouse had some compensation, but not \$250 in compensation, that lower-earning spouse could establish the IRA only up to the amount of compensation received.
- B. Under the Act a couple may elect on their income tax form to treat the lower-earning spouse as having no compensation at all for the taxable year. IRC Section 219(c)(1)(B)(ii). Therefore, a spousal IRA will be available for that spouse. This provision is effective for taxable years beginning after December 31, 1985. No deduction is allowed for taxable years before 1986.

VII. Qualified Voluntary Employee Contributions Eliminated.

- A. Qualified voluntary employee contributions ("QVECs") have been eliminated for tax years beginning after December 31, 1986. The repeal does not affect contributions on behalf of the 1986 tax year so long as they are made before April 15, 1987 and designated as made for the 1986 tax year.
- B. Qualified plans which retain these IRA-like contributions need not amend plan documents to repeal them until the last day of the first plan year beginning on or after January 1, 1989. In addition, the funds need not be distributed.

VIII. Gold and Silver Coins.

- A. An IRA may not be invested in a "collectible" without the amount invested being considered distributed. Coins are generally collectibles. See IRC Section 408(m).
- B. An exception under the Act, however, allows an IRA to invest in gold or silver coins issued by the U.S. IRC Section 408(m)(3). The investment is available for contributions made prior to December 31, 1986, as well as contributions made after that date.
- C. An IRA may not invest in a coin which has been made into jewelry. These coins are still considered collectibles. IRS Notice 87-16.

IX. Miscellaneous issues.

- A. Effective date of the provisions relating to IRAs is the first taxable year beginning after December 31, 1986 unless otherwise noted. Because the Act generally affects individual deductions and not individual retirement arrangements themselves and because most taxpayers are calendar year taxpayers, the provisions generally apply beginning in calendar year 1987.
- B. No date is specified in the Act for amending model IRAs, master IRAs or prototype IRAs. The IRS will notify custodians, trustees, and sponsors as to

when they should amend their documents. IRS Notice 87-16.

X. Simplified Employee Pensions.

- A. Among other objectives, the Act was intended to reduce the administrative burdens for SEPs. It also provides for a new kind of SEP which is maintained pursuant to a salary reduction arrangement. See IRC Section 408(k)(6). Thus, an employee may reduce his current salary and have his employer contribute the money to an IRA account, thereby reducing his income taxes and saving money. The employer incurs little expense in operating the program.
- B. To maintain a salary reduction SEP, an employer can have no more than 25 employees at any time during the preceding tax year. IRC Section 406(k)(6)(B). An election to defer salary for a year must be made by at least 50% of all employees of the employer. The sponsoring employer may not be a state or local government agency or tax exempt organization. IRC Section 408(k)(6)(E). These sponsors are required to use the deferral provisions of IRC Section 457.
  - 1. In operation, at least two kinds of tests will limit the salary reduction type of contributions.
    - a. The contribution on behalf of an employee may not exceed the lesser of 15% of the employee's compensation or the dollar limit in effect for the year on annual additions to qualified defined contribution plans. This limit is currently \$30,000 and is likely to remain at this level for a number of years. See IRC Section 415(c) and (d). Elective deferrals under SEPs are aggregated with CODA election deferrals for purposes of the \$7,000 limit of IRC Section 402(g)(3).
    - b. The elective deferrals are also subject to an Average Deferral Percentage ("ADP") test. The deferral percentage for each highly compensated employee (as defined

in IRC Section 414(q)) eligible to participate may not be more than 1.25 times the average of the deferral percentages for the year for all employees of the employer who are eligible to participate and who are not highly compensated employees.

- i. The deferral percentage is determined by dividing the elective employer contributions actually paid to the SEP on behalf of an employee by the employee's compensation. Compensation of all employees who are eligible for a contribution, whether or not they elect to have contributions made on their behalf, is aggregated for the purpose of this test. The deferral percentage of the non-highly compensated is reduced for those who elect not to have contributions made on their behalf.
  - ii. Although this test is similar to that used for CODAs, it differs because each highly compensated employee's deferral percentage is measured against the average of all non-highly compensated employees. In addition, the 200% and 2% limit portion of the test applicable to CODAs does not apply. SEP non-elective contributions may not be combined with elective SEP deferrals to increase the deferral percentage for non-highly compensated so as to allow the highly compensated to contribute a greater percentage amount.
  - iii. Excess deferrals made on behalf of the highly compensated participants will be returned to them in a manner which is consistent with the rules governing CODAs under IRC Section 401(k)(8). IRC Section 408(k)(6)(C).
2. Contributions made under salary reduction SEPs are exempt for income tax, unlike other



SEP contributions which are included in income, but deductible.

- C. The age at which an employee is eligible for participation in all SEPs has been lowered from 25 to 21 to be consistent with plans qualified under IRC Section 401(a). See IRC Section 408(k)(2).
- D. The Act adds a minimum compensation requirement for the first time. IRC Section 408(k)(2). Employees who receive less than \$300 in annual compensation may be excluded from participation in a SEP. The \$300 amount will be adjusted for inflation beginning in 1988 (in the same manner as the dollar limitation for defined benefit plans qualified under IRC Section 401(a)).
- E. Employers may now elect to have their SEPs maintained on a fiscal year basis. IRC Section 408(k)(7)(C).
- F. One of the more important aspects of the SEP changes is the provision which allows plans to integrate with Social Security just as defined contribution plans do. IRC Section 408(k)(3)(D) and 401(l)(2).
  - 1. Salary deferral SEPs may not take advantage of the new integration rules.
  - 2. These provisions are generally effective for plan years beginning after December 31, 1988.
- G. SEP distributions are to be included in the gross income of a payee or distributee in the same manner as distributions from IRAs are treated under IRC Section 408(d). IRC Section 402(h).

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**Part III. Administrative, Procedural, and Miscellaneous**

**General Rules for Individual Retirement Arrangements under the Tax Reform Act of 1986**

**Notice 87-16**

The Tax Reform Act of 1986 (the Act) substantially modified the provisions of the Internal Revenue Code relating to Individual Retirement Arrangements (IRAs). Specifically, provisions of the Act reduce and, in some cases, eliminate deductions for IRA contributions, allow nondeductible IRA contributions, and change some of the current rules concerning collectibles and spousal IRAs. In general, these provisions are effective for taxable years beginning after December 31, 1986.

This Notice provides guidance concerning these provisions, and, until applicable regulations are published, taxpayers may rely on the guidance provided in this Notice to resolve the issues which are specifically considered. However, some issues related to the treatment of IRAs are not addressed in this Notice. No conclusions should be drawn with respect to these issues or the reasons for their exclusion from this Notice.

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**I. Deductible Contributions to IRAs**

**A. Active Participant Status**

An individual who is not an active participant in a retirement arrangement specified in section 219(g)(5) of the Code may make a deductible IRA contribution for the taxable year of up to the lesser of \$2,000 (\$2,250 for spousal IRAs) or 100% of compensation. An individual who is married and files a joint federal income tax return will be treated as an active participant if such individual's spouse is an active participant.

Section 219(g) of the Code provides that if an individual is an active participant in such a retirement arrangement for a taxable year, the \$2,000 (\$2,250 for spousal IRAs) dollar limit on the individual's deduction may be reduced or eliminated for such year. Accordingly, the first step in determining the permissible IRA deduction for a year is to determine active participant status for the taxable year.

For purposes of the IRA deduction rules, an individual shall be an "active participant" for a taxable year if either the individual or the individual's spouse (with whom the individual files a joint tax return) actively participates in any of the following:

- 1) a qualified plan described in section 401(a) of the Code,
- 2) an annuity plan described in section 403(a) of the Code,
- 3) a plan established for its employees by the federal, state or local government or by an agency or instrumentality thereof (other than a plan described in section 457 of the Code),
- 4) an annuity contract or custodial account described in section 403(b) of the Code,
- 5) a simplified employee pension described in section 408(k) of the Code, or
- 6) a trust described in section 501(c)(18) of the Code.

See Questions A1 through A14 for active participant rules that apply to all plans.

In determining when an individual is an active participant in a retirement arrangement for a taxable year, different rules are applied, depending upon whether the retirement arrangement is a defined benefit or a defined contribution plan.

**Defined Benefit Plan Rule**

In the case of a defined benefit plan, an individual who is not excluded under the eligibility provisions of the plan for the plan year ending with or within the individual's taxable year shall be an active participant in the plan, regardless of whether such individual has elected to decline participation in the plan, has failed to make a mandatory contribution specified under the plan or has failed to perform the minimum service required to accrue a benefit under the plan. For example:

An individual is a calendar year taxpayer who is not excluded from participation under the provisions of a defined benefit plan with a July 1 to June 30 plan year. The individual separates from service on December 31, 1987. Because the individual is not excluded under the plan's eligibility provisions for the plan year ending in such individual's 1988 taxable year, such individual shall be an active participant for the 1988 taxable year.

See Questions A15 through A18 for defined benefit plan active participant rules.

**Defined Contribution Plan Rule**

Generally, in the case of a defined contribution plan, an individual shall be an active participant if employer or employee contributions or forfeitures are allocated to such individual's account with respect to a plan year ending with or within the individual's taxable year. For example:

Company B sponsors a money purchase pension plan with a plan year ending on June 30. The plan provides that contributions must be allocated as of the last day of the plan year. On December 31, 1987, an individual employed by the Company separates from service. The contribution for the plan year ending on June 30, 1988 is not made until February 15, 1989, when the Company files its corporate return. In this case, the individual is an active participant for such individual's 1988 taxable year.

A special rule applies to certain plans in which it is impossible to determine whether or not an amount (other than earnings) will be allocated to an individual's account for a given plan year. If, with respect to a particular plan year, no amount attributable to forfeitures, employer contributions or employee contributions has been allocated to an individual's account by the last day of the plan year, and contributions to the plan are purely discretionary for the plan year, such individual shall not be an active participant for the taxable year in which such plan year ends. If, however, after the end of such plan year, the employer contributes an amount for such plan year, an individual to whose account an allocation is made shall be an active participant for

the taxable year in which the contribution is made.

Contributions shall be treated as purely discretionary for the plan year if, as of the end of the plan year, the employer is not obligated under the law or terms of the plan to make a contribution for the plan year, and whether or not contributions are made to the plan is ultimately dependent upon the employer's decision or factors within the control of the employer. Contributions are not purely discretionary merely because they are dependent on profits. For example:

An individual covered by a profit-sharing plan separated from service on December 31, 1987. The plan year runs from July 1 to June 30. Under the terms of the plan, employer contributions, if any, shall be made at the complete discretion of the Board of the Directors and shall be contributed to the plan prior to the due date for filing the employer's tax return. Such contributions are allocated as of the last day of the plan year, and allocations are made to the accounts of individuals who have any service during the plan year. As of June 30, 1988, no employer or employee contributions has been made that are allocated to the June 30, 1988 plan year, and no forfeitures had been allocated within the plan year. In addition, as of such date, the employer was not obligated to make a contribution for such plan year and it was impossible to determine whether or not a contribution would be made with respect to the plan year. On December 31, 1988, the Board of Directors agreed to contribute a specified amount to the plan, with respect to the plan year ending June 30, 1988; on February 15, 1989, such contribution was made to the plan. As a result of the amount allocated to such individual's account as of June 30, 1988, the individual is an active participant in the plan for the 1989 calendar year but not for the 1988 year.

See Questions A19 through A26 for the defined contribution plan rules.

#### *General Active Participant Questions*

**A1:** How will an employer report active participant status for a taxable year?

**A:** An individual's employer (or former employer) must inform an individual of active participant status for the taxable year of the individual. This status must be reported on a Form W-2.

**A2:** If an individual is not an active participant, but such individual's spouse is an active participant, will the individual be treated as an active participant?

**A:** If the couple files a joint federal income tax return for the applicable year, active participation by either spouse will cause both spouses to be treated as active participant. But see Question A3.

**A3:** If an individual is married but files a separate tax return, will active participation by his or her spouse affect the individual's active participant status?

**A:** No. Section 219(g)(4) of the Code provides that a married individual who files a separate tax return is considered single for purposes of determining active participant status. Thus, if the individual is not an active participant, the fact that his or her spouse is an active participant will not limit such individual's IRA deduction.

**A4:** If a married individual obtains a divorce during his or her taxable year (and does not remarry during such year), is the individual considered an active participant merely because the former spouse is an active participant for the year?

**A:** No. Marital status is determined as of the end of the year. Thus, if the individual is not married at the end of the year, the fact that his or her former spouse is an active participant will not cause the individual to be treated as an active participant. Similarly, if an individual marries during the year, and the individual's new spouse is an active participant, the individual shall be treated as an active participant for the entire year if the couple files a joint tax return.

**A5:** If a married individual dies during a taxable year and is an active participant for such taxable year, will the survivor be treated as an active participant for purposes of section 219(g) of the Code?

**A:** Yes. In the taxable year of death, active participation is determined as if the deceased spouse was still alive. Thus, if the deceased spouse was an active participant for the taxable year of death and a joint return is filed for the taxable year of death, the survivor will also be treated as an active participant. In such a case, the applicable dollar limitation for AGI purposes is \$40,000. (See I. B., below.) For taxable years following the taxable year of death, the deceased spouse's status as an active participant in the year of death has no effect on the survivor's status as an active participant because the survivor is not treated as married to the deceased

spouse for purposes of the active participation rules. However, for AGI purposes, in those cases in which the survivor meets the filing status requirements under section 2(a) of the Code, the survivor will use the same \$40,000 applicable dollar limitation used by married taxpayers filing jointly.

**A6:** An individual has an amount deferred for a taxable year in a plan described in section 457 of the Code. Does participation in such a plan cause the individual to be an active participant?

**A:** No. Section 219(g)(5) of the Code specifically exempts unfunded deferred compensation plans described in section 457 of the Code from the definition of relevant plans for purposes of determining who is an active participant. Participation in any retirement plan established by a state or local government, other than a plan described in section 457 of the Code, is active participation for purposes of section 219(g)(5) of the Code.

**A7:** Is an individual who is covered under Social Security or Railroad Retirement (Tier I or Tier II) an active participant?

**A:** No. Under Section 219(g)(5), neither Social Security nor Railroad Retirement (Tier I and Tier II) is a retirement arrangement for purposes of determining active participant status.

**A8:** Is a retired individual who is receiving pension annuity payments an active participant?

**A:** No. An individual will not be treated as an active participant merely because the individual receives benefits under a retirement arrangement described in section 219(g)(5) of the Code.

**A9:** If an individual is ineligible for benefit accrual in a retirement plan that is integrated with Social Security solely because the compensation of that individual is below the integration level or because the full benefit will be offset by Social Security, is the individual an active participant?

**A:** No. In the case of a defined benefit plan, an individual who is not excluded under the eligibility provisions of the plan, but who is nonetheless ineligible to accrue a benefit under a plan because compensation is below the integration level or whose benefit will be fully offset by social security for the plan year ending with or within the taxable year, shall not be an active participant in such plan. (Note: This is an exception to the general rule applicable to defined benefit plans, and it is

limited to the facts set forth in the preceding sentence.) Similarly, in a defined contribution plan, if an individual is ineligible for an allocation in a plan year because of the individual's compensation is below the integration level, such individual shall not be an active participant for the taxable year with or within which such defined contribution plan year ends.

**A10:** Is an individual who makes employee contributions to a qualified plan described in section 219(g)(5) an active participant?

**A:** Yes. If an individual makes either voluntary or mandatory employee contributions to a plan, such individual shall be an active participant for the individual's taxable year containing the end of the plan year in which the contributions are allocated.

**A11:** In the case of a plan year that begins in 1986 and ends in 1987, will actions attributable to the 1986 part of the plan year that would normally make an individual an active participant for a year, make an individual an active participant for the 1987 taxable year?

**A:** No. For purposes of determining whether an individual is an active participant for 1987, a plan year beginning in 1986 and ending in 1987 (an "overlap plan year") is to be treated as two short plan years, the first ending on December 31, 1986 and the second beginning on January 1, 1987. In addition, any employee contributions or employer contributions or forfeitures allocated during the 1987 portion of the overlap plan year shall be treated as allocated on December 31, 1986 to the extent such contributions are attributable (i) to compensation that would have been paid (but for a deferral election) or was actually paid before January 1, 1987 or (ii) to services performed before January 1, 1987.

For example, if a participant in a cash or deferred arrangement that is part of a plan with an overlap plan year elects to have no elective deferrals made out of compensation that would have been paid (but for the deferral election) in the 1987 portion of the overlap plan year, such participant will not be treated as an active participant for the 1987 taxable year merely because of the elective deferrals made out of compensation that would have been paid (but for the deferral election) before January 1, 1987. Similarly, if a participant in a defined contribution plan with an overlap plan year separates from service from the employer on December 31, 1986,

such participant will not be treated as an active participant for the 1987 taxable year merely because an employer contribution that is based on the participant's compensation and service before January 1, 1987 is allocated to such participant's account as of the last day of the overlap plan year.

**A12:** Is an individual considered an active participant merely because such individual participates in a plan as an Armed Forces reservist if the individual has less than 90 days of active duty during the year, or participates in a plan described in section 219(g)(5)(A)(iii) of the Code, based on activities as a volunteer firefighter?

**A:** No. Such individual is not an active participant pursuant to section 219(g)(6) of the Code.

**A13:** If only a single dollar is allocated to an individual's account for a plan year (in a defined contribution plan), or an individual accrues a benefit of only one dollar for a plan year (in a defined benefit plan), is such an individual an active participant in such plan?

**A:** Yes.

**A14:** If an amount is allocated to an individual's plan account for a plan year in a defined contribution plan, or an individual accrues a benefit for a plan year in a defined benefit plan, but such individual has no vested interest in such account or accrual, is such an individual an active participant in such plan?

**A:** Yes. Active participant status is determined without regard to vesting.

#### *Defined Benefit Plan Active Participation Questions*

**A15:** In many defined benefit plans a participant's right to benefit accruals is conditioned upon the performance of a prescribed number of hours of service. If an individual does not complete the requisite hours of service needed in order to accrue a benefit in a plan year, is the individual an active participant for such year?

**A:** Yes. If the individual is not excluded under the eligibility provisions of the plan for the plan year with or within the individual's taxable year, the individual is an active participant.

**A16:** If an individual participates in a defined benefit plan in which benefit accruals are frozen for the entire plan year ending with or within the individual's taxable year, is such individual an active participant in such plan for the taxable year?

**A:** No. When a plan is frozen, i.e.,

when benefit accruals under a plan have ceased for all participants, an individual in such a plan is not an active participant. However, where a benefit may vary with future compensation, all accruals will not be considered to have ceased. For example, a "High 3" plan, in which future accruals have ceased but the actual benefit will depend upon future compensation, will not be considered as a plan in which accruals have ceased for all participants.

**A17:** If a calendar year defined benefit plan terminates on January 2, 1988, is an individual who is covered under the plan an active participant for such individual's 1988 taxable year?

**A:** Yes. If an individual is not excluded under the eligibility provisions of the plan for any portion of the plan year ending with or within the taxable year, the individual is an active participant. Accordingly, an individual covered by the plan shall be an active participant for the taxable year in which the plan year ends, whether or not the plan terminated.

**A18:** If a calendar year defined benefit plan terminates on November 30, 1987, but does not commence distributions until January 31, 1988, is an individual covered under the plan an active participant in either plan year?

**A:** As noted in question A17, the individual will be an active participant for the taxable year within which the plan terminates (1987) because such individual was not excluded under the eligibility provisions of the plan in the plan year which ended with or within the taxable year. In the 1988 plan year, a participant is excluded under the eligibility provisions for the plan year which ends with or within the participant's taxable year because the plan has terminated.

#### *Defined Contribution Plan Active Participation Questions*

**A19:** Is an individual an active participant merely because earnings are allocated to such individual's account?

**A:** No. An individual is not an active participant merely because earnings have been allocated to such individual's account.

**A20:** Certain defined contribution plans condition the right to an allocation on the performance of a specified number of hours (e.g., 1,000) or on the employment of the participant on a certain day. In such a plan, if an individual does not meet the condition for a particular plan year, is the individual an active participant with re-

spect to the taxable year within which such plan year ends?

A: No. An individual is not an active participant in a defined contribution plan if, under the terms of the plan, the individual is not entitled to an allocation of contributions or forfeitures to the individual's account with respect to the plan year ending with or within the individual's taxable year.

A21: If an employer sponsoring a defined contribution plan is required to make a contribution to an individual's account but fails to do so (whether or not in violation of section 412(d) of the Code), is an individual for whom an allocation is required an active participant in the plan for the plan year ending in the individual's taxable year?

A: Yes. In the case of such a plan, if an allocation must be made to an individual's account with respect to a particular plan year, such individual shall be an active participant in the taxable year in which such plan year ends, regardless of whether the contribution is made.

A22: If a plan is required to make a top heavy minimum allocation for the plan year, and must make an allocation to the account of an individual who would not otherwise be entitled to an allocation for the plan year, is the individual an active participant merely because a top heavy minimum allocation is made to such individual's account?

A: Yes. If a top heavy minimum is required to be allocated to an individual's account, the individual is an active participant for the taxable year in which ends the plan year with or within which the allocation is required to be made.

A23: If an individual elects to defer compensation under a section 401(k) cash or deferred arrangement (CIDA), is such individual an active participant?

A: Yes. An individual who elects to defer compensation pursuant to a plan described in section 401(k) shall be an active participant. The same rule applies to elective deferrals and salary reductions under sections 408(k), 501(c)(18), and 403(b).

A24: If an individual who is eligible to make elective deferrals under a CODA declines to make elective deferrals for a year, and no other contributions or forfeitures are allocated to such individual's account for the plan year ending with or within the individual's taxable year, is such individual an active participant for that year?

A: No. An individual shall not be an

active participant merely due to eligibility to participate in a CODA.

A25: If an individual makes an elective deferral during a plan year, but later has the deferral distributed from the plan as an excess deferral, pursuant to section 402(g)(2) of the Code, is such individual an active participant for the taxable year with or within which ends the plan year?

A: Yes. For purposes of determining active participant status, if an individual chooses to make an elective deferral to a plan, the individual is an active participant for the plan year as of which the deferral contribution is allocated, regardless of whether the contribution remains in the individual's account.

A26: A profit sharing plan has a July 1 to June 30 plan year. Under the terms of the plan, employer contributions, if any, are made at the sole discretion of the Board of Directors. As of June 30, 1987, no employee or employer contributions have been made and no amounts have been forfeited for the plan year ending June 30, 1987. Moreover, it is impossible to determine whether a contribution will be made for the plan year ending on June 30, 1987. On January 15, 1988, the employer makes a contribution for the plan year ending on June 30, 1987. On November 30, 1988, the employer makes a contribution for the plan year ending June 30, 1988.

On June 30, 1989 it is again impossible to determine whether a contribution will be made for the plan year ending on that date, and no contribution is made by December 31, 1989. Will a participant in the plan described above be an active participant only for the 1988 taxable year?

A: No. In such a situation, when con-

$$\frac{\$10,000 - (\text{Excess AGI})}{\$10,000} \times \frac{\text{Maximum Permissible Dollar Deduction}}{\text{Adjusted Dollar Deduction Limit}}$$

Excess AGI is the amount by which the individual's AGI exceeds the applicable dollar limitation.

The maximum permissible dollar deduction is the section 219(b)(1)(A) limit of \$2,000, or the section 219(c)(2)(A)(i) limit of \$2,250, in the case of a spousal IRA.

If the adjusted dollar deduction limit is not a multiple of 10, it is rounded up to the next highest \$10 increment. If the amount so calculated is below \$200, but above zero, the adjustable dollar deduction limit equals \$200. The 100% of compensation limit is unaffected by these adjustments to the dollar limit.

contributions to a discretionary defined contribution plan for two plan years are made in one calendar year, solely for the purposes of determining active participant status, the contributions for the later plan year are deemed to be made in the next taxable year. In the fact pattern described above, the contribution made on November 30, 1988 is deemed to be made in taxable year 1989. Thus, the individual is an active participant in both the 1988 and 1989 taxable years.

#### B. Adjusted Gross Income

An active participant with AGI below the "applicable dollar limitation" may make a deductible contribution to an IRA up to the limits of section 219(b)(1) or (c)(2)(A) of the Code, as applicable. The "applicable dollar limitation" for an individual's taxable year is \$25,000 for single taxpayers, \$40,000 for married taxpayers filing a joint tax return, and zero for married individuals who file separately. The AGI used for purposes of section 219(g)(3)(A) (IRA deductions for active participants) is calculated after taking into account social security benefits (section 86 of the Code) and losses or gains on passive investments (section 469 of the Code). IRA contributions are not deducted when determining the relevant AGI.

If an individual is an active participant with AGI less than \$10,000 above the applicable dollar limitation, the individual may make a deductible contribution to an IRA equal to the lesser of (i) the adjusted dollar deduction limit, or (ii) 100% of compensation. Such adjusted dollar deduction limit is based upon the amount by which the AGI exceeds the applicable dollar limitation. This is calculated using the following formula:

An individual is never permitted to take a deduction in excess of such individual's compensation. Thus, if the individual's compensation is less than the adjusted dollar deduction limit, the adjusted dollar deduction limit is equal to 100% of compensation. (See example 4).

*Example 1:* An individual who is single and an active participant in a section 403(b) annuity contract arrangement for a taxable year has an AGI for the taxable year of \$35,000 (this is determined after the 403(b) salary reduction). To calculate the individual's adjusted dollar deduction limit the following steps must be taken:

Applicable Dollar Limitation = \$25,000  
 Excess AGI = (\$33,000 - \$25,000) = \$8,000  
 Maximum Permissible Dollar Deduction = \$2,000

$$\frac{\$10,000 - \$8,000}{\$10,000} \times \$2,000 = \$400 \text{ adjusted dollar deduction limit.}$$

**Example 2:** An individual is not an active participant in a plan, but the individual's spouse is an active participant for the taxable year. They file a joint tax return for the taxable year and each has compensation in excess of \$2,000. Their AGI is \$46,555. The adjusted dollar deduction limit for each spouse is calculated as follows:

Applicable Dollar Limitation = \$40,000  
 Excess AGI = (\$46,555 - \$40,000) = \$6,555  
 Maximum Permissible Dollar Deduction for the individual = \$2,000  
 Maximum Permissible Dollar Deduction for the individual's spouse = \$2,000

$$\frac{10,000 - 6,555}{10,000} \times \$2,000 = \$689, \text{ rounded to } \$690.$$

Each spouse may establish an IRA and may make a deductible contribution of \$690 for the taxable year. Neither spouse may make a deductible contribution in excess of that amount; that is, if one spouse makes a deductible contribution of only \$100, the other spouse's deductible contribution is still limited to \$690.

**Example 3:** If either spouse, in example 2, had no compensation for the year, or

Applicable Dollar Limitation = \$40,000  
 Excess AGI = (\$46,555 - \$40,000) = \$6,555  
 Maximum Permissible Dollar Deduction = \$2,250

$$\frac{\$10,000 - \$6,555}{\$10,000} \times \$2,250 = \$775, \text{ rounded to } \$780.$$

The adjusted dollar deduction limit for the couple is \$780. Second, to determine the maximum portion of this amount that may be allocated to a single account, the method in example 2 is used. Thus, no more than \$690 of the \$780 adjusted dollar deduction limit may be contributed to either of the two IRAs.

Applicable Dollar Limitation = \$0  
 Excess AGI = \$1,500  
 Maximum Permissible Dollar Deduction = \$2,000

$$\frac{\$10,000 - \$1,500}{\$10,000} \times \$2,000 = \$1,700$$

The adjusted dollar deduction limit is \$1,700. However, because the individual may not deduct an amount in excess of 100% of compensation, in this example, the individual may make a deductible contribution of only \$1,500.

selected to be treated as having no compensation, a spousal IRA could be established for that individual. To calculate the maximum amount of a spousal IRA contribution which may be contributed to an account, the individual must use a two step process. First, the adjusted dollar deduction limit for the couple is calculated (assume the combined AGI is the same as in Example 2):

**Example 4:** A married individual filing a separate tax return is an active participant for a taxable year. The individual's AGI and compensation are \$1,500 for the taxable year. The adjusted dollar deduction limit is calculated as follows:

#### Deductibility Questions

**B1:** In determining the adjusted dollar deduction limit, is the calculation described above performed on each spouse's separate AGI or on the couple's aggregate AGI?

**A:** When computing the adjusted dollar deduction limit for each spouse filing a joint tax return, the couple's aggregate AGI is used. (See example 2 above.)

**B2:** How is the adjusted dollar deduction limit calculated when an individual's compensation for a taxable year is less than \$2,000?

The adjusted dollar deduction limit is first calculated under section 219(b)(1)(A) or section 219(c)(2)(A)(1). The individual may then make a deductible contribution to an IRA to the extent of the lesser of the adjusted dollar deduction limit and the 100% of compensation limit of section 219(b)(1)(B) or section 219(c)(2)(A)(ii). (See example 4 above.)

#### II. Nondeductible Contributions to IRAs

Section 408(o) of the Code provides that a taxpayer may make a nondeductible IRA contribution provided that such amount does not exceed the amount described in section 219(b)(1) or (c)(2)(A) of the Code (as applicable) reduced by the IRA contribution which are deducted for the year. Thus, an individual may make nondeductible contributions to the extent of the excess of (1) the lesser of \$2,000 (\$2,250 in the case of a spousal IRA) or 100 percent of compensation, over (2) the amount of the IRA contribution which is deducted. An individual may make nondeductible contributions in lieu of deductible contributions. Earnings attributable to deductible or nondeductible IRA contributions will not be subject to income tax until distribution.

When a taxpayer makes a nondeductible IRA contribution, any nondeductible portion of the IRA contribution must be indicated on the tax return for the year in which the contribution is made and in each subsequent year until the amount is fully recovered (section 408(o)(2)(C) of the Code). A taxpayer who overstates the nondeductible designation on the tax form is subject to a \$100 penalty per overstatement unless the overstatement is due to reasonable cause and the taxpayer demonstrates that steps have been taken to correct the overstatement (see section 6693(b) of the Code).

#### Nondeductible IRA Contribution Questions

**C1:** May nondeductible and deductible contributions be made to the same IRA?

**A:** Yes. Section 408(o) of the Code provides that an individual need not designate a contribution as deductible or

nondeductible until the tax return is filed. Moreover, the individual is not, under the Code, required to report the nondeductible status of the contribution to the bank or institution holding the IRA. Accordingly, both deductible and nondeductible contributions may be made to a single IRA.

**C2: What is the rule for removing excess contributions?**

**A:** Prior to the Act, section 408(d)(4) of the Code permitted individuals who had made excess contributions to an IRA to withdraw such excess IRA contributions with earnings by April 15 of the year following the year for which the contribution was made. By withdrawing the excess in such manner, the individual was able to avoid the excise tax under section 4973 of the Code applicable to excess IRA contributions. Under the Act, amounts contributed to an IRA for an individual's taxable year (both deductible and nondeductible contributions) may be treated as excess contributions and withdrawn by the individual by April 15 of the following

year. Generally, if an individual is not yet 59½ at the time of the withdrawal, upon withdrawing such amounts the individual will be required to pay the early withdrawal tax under section 72(t) on the earnings (if any) for the year for which the contribution was made.

**C3: May a taxpayer change a deductible or nondeductible designation of a contribution to an IRA on a prior year's return?**

**A:** Yes. The designation may be changed by amending the tax return prior to expiration of the statute of limitations on assessments, pursuant to section 6501 of the Code. Of course, since contributions must be made by April 15 of the year following the year for which the contribution are made, no additional contributions may be made after that date.

**C4: May an individual roll over employee contributions from a qualified plan to an IRA.**

**A:** No. Section 402(a)(5)(B) continues to prohibit such a rollover.

### III. Distributions

In general, the rules of section 72, including section 72(e)(8), will apply to the taxability of distributions from IRAs. To the extent that the following rules are inconsistent with the rules set forth in section 72, the rules in this Notice govern. For example, if an individual has a single IRA annuity contract the rules herein, which generally treat such a distribution as being an amount not received as an annuity under section 72(e), shall apply rather than those set forth in section 72 for annuities.

An individual who has made nondeductible contributions has, with respect to the IRA, investment in the contract (i.e., basis). In such a case a portion of the distribution will be treated as a nontaxable return of the nondeductible contributions (return of basis). The portion of the distribution attributable to the return of nondeductible contributions is determined by using the following formula:

$$\frac{\text{Total Nondeductible Contributions}}{\text{Total IRA Account Balance} + \text{Distribution Amount} \times \text{Distribution Amount} + \text{Outstanding Rollover}}$$

An "outstanding rollover" is any amount distributed by an IRA within 60 days of the end of the taxable year, not rolled over to another IRA by the end of the year, but rolled over in the following year to another IRA before the 60 days end.

When making these computations the individual shall treat all IRAs, whether accounts or annuity contracts, maintained by the individual as a single IRA. This includes amounts held in Simplified Employee Pension (SEP) IRAs and rollover IRAs. In general, the total IRA account balance is the fair market value of all IRAs, computed as of the last day of the taxable year in which a distribution was made. The fair market value includes both realized and unrealized appreciation. The distribution amount is the sum of all distributions from the IRA during the taxable year. Each distribution is valued as of the day of distribution. Neither the numerator nor the denominator of the above

$$\frac{\$6,000}{\$12,500 + \$5,000}$$

\$1,714.30 of the \$5,000 distribution consists of a return of basis. The remainder is includible in the individual's income.

On June 30, 1993, the individual receives a distribution of \$3,000. No additional contributions are made in 1993; and

equation shall include amounts previously withdrawn pursuant to section 408(d)(4) of the Code.

**Example:** An individual makes the following contributions:

	Deductible	Nondeductible
1984	\$2,000	\$0
1985	\$2,000	\$0
1986	\$2,000	\$0
1987	\$1,000	\$1,000
1988	\$1,000	\$1,000
1989	\$0	\$2,000
1990	\$0	\$2,000
	\$8,000	\$6,000

On October 31, 1992, the individual receives a distribution of \$5,000. At the end of the year, the total IRA account balance is \$12,500. There are no outstanding rollovers. The portion of the distribution which is not includible in gross income for 1992 is calculated as follows:

$$= \$5,000 = \$1,714.30$$

the total IRA account balance on December 31, 1992 is \$10,875. There are no outstanding rollovers. The total nondeductible contributions made to any IRA must be reduced by the portion of prior distributions attributable to return of nonde-

ductible contributions, in this case \$1,714.30. Thus, the reduced nondeductible contribution balance equals \$6,000 minus \$1,714.30, or \$4,285.70. The portion of the distribution which is not includible in gross income for 1993 is calculated as follows:

$$\frac{\$4,285.70}{\$10,875 + \$3,000} \times \$3,000 = \$926.64$$

\$926.64 of the \$3,000 distribution consists of return of basis. The remainder is includible in the individual's income.

The calculation to determine the nontaxable portion must be made each year in which a distribution is received.

See D7 below for an example involving outstanding rollovers.

#### Distribution Questions

**D1: How is the return of basis in a distribution calculated if an individual has a number of accounts and annuity contracts but only wishes to take a distribution out of one account?**

**A:** Section 408(d)(2) provides that, for purposes of calculating the tax on IRA distributions during a calendar year, all IRA accounts and contracts (including SEPs and rollover IRAs) are treated as a single IRA, taken at fair market value at



the end of the calendar year in which the distributions are made (with the amount of the distribution added back in, other than distributions rolled over to another IRA within the year). For purposes of this section it does not matter whether the individual receives distributions from one account or several accounts.

D2: May an individual designate a particular distribution as being from such individual's nondeductible contributions?

A: No. Generally, under the new rules, each withdrawal is treated as a pro rata recovery of both the nontaxable portion (basis) and the taxable portion. This is true regardless of whether the nondeductible contributions are kept in a separate account with withdrawals only made from that separate account.

D3: Upon an IRA withdrawal, may an individual who has made nondeductible contributions to an IRA segregate the basis from the taxable portion of the withdrawal (using the formula above) and avoid taking any amount into income by rolling over the portion which would otherwise have been taxable?

A: No. In such a case the amount withdrawn less the amount rolled over is the amount actually distributed. This amount would be used in the pro rata calculation to determine what portion is recovery of basis, and what part is included in gross income.

D4: May amounts attributable to nondeductible contributions be rolled over from one IRA to another?

A: Yes. Indeed, in rolling over amounts

from one IRA to another, an individual must roll over amounts attributable to nondeductible contributions as well as deductible contributions.

D5: In what circumstances does an individual recognize a loss from an IRA?

A: A loss from an IRA may be recognized only when all amounts have been distributed and the amounts distributed are less than the individual's unrecovered basis. For example:

An individual makes contributions totaling \$10,000, all nondeductible, to an IRA. The IRA earns \$4,000 over the course of the 5 years. Distributions commence at the end of the fifth year and the individual removes \$6,000. The nontaxable portion (return of basis) equals

$$\frac{\$10,000}{\$14,000} \times \$6,000 = \$4,285.71$$

The remaining balance is \$14,000 - \$6,000 = \$8,000

The remaining basis is \$10,000 - \$4,285.71 = \$5,714.29

In the next year the IRA sustains a loss of \$5,000. The account balance as of the end of the year is \$3,000, which is less than the remaining basis. If the individual withdraws the entire \$3,000, no pro rata calculation is necessary and the individual may claim a loss of \$2,714.29. If the taxpayer withdraws less than the entire balance, the pro rata calculation is necessary.

D6: How is the taxability of a distribution determined when an individual has rolled over funds from one IRA to another?

A: Any amount distributed and rolled over during the taxable year (i.e., completed before December 31) will be present in an IRA account as of the close of the year and will be reported as part of the aggregate IRA account balance. However, if an amount is distributed from an account within the last 60 days of the taxable year and is not rolled into another

account by December 31, but is later rolled over after December 31 and before the 60th day after the distribution, it is an "outstanding rollover" and is added to the denominator of the equation used to determine the portion of the distribution attributable to basis. If it is not rolled over in a timely manner, the distribution is not treated as an "outstanding rollover." For example:

An individual has two IRAs and has made a total of \$6,000 of nondeductible IRA contributions.

The individual takes a \$300 distribution from IRA B on October 10, 1989. On December 11, 1989, the individual receives \$7,000 from IRA A. There has not been any earlier distributions from either IRA. As of December 31, 1989, the individual has not yet rolled any amount into another IRA and thus, the year-end valuation does not include the distribu-

tion. On January 30, 1990 the individual rolls over \$7,000 to another IRA. The year-end valuations of the accounts show the following:

$$\begin{array}{r} \text{IRA A} \\ \$3,000 \end{array} \quad \begin{array}{r} \text{IRA B} \\ \$20,000 \end{array} = \$23,000$$

The amount removed from IRA A and rolled over on January 30, is, of course, not included in the valuation as of December 31, 1989; nor is the \$300 distributed from IRA B and not rolled over later. To calculate the taxability of the 1989 distribution that was not rolled over (the \$300), the "outstanding rollover" (the \$7,000) must be added back to the denominator of the fraction used to determine the portion of the distribution attributable to basis. The portion of the distribution attributable to basis is thus calculated as follows:

$$\begin{array}{r} \$6,000 \\ (\$23,000 + \$300) + \$300 \\ \text{(IRA Account Balance} \\ \text{+ Outstanding Rollover)} \end{array} \times \$300 = \$59.41$$

D7: In calculating the IRA account balance for purposes of determining the pro rata distribution, are accounts owned by an individual's spouse included?

A: No. IRAs belonging to another person are not aggregated for purposes of

this calculation.

D8: Is there any way to make an early distribution of IRA funds before age 59½ without incurring the additional tax under section 72(t)?

A: Yes. Under Code section

72(t)(2)(A)(iv), distributions before age 59½ are not subject to the additional tax if they are in the form of substantially equal periodic payments over the life or life expectancy of the individual, or of the individual and his or her beneficiary. In

addition, under sections 72(t)(2)(A)(ii) and (iii), exceptions are provided for distributions attributable to the taxpayer's becoming disabled within the meaning of section 72(m)(7), and distributions made to a beneficiary after the death of the individual.

D9: If an individual receives a distribution, prior to age 59½, from an IRA to which nondeductible contributions have been made is the entire amount distributed subject to the additional tax under section 72(t) of the Code?

A: No, the tax is assessed only against the portion of the distribution which is includible in gross income.

D10: Are IRA trustees required to calculate the amount of the distribution attributable to return of basis for an individual?

A: No. Generally, the trustee will not have the information needed to make this calculation. The bank of institution holding the IRA must provide the actual account balance of each IRA, but is not required to know whether a particular contribution was deductible or nondeductible and is not required to have a record of the aggregate nondeductible contributions. Accordingly, the taxpayer is responsible for calculating the taxable amount of an IRA distribution.

#### IV. Spousal IRAs

Under section 219(c)(1)(B) of the Code, as amended, a married couple filing a joint return may elect to treat one spouse as having no compensation for purposes of establishing a spousal IRA. This provision is effective for contributions made

before, on or after the taxable years beginning after December 31, 1985.

E1: May a married couple make a contribution to a spousal IRA with respect to a spouse who made \$100 of compensation during the 1986 taxable year?

A: If the couple elects on their joint tax return to treat that spouse as having no compensation for the year, they may establish a spousal IRA.

E2: May a taxpayer amend his or her tax returns for the 1985 and prior taxable years and contribute to spousal IRAs for those years?

A: No. Section 219(f)(3) and the regulations thereunder provide that contributions to an IRA must have been made no later than the time prescribed by law for filing the return for such taxable year (excluding extensions).

#### V. Collectibles

The Act creates an exception to the general rule set forth in section 408(m)(1) under which acquisition of collectibles (as defined in section 408(m)(2)) are treated as distributions. To the extent that IRA funds are invested after December 31, 1986, in gold or silver coins issued by the United States, as specified in 31 USC 5112(a)(7), (8), (9), or 910), or 31 USC 5112(e), such funds will not be treated as distributed. IRA funds attributable to contributions made before December 31, 1986, may also be invested in such coins.

An investment by an IRA in a coin which has been made into jewelry is still considered an investment in a collectible, and will be treated as a distribution.

#### VI. Withholding

Under section 3405(d)(1)(B) of the Code, for purposes of withholding taxes, the payor must assume that the entire amount of an IRA distribution is taxable.

#### VII. Deductible Employee Contributions

For taxable years beginning after January 1, 1982, a qualified retirement plan may allow participants to make deductible contributions to separate accounts within the plan. The Act prohibits these qualified voluntary employee contributions (QVECs) for years beginning after December 31, 1986. Plan administrators may not accept such contributions in any calendar year after 1986 (except those made before the April 15, 1987 filing date specifically for the 1986 year). Plans need not be amended for this change until the amendment date for other retirement plan changes required by the Act (generally, the first plan year beginning on or after January 1, 1989).

Plans with QVECs need not immediately distribute the amount already accumulated in such accounts. In addition, amounts now held in such accounts are not aggregated with IRA accounts for purposes of determining the nontaxable portion of an IRA distribution.

#### VIII. IRA Arrangements

Trustees using model IRA, Master IRAs or Prototype IRAs are not required to amend their IRA documents to comply with the new law until notified to do so by the Service. The Act generally affects individual deductions rather than provisions required to be in most IRA documents.

## Part IV. Items of General Interest

### General Description of the Tax Reform Act of 1986 Provisions Affecting Individual Retirement Arrangements

#### Announcement 86-121

This announcement highlights some of the changes made by the Tax Reform Act of 1986 (the Act) with respect to Individual Retirement Arrangements (IRAs). The announcement is intended to be a nontechnical explanation, rather than a comprehensive statement of the new rules concerning IRAs.

For a nontechnical explanation of the rules in effect before the new Act, as well as an explanation of the new law, see Internal Revenue Service Publication 590, which will be available at any IRS District office beginning early in January 1987.

This announcement may be used by a master or prototype IRA sponsor to update its disclosure statement, required by Treasury Regulations at section 1.408-6.

The Service expects to publish technical guidance concerning the Act changes to IRAs in the near future.

The nontechnical explanation follows:

The Tax Reform Act of 1986 (which we will call the Act) makes a number of major changes to the law governing the deductibility of contributions to Individual Retirement Arrangements (IRAs).

The changes made by the Act are generally not effective until January 1, 1987. This means that contributions made for 1987 are subject to the Act's new rules; however, you can still make a contribution for 1986 as late as April 15, 1987 under the old rules.

#### ELIGIBILITY

Under the new law, if neither you, nor your spouse, is an active participant (see A. below) you may make a contribution of up to the lesser of \$2,000 (or \$2,250 in the case of a spousal IRA) or 100% of compensation and take a deduction for the entire amount contributed. If you are an active participant but have an adjusted gross income (AGI) below a certain level (see B. below), you may make a deductible contribution as under current law. If, however, you or your spouse is an active participant and your combined AGI is above the specified level, the amount of the deductible contribution you may make

to an IRA is phased down and eventually eliminated.

#### A. Active Participant

You are an "active participant" for a year if you are covered by a retirement plan. You are covered by a "retirement plan" for a year if your employer or union has a retirement plan under which money is added to your account or you are eligible to earn retirement credits. For example, if you are covered under a profit-sharing plan, certain government plans, a salary reduction arrangement (such as a tax sheltered annuity arrangement or a 401(k) plan), a simplified employee pension plan (SEP) or a plan which promises you a retirement benefit which is based upon the number of years of service you have with the employer, you are likely to be an active participant. Your Form W-2 for the year, starting with the 1987 tax year, should indicate your participation status.

You are an active participant for a year even if you are not yet vested in your retirement benefit. Also, if you make required contributions or voluntary employee contributions to a retirement plan, you are an active participant. In certain plans you may be an active participant even if you were only with the employer for part of the year.

You are not considered an active participant if you are covered in a plan only because of your service as 1) an Armed Forces Reservist, for less than 90 days of active service, or 2) a volunteer firefighter covered for firefighting service by a government plan. Of course, if you are covered in any other plan, these exceptions do not apply.

If you are married but file a separate tax return, your spouse's active participation does not affect your ability to make deductible contributions.

#### B. Adjusted Gross Income (AGI)

If you are an active participant, you must look at your Adjusted Gross Income for the year (if you and your spouse file a joint tax return you use your combined AGI) to determine whether you can make a deductible IRA contribution. Your tax return will show you how to calculate your AGI for this purpose. If you are at or below a certain AGI level, called the

Threshold Level, you are treated as if you were not an active participant and can make a deductible contribution under the same rules as a person who is not an active participant.

If you are single, your threshold AGI level is \$25,000. The threshold level if you are married and file a joint tax return is \$40,000, and if you are married but file a separate tax return, the threshold level is \$0.

If your AGI is less than \$10,000 above your threshold level, you will still be able to make a deductible contribution but it will be limited in amount. The amount by which your AGI exceeds your Threshold Level (AGI - Threshold Level) is called your Excess AGI. The Maximum Allowable Deduction is \$2,000 (or \$2,250 for a Spousal IRA). You can estimate your Deduction Limit using Table I on Page 16, or calculate it as follows:

(Your Deduction Limit may be slightly higher if you use this formula rather than the Table).

$$\frac{10,000 - \text{Excess AGI}}{10,000} \times \text{Maximum Allowable Deduction} = \text{Deduction Limit}$$

You must round up the result to the next highest \$10 level (the next highest number which ends in zero). For example, if the result is \$1,525, you must round it up to \$1,530. If the final result is below \$200 but above zero, your Deduction Limit is \$200. Your Deduction Limit cannot, in any event, exceed 100% of your compensation.

*Example 1:* Ms. Smith, a single person, is an active participant and has an AGI of \$31,619. She calculates her deductible IRA contribution as follows:

Her AGI is \$31,619

Her Threshold Level is \$25,000

Her Excess AGI is (AGI - Threshold Level) or (\$31,619 - \$25,000) = \$6,619

Her Maximum Allowable Deduction is \$2,000

So, her IRA deduction limit is:

$$\frac{10,000 - \$6,619}{10,000} \times \$2,000 = \$676 \text{ (rounded to } \$680\text{)}$$

*Example 2:* Mr. and Mrs. Young file a joint tax return. Each spouse earns more than \$2,000 and one is an active participant. They have a combined AGI of

\$44,255. They may each contribute to an IRA and calculate their deductible contributions to each IRA as follows:

Their AGI is \$44,255

Their Threshold Level is \$40,000

Their Excess AGI is (AGI - Threshold Level) or (\$44,255 - \$40,000) = \$4,255

The Maximum Allowable Deduction for each spouse is \$2,000

So, each spouse may compute his or her IRA deduction limit as follows:

$$\frac{\$10,000 - \$4,255}{\$10,000} \times \$2,000 = \$1,149 \text{ (rounded to } \$1,150\text{)}$$

**Example 3:** If, in example 2, Mr. Young did not earn any compensation, or elected to be treated as earning no compensation, Mrs. Young could establish a Spousal IRA (consisting of an account for herself and one for her husband). The amount of deductible contributions which could be made to the two IRAs is calculated using a Maximum Allowable Deduction of \$2,250 rather than \$2,000.

$$\frac{\$10,000 - \$4,255}{\$10,000} \times \$2,250 = \$1,293 \text{ (rounded to } \$1,300\text{)}$$

The \$1,300 can be divided between the two accounts, but neither IRA may receive a deductible contribution of more than \$1,150.

**Example 4:** Mr. Jones, a married person, files a separate tax return and is an active participant. He has \$1,500 of compensation and wishes to make a deductible contribution to an IRA.

His AGI is \$1,500

His Threshold Level is \$0

His Excess AGI is (AGI - Threshold Level) or (\$1,500 - \$0) = \$1,500

His Maximum Allowable Deduction is \$2,000

So, his IRA deduction limit is:

$$\frac{\$10,000 - \$1,500}{\$10,000} \times \$2,000 = \$1,700$$

Even though his IRA deduction limit under the formula is \$1,700, Mr. Jones may not deduct an amount in excess of his compensation, so, his actual deduction is limited to \$1,500.

#### SPOUSAL IRAs

As noted in Example 3 above, under the Act you may contribute to a Spousal IRA even if your spouse has earned some compensation during the year. Provided your spouse does not make a contribution to an IRA, you may set up a Spousal IRA consisting of an account for your spouse

as well as an account for yourself. The maximum deductible amount for the spousal IRA is the lesser of \$2,250 or 100% of compensation. This rule applies for 1986 spousal IRAs as well as 1987 spousal IRAs.

#### NONDEDUCTIBLE CONTRIBUTIONS TO IRAs

Even if you are above the threshold level and thus may not make a deductible contribution of \$2,000 (\$2,250 for a spousal IRA), you may still contribute up to the lesser of 100% of compensation or \$2,000 to an IRA (\$2,250 for a Spousal IRA). The amount of your contribution which is not deductible will be a nondeductible contribution to the IRA. You may also choose to make a contribution nondeductible even if you could have deducted part or all of the contribution. Interest or other earnings on your IRA contribution, whether from deductible or nondeductible contributions, will not be taxed until taken out of your IRA and distributed to you.

If you make a nondeductible contribution to an IRA you must report the amount of the nondeductible contribution to the IRS as a part of your tax return for the year.

You may make a \$2,000 contribution at any time during the year, if your compensation for the year will be at least \$2,000, without having to know how much will be deductible. When you fill out your

tax return you may then figure out how much is deductible.

You may withdraw an IRA contribution made for a year any time before April 15 of the following year. If you do so, you must also withdraw the earnings attributable to that portion and report the earnings as income for the year for which the contribution was made. If some portion of your contribution is not deductible, you may decide either to withdraw the nondeductible amount, or to leave it in the IRA and designate that portion as a nondeductible contribution on your tax return.

#### IRA DISTRIBUTIONS

Because nondeductible IRA contributions are made using income which has already been taxed (that is, they are not deductible contributions), the portion of the IRA distributions consisting of nondeductible contributions will not be taxed again when received by you. If you make any nondeductible IRA contributions, each distribution from your IRAs will consist of a nontaxable portion (return of nondeductible contributions) and a taxable portion (return of deductible contributions, if any, and account earnings). Thus, you may not take a distribution which is entirely tax-free. The following formula is used to determine the nontaxable portion of your distributions for a taxable year:

$$\frac{\text{Remaining Nondeductible contributions}}{\text{Year-end total IRA account balances}} \times \text{Total Distributions (for the year)} = \text{Nontaxable distributions (for the year)}$$

To figure the year-end total IRA account balance you treat all of your IRAs as a single IRA. This includes all regular IRAs, as well as Simplified Employer Pension (SEP) IRAs, and Rollover IRAs.

You also add back the distributions taken during the year.

**Example:** An individual makes the following contributions to his or her IRAs:

Year	Deductible	Nondeductible
1983	\$2,000	
1984	1,800	
1987	1,000	\$1,000
1989	600	1,400
	\$5,400	\$2,400

Deductible Contributions:	\$5,400
Nondeductible Contributions:	2,400
Earnings on IRAs:	1,200

Total Account Balance of IRAs as of 12/31/91: \$9,000  
(including distributions in 1991)

In 1991 the individual takes a distribution of \$3,000. The total account balance in the IRAs on 12/31/91 plus 1991

Total nondeductible contributions	\$2,400 × \$3,000 = \$800
Total account balance in the IRAs plus distributions	\$9,000

Thus, \$800 of the \$3,000 distribution in 1991 will not be included in the individual's taxable income. The remaining \$2,200 will be taxable for 1991.

#### ROLLOVER IRA RULES

The Act made some changes in the rules for rollovers of *partial* distributions from retirement plans into IRAs. (A partial distribution is one which represents at least 50 percent of the amount owed to you from a retirement plan.)

After December 31, 1986, if you receive a partial distribution from an employer's pension plan after December 31, 1986, and the distribution is paid to you

- 1) because you separated from service with the employer.
- 2) because you became disabled while working for the employer, or
- 3) because of the death of your spouse while he or she was covered under the employer's plan, if you are named as a beneficiary.

then you may deposit that amount into a Rollover IRA.

#### IRA ARRANGEMENTS

In general, the above changes affect individual deduction provisions, rather than provisions required in IRA documents. Therefore, until further notice, trustees using Model IRAs and IRAs which have been approved under the IRA National Office Master and Prototype program need not amend their IRA documents to reflect the changes in the laws concerning IRAs.

#### **New Form 1120-ND, Return For Nuclear Decommissioning Funds and Certain Related Persons**

##### **Announcement 86-123**

New Form 1120-ND, Return For Nuclear Decommissioning Funds and Certain Related Persons, has been developed for use by qualified funds that are created by public utilities to pay the future costs of decommissioning nuclear power plants. These funds must file the Form 1120-ND to report contributions received, income earned, payment of the administrative expenses of the fund, the tax on income earned, and information on whether any

distributions is \$9,000. The nontaxable portion of the distributions for 1991 is figured as follows:

acts of self-dealing have occurred during the tax year. Form 1120-ND must also be filed by trustees or disqualified persons who engage in acts of self-dealing with the fund.

Form 1120-ND must be filed within two and one-half months after the close of the taxpayer's tax year. It will be available beginning in January 1987.

#### **New Form 1120-W (FY)(1986-87), Fiscal Year Corporation Estimated Tax**

##### **Announcement 86-124**

New Form 1120-W (FY)(1986-87), Fiscal Year Corporation Estimated Tax, has been developed for use by corporations whose tax years begin in 1986 and end in 1987. The form highlights the changes made by the Tax Reform Act of 1986 that affect fiscal year taxpayers. It also provides a prorated tax computation for taxpayers whose tax years end after June 30, 1987, and includes a new computation of alternative tax under section 1201 of the Internal Revenue Code for all fiscal 1986-87 filers.

Corporations whose tax years begin in 1986 and end in 1987 should use this form to compute their estimated tax or recompute the amount due for each installment if estimated tax payments have already been made.

Form 1120-W (FY) (1986-87) will be available in January 1987.

#### **New Form 5500EZ, Annual Return of One-Participant Pension Benefit Plan**

##### **Announcement 86-125**

New Form 5500EZ, Annual Return of One-Participant Pension Benefit Plan, has been developed for use by pension benefit plans that cover only an individual or an individual and the individual's spouse who wholly own a business. This form may also be used for a plan or a partnership that covers only the partners, or the partners and their spouses, as long as the plan meets the coverage requirements of Internal Revenue Code section 410(b)(1) without being combined with any other plan.

The Form 5500EZ may not be used for a pension plan of a business that:

- (a) is a member of an affiliated service group,
- (b) is a member of a controlled group of corporations,
- (c) is a member of a group of businesses under common control, or
- (d) leases employees.

The use of Form 5500EZ will substantially reduce the reporting burden for small "one-participant" pension plans.

The Form 5500EZ will be available to the public in January 1987. It may be filed for plan years starting in 1986.

#### **New Form 8453-F, U.S. Fiduciary Income Tax Declaration for Magnetic Media/Electronic Filing, and Form 8453-P, U.S. Partnership Declaration for Magnetic Media/Electronic Filing**

##### **Announcement 86-126**

New Form 8453-F, U.S. Fiduciary Income Tax Declaration for Magnetic Media/Electronic Filing, and Form 8453-P, U.S. Partnership Declaration for Magnetic Media/Electronic Filing, have been developed for use by estates and trusts, and partnerships, respectively, participating in the 1986 electronic/magnetic media filing pilot program. These entities can use the program only for tax years ending on December 31, 1986. The details of the pilot program were published in the Federal Register, dated March 31, 1986.

The Form 8453-F program is limited to Forms 1041 with any of the following attachments:

- Schedule D (Form 1041), Capital Gains and Losses
- Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc.
- Form W-2, Wage and Tax Statement
- Form 6251, Alternative Minimum Tax Computation

The Form 8453-P program is limited to Forms 1065 with any of the following attachments:

- Schedule D (Form 1065), Capital Gains and Losses
- Schedule K (Form 1065), Partners' Shares of Income, Credits, Deductions, etc.
- Schedule K-1 (Form 1065), Partner's Share of Income, Credits, Deductions, etc.

## ESTIMATED DEDUCTION TABLE

If your Maximum Allowable Deduction is \$2,000, use this table to estimate the amount of your contribution which will be deductible. (See page 3 for formula.)

<u>Excess AGI</u>	<u>Deduction</u>	<u>Excess AGI</u>	<u>Deduction</u>	<u>Excess AGI</u>	<u>Deduction</u>	<u>Excess AGI</u>	<u>Deduction</u>	<u>Excess AGI</u>	<u>Deduction</u>
\$ 0.00	\$2,000.00	\$2,000.00	\$1,600.00	\$4,000.00	\$1,200.00	\$6,000.00	\$800.00	\$8,000.00	\$400.00
50.00	1,990.00	2,050.00	1,590.00	4,050.00	1,190.00	6,050.00	790.00	8,050.00	390.00
100.00	1,980.00	2,100.00	1,580.00	4,100.00	1,180.00	6,100.00	780.00	8,100.00	380.00
150.00	1,970.00	2,150.00	1,570.00	4,150.00	1,170.00	6,150.00	770.00	8,150.00	370.00
200.00	1,960.00	2,200.00	1,560.00	4,200.00	1,160.00	6,200.00	760.00	8,200.00	360.00
250.00	1,950.00	2,250.00	1,550.00	4,250.00	1,150.00	6,250.00	750.00	8,250.00	350.00
300.00	1,940.00	2,300.00	1,540.00	4,300.00	1,140.00	6,300.00	740.00	8,300.00	340.00
350.00	1,930.00	2,350.00	1,530.00	4,350.00	1,130.00	6,350.00	730.00	8,350.00	330.00
400.00	1,920.00	2,400.00	1,520.00	4,400.00	1,120.00	6,400.00	720.00	8,400.00	320.00
450.00	1,910.00	2,450.00	1,510.00	4,450.00	1,110.00	6,450.00	710.00	8,450.00	310.00
500.00	1,900.00	2,500.00	1,500.00	4,500.00	1,100.00	6,500.00	700.00	8,500.00	300.00
550.00	1,890.00	2,550.00	1,490.00	4,550.00	1,090.00	6,550.00	690.00	8,550.00	290.00
600.00	1,880.00	2,600.00	1,480.00	4,600.00	1,080.00	6,600.00	680.00	8,600.00	280.00
650.00	1,870.00	2,650.00	1,470.00	4,650.00	1,070.00	6,650.00	670.00	8,650.00	270.00
700.00	1,860.00	2,700.00	1,460.00	4,700.00	1,060.00	6,700.00	660.00	8,700.00	260.00
750.00	1,850.00	2,750.00	1,450.00	4,750.00	1,050.00	6,750.00	650.00	8,750.00	250.00
800.00	1,840.00	2,800.00	1,440.00	4,800.00	1,040.00	6,800.00	640.00	8,800.00	240.00
850.00	1,830.00	2,850.00	1,430.00	4,850.00	1,030.00	6,850.00	630.00	8,850.00	230.00
900.00	1,820.00	2,900.00	1,420.00	4,900.00	1,020.00	6,900.00	620.00	8,900.00	220.00
950.00	1,810.00	2,950.00	1,410.00	4,950.00	1,010.00	6,950.00	610.00	8,950.00	210.00
1,000.00	1,800.00	3,000.00	1,400.00	5,000.00	1,000.00	7,000.00	600.00	9,000.00	200.00
1,050.00	1,790.00	3,050.00	1,390.00	5,050.00	990.00	7,050.00	590.00	9,050.00	200.00
1,100.00	1,780.00	3,100.00	1,380.00	5,100.00	980.00	7,100.00	580.00	9,100.00	200.00
1,150.00	1,770.00	3,150.00	1,370.00	5,150.00	970.00	7,150.00	570.00	9,150.00	200.00
1,200.00	1,760.00	3,200.00	1,360.00	5,200.00	960.00	7,200.00	560.00	9,200.00	200.00
1,250.00	1,750.00	3,250.00	1,350.00	5,250.00	950.00	7,250.00	550.00	9,250.00	200.00
1,300.00	1,740.00	3,300.00	1,340.00	5,300.00	940.00	7,300.00	540.00	9,300.00	200.00
1,350.00	1,730.00	3,350.00	1,330.00	5,350.00	930.00	7,350.00	530.00	9,350.00	200.00
1,400.00	1,720.00	3,400.00	1,320.00	5,400.00	920.00	7,400.00	520.00	9,400.00	200.00
1,450.00	1,710.00	3,450.00	1,310.00	5,450.00	910.00	7,450.00	510.00	9,450.00	200.00
1,500.00	1,700.00	3,500.00	1,300.00	5,500.00	900.00	7,500.00	500.00	9,500.00	200.00
1,550.00	1,690.00	3,550.00	1,290.00	5,550.00	890.00	7,550.00	490.00	9,550.00	200.00
1,600.00	1,680.00	3,600.00	1,280.00	5,600.00	880.00	7,600.00	480.00	9,600.00	200.00
1,650.00	1,670.00	3,650.00	1,270.00	5,650.00	870.00	7,650.00	470.00	9,650.00	200.00
1,700.00	1,660.00	3,700.00	1,260.00	5,700.00	860.00	7,700.00	460.00	9,700.00	200.00
1,750.00	1,650.00	3,750.00	1,250.00	5,750.00	850.00	7,750.00	450.00	9,750.00	200.00
1,800.00	1,640.00	3,800.00	1,240.00	5,800.00	840.00	7,800.00	440.00	9,800.00	200.00
1,850.00	1,630.00	3,850.00	1,230.00	5,850.00	830.00	7,850.00	430.00	9,850.00	200.00
1,900.00	1,620.00	3,900.00	1,220.00	5,900.00	820.00	7,900.00	420.00	9,900.00	200.00
1,950.00	1,610.00	3,950.00	1,210.00	5,950.00	810.00	7,950.00	410.00	9,950.00	200.00
								10,000.00	0.00

**Excess AGI = Your AGI minus your Threshold Level:**

**If you are single, your Threshold Level is \$25,000.**

**If you are married, your Threshold Level is \$40,000.**

**If you are married and file a separate tax form, your Excess AGI = your AGI.**

CHANGES IN EMPLOYEE BENEFIT LAW  
AFFECTING THE BANKING INDUSTRY  
UNDER THE 1986 TAX REFORM ACT  
(Other than IRA's and SEPP's)

By

Richard S. Holt  
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Lexington, Kentucky





COLLEGE OF LAW  
UNIVERSITY OF KENTUCKY

SEVENTH ANNUAL SEMINAR  
ON LEGAL ISSUES FOR  
BANK COUNSEL

March 13 - 14, 1987

RICHARD S. HOLT  
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Lexington, Kentucky

CHANGES IN EMPLOYEE BENEFIT LAW AFFECTING THE BANKING INDUSTRY  
(OTHER THAN INDIVIDUAL RETIREMENT ACCOUNT AND SEPP'S UNDER THE  
1986 TAX REFORM ACT)

I. MATTERS UNDER THE INTERNAL REVENUE CODE OF 1986

A. Changes Applicable to Tax Qualified Plans Generally  
Effective Before 1989

1. 401(k) plans

- a. Maximum deferral is limited to \$7,000 effective for taxable years beginning after December 31, 1986
- b. Tougher nondiscrimination rules effective for plan years beginning after December 31, 1986
  - (i) Average deferral percentage (ADP) for the highly-compensated employees cannot exceed the greater of
    - (A) 125% of the average deferral percentage for the nonhighly-compensated employees, or
    - (B) The lower of 200% of the average deferral percentage for the nonhighly-compensated employees or the average deferral percentage for the highly compensated employees plus 2%
  - (ii) A comparison of the new ADP ratios versus the old ADP ratios is as follows:

<u>ADP for Nonhighly Compensated Employees</u>	<u>Maximum ADP for Highly Compensated (Prior Law)</u>	<u>Maximum ADP for Highly Compensated (TRA '86)</u>
1 percent	2.50 percent	2.00 percent
2 percent	5.00 percent	4.00 percent
3 percent	6.00 percent	5.00 percent
4 percent	7.00 percent	6.00 percent
5 percent	8.00 percent	7.00 percent
6 percent	9.00 percent	8.00 percent
7 percent	10.50 percent	9.00 percent
8 percent	12.00 percent	10.00 percent
9 percent	13.50 percent	11.25 percent
10 percent	15.00 percent	12.50 percent
11 percent	16.50 percent	13.75 percent
12 percent	18.00 percent	15.00 percent

c. Hardship withdrawals

(i) Withdrawals before separation from service are limited to the participant's elective deferrals only (not including earnings or nonelective contributions), effective for taxable years beginning after December 31, 1988

(ii) Withdrawals may be subject to early distribution excise tax

d. Only one year of service may be imposed as a condition for eligibility to make deferrals, effective for plan years beginning after December 31, 1988

2. Early withdrawals of benefits - the "too soon" rule - IRC §§ 72(t) and 4974

a. Additional income tax of 10% is imposed on distributions from all qualified retirement plans prior to attainment of age 59-1/2

b. Exceptions include

(i) Distributions in the form of an annuity payable over the life or life expectancy of the participant or the joint life expectancies of the participant and his or her beneficiary

(ii) Distributions made after the participant has attained age 55, separated from service

and satisfied the conditions for early retirement under the plan

- (iii) Distributions used for payment of certain deductible medical expenses
  - (iv) Distributions to an alternate payee pursuant to a qualified domestic relations order
  - (v) Distributions received before March 15, 1987 if made on account of a separation from service in 1986 if the participant elects to be taxed on the distribution in 1986
  - (vi) Certain distributions received from an ESOP before January 1, 1990
  - (vii) Distributions after the death of an employee
  - (viii) Certain distributions of excess contributions to and excess deferrals under 401(k) plans
3. Uniform distribution requirements - the "too late" rule - IRC §§ 401, 408, 457 and 4974
- a. Applicable to qualified plans, IRA's, SEPP's, 403(b) annuities
  - b. Distributions must commence by April 1 following the year in which employee attains age 70-1/2
  - c. Benefits not distributed when required or in the amount required are subject to an excise tax of 50% - paid by the participant
  - d. Effective for year beginning after 12/31/88
4. Excess distributions and accumulations - the "too much" rule - IRC § 4981
- a. An excise tax is imposed on the recipient of an "excess retirement distribution" of 15% of the excess
  - b. A retirement distribution includes the amount distributed during the recipient's taxable year, under
    - (i) any qualified pension, profit sharing or stock bonus plan,

- (ii) any Section 403(a) or 403(b) annuity,  
and
  - (iii) any IRA
- c. Exceptions include
- (i) any distribution consisting of after-tax employee contributions
  - (ii) any retirement distribution rolled over to another qualified plan or IRA
  - (iii) retirement distributions with respect to an individual after his or her death
  - (iv) any retirement distributions made with respect to an individual payable to another person under a qualified domestic relations order
- d. Generally, an "excess retirement distribution" is a retirement distribution in excess of \$150,000 per year (or \$750,000 in the case of a distribution which is a "lump sum distribution")
- e. Federal estate taxes are increased by an amount equal to 15% of a decedent's "excess retirement accumulations"
- f. An excess retirement accumulation is the excess of the value of the decedent's interest in all qualified plans, tax sheltered annuities and IRA's over the present value of the maximum defined benefit limit - a grandfather amount equal to \$562,500 is exempt from the excise tax
- g. Excise tax applies to excess retirement distributions made after December 31, 1986 and on excess retirement accumulations with respect to decedents dying after December 31, 1986
5. Ten-year averaging and capital gains
- a. Ten-year averaging repealed and replaced with five-year averaging for lump sum distributions for those over age 59-1/2
  - b. Capital gains for distributions attributable to pre-1974 contributions is phased out over a six-year period
  - c. Effective date

- (i) Distributions made after December 31, 1986
- (ii) Any participant who attained age 50 before January 1, 1986 may make a one-time election to use either five-year forward averaging using new rates or ten-year forward averaging using 1986 rates
  - (A) Election applies without regard to the requirement of attainment of age 59-1/2 (but still must otherwise be a "lump sum distribution")
  - (B) Such Participant also may elect to retain the capital gain character of pre-1974 portion of the distribution with capital gain taxed at existing 20% rate

6. Taxation of voluntary contributions

a. Pre-retirement distributions

- (i) Distributions prior to annuity starting date from plans in which there are voluntary contributions (i.e., after-tax employee contributions) are treated as being made on a pro rata basis out of both taxable amounts and nontaxable voluntary contributions
- (ii) Effective date
  - (A) Generally applies to distributions after December 31, 1986
  - (B) In the case of a plan that on May 5, 1986 permitted in-service withdrawals of voluntary contributions, distributions are treated as made first out of pre-12/31/86 voluntary contributions to the extent of voluntary contributions made on or before December 31, 1986

b. Post-retirement distributions

- (i) Special three-year basis recovery rule is repealed for distributions after the annuity starting date
- (ii) Generally effective for distributions after July 1, 1986

7. Plan loans

- a. \$50,000 maximum on plan loans must be reduced by the participant's highest outstanding loan balance during the preceding 12-month period
- b. Repayment of a plan loan over a period in excess of five years is no longer available for loans used to make home improvements or to purchase a principal residence of a member of the participant's immediate family
- c. The deduction for "personal interest", which includes consumer plan loans, is phased out over the next four years, as follows:

	<u>% Deductible</u>
1987	65%
1988	40%
1989	20%
1990	10%
1991	0%

- d. Interest on a plan loan secured by a mortgage on the participant's residence continues to be deductible under TRA '86 to the extent the loan does not exceed the cost of the residence plus the cost of any improvements on the residence. But note that even interest on a mortgage loan from a plan is not deductible if the loan is made, renewed, renegotiated, modified or extended after December 31, 1986 and:
  - (i) the participant is a key employee; or
  - (ii) the loan is secured by tax deferred annuities or an elective deferral account under Section 401(k) plans

Key employees include persons who own greater than 5% of a partnership or corporation, 1% owners earning in excess of \$150,000, officers whose compensation is in excess of \$45,000 and any individual who owns one of the 10 highest interests in the employer

- e. Application of Regulation Z to plan loans

f. Repayment of loans from qualified plans must be in substantially level amounts and made at least quarterly

8. Contributions and benefit limits

a. All voluntary contributions (after tax employee contributions) made after 12/31/86 will count against annual addition limits

b. There will be no increase in \$30,000 defined contribution limit until defined benefit limit (presently \$90,000) exceeds \$120,000

c. Defined benefit limit (presently \$90,000):

(i) Based on Social Security retirement age

(ii) "Floor" of \$75,000 for retirement at age 55 is eliminated

(iii) Reduced 1/10 for each year of participation less than 10; e.g., after one year of participation, defined benefit limit is only \$9,000; two years, \$18,000, etc.

9. 401(k) provisions in master plans

Section 1142 of TRA '86 requires the IRS to begin accepting applications by May 1, 1987 from sponsoring organizations of master plans with regard to 401(k) provisions.

B. Changes Applicable to Tax Qualified Plans Generally Effective After 1989

1. Minimum Coverage Requirements

a. Identification of "Highly Compensated"

b. Alternative Coverage Tests

(i) Percentage test - the plan must benefit at least 70% of employees who are not highly compensated employees

(ii) Ratio test - the plan benefits a percentage of nonhighly compensated employees which is at least 70% of the percentage of highly compensated employees benefiting under the plan

- (ii) Average benefit test - the plan must benefit a nondiscriminatory class of employees and the average benefit percentage for nonhighly compensated employees is at least 70% of the average benefit percentage for highly compensated employees

2. Minimum Participation Requirements

- a. Plan must benefit lesser of 40% of all employees, or 50 employees

3. Minimum Vesting Requirements

- a. Five-year cliff vesting
- b. Seven-year graded vesting
- c. Top-heavy vesting still applicable to top-heavy plans

4. Compensation in excess of \$200,000 not to be taken into account in determining contributions or benefits

5. Changes in the manner in which plans may be integrated with Social Security

C. Welfare Plan Requirements - IRC § 89.

1. Nondiscrimination Rules for Health and Life Benefits

Uniform nondiscrimination rules are extended to all employer provided health and life benefits for years beginning after the later of (a) December 31, 1987, or (b) the earlier of (i) the date three months following the issuance of Treasury Regulations or (ii) December 31, 1988.

- a. Types of Plans. Health and life benefits subject to these nondiscrimination rules include employer maintained group term life insurance, and accident and health benefit plans (whether insured or self-insured).
- b. Noncompliance Penalty. If a plan is discriminatory, highly compensated employees are taxed on the value of the "excess benefit" received for the plan year ending with or within the employer's taxable year. The "excess benefit" for a highly compensated employee is the excess of the employer provided benefit over the "highest permitted benefit". The highest permitted benefit is determined by reducing



the nontaxable benefits of highly compensated employees until the plan would not be discriminatory. The value of "excess benefits" under a discriminatory group term life insurance plan is the greater of the actual cost of the excess coverage or the value of the excess coverage determined from the table under IRC Section 79(c). No guidance has been developed for determining the value of employer provided benefits under a discriminatory health and accident plan.

c. **Discrimination Test.** The purpose of a discrimination test is to insure that a significant number of rank and file employees are eligible for and actually receive plan benefits. For a plan to satisfy the nondiscrimination rules, it must satisfy either a two-part eligibility test, plus a 75% benefits test, or an alternative test.

(i) **The Three-Part Test.** A plan satisfies the three-part test if it satisfies each of two separate eligibility tests (the 50% test and the 90%/50% test), plus a benefits test. A plan satisfies the 50% test if at least 50% of the employees eligible to participate in the plan are nonhighly compensated employees. A plan satisfies the 90%/50% test if at least 90% of the nonhighly compensated employees are eligible to participate in the plan or in another health plan of the employer, and the employer provided benefit available to nonhighly compensated employees under each plan is at least 50% of the largest employer provided benefit available to a highly compensated employee under any such plan. A plan satisfies the benefits test if the average employer provided benefit received by nonhighly compensated employees under all health plans of the employer is equal to at least 75% percent of the average employer provided benefit received by highly compensated employees under all such plans.

(ii) **Alternative Test.** A plan satisfies the alternative test if at least 80% of the nonhighly compensated employees are covered by the plan.

2. **Written Plan Document Requirement.** A plan subject to IRS Section 89(k)(2) is required to (a) be in

writing (b) provide that employees' rights under the plan are legally enforceable, (c) be maintained for the exclusive benefit of employees, and (d) be established with the intent that it be permanent. Plans subject to IRC Section 89 include not only health or accident plans and group term life insurance plans, but also dependent care assistance programs, qualified tuition reduction programs, cafeteria plans, program providing no additional cost services, qualified employee discounts or employer operated eating facilities, or plans providing benefits subject to the nondiscrimination rules under IRC Section 505. If the listed requirements are not satisfied with respect to a plan or program, the value of benefits provided an employee under the plan are included in the employee's gross income.

## **II. SINGLE-EMPLOYER PENSION PLANS AMENDMENTS ACT OF 1986**

SEPPAA was signed into law on April 7, 1986 as part of the Consolidated Omnibus Budget Reconciliation Act of 1986.

SEPPAA changes the substantive law and procedures for termination of a defined benefit pension plan. Plan terminations are now classified as standard or distress terminations.

A standard termination occurs if a plan has sufficient funds to pay all benefits required under the plan. A distress termination occurs if the plan sponsor (and each substantial member of its controlled group) is either involved in a liquidated proceeding, involved in a reorganization proceeding or is unable to meet its financial obligations. For purposes of the PBGC and the IRS, a purported termination which is not a standard termination or a distress termination is ineffective.

## **III. CONTINUATION OF HEALTH INSURANCE**

### **A. Coverage**

COBRA also amended the Internal Revenue Code and ERISA to provide that certain employees and their family members be allowed to elect to continue coverage under an employer's group health plan upon certain "qualifying events".

### **B. Qualifying Events**

1. Death of a covered employee

2. Termination or reduction of hours of a covered employee
  3. Divorce or legal separation of a covered employee
  4. A covered employee's eligibility for benefits under Title XVIII of the Social Security Act and (e) loss of status as a "dependent" under the terms of the plan.
- D. Individuals who may elect continuation coverage include the covered employee, and anyone who on the day before an event described above was the spouse or dependent child of a covered employee.
- E. Continuation of coverage is required for group health plans for plan years beginning on or after July 1, 1986 and applies to plans of employers who normally employ at least 20 employees on a typical business day. Continuation applies to conventional insurance plans and self-insured plans. Church and U.S. government group health plans are exempt, but state and local government plans are subject to similar continuation coverage requirements.
- F. The maximum period of continued coverage is 18 months in the case of a termination of employment or reduction of hours, and 36 months in all other situations.
- G. The employer may require the individual electing continuation coverage to pay the premiums for that coverage.
- H. Penalties for failure to comply with these rules include loss of income tax deduction for the cost of the plan. Additionally, highly compensated individuals would not be allowed to exclude from income the employer contributions to the plan attributable to them. Finally, the plan administrator is personally liable to a participant or beneficiary in the amount of \$100 a day for each day he failed to give the required notice.

#### IV. AGE DISCRIMINATION IN EMPLOYMENT ACT

P.L. 99-509 amends ADEA, ERISA and the Internal Revenue Code with regard to participation in employee benefit plans after attaining "normal retirement age." Benefit accruals in defined benefit plans and allocations under defined contribution plans may not cease or decrease merely because a

participant attains the normal retirement age specified in the plan.

Further, unlike prior law, defined benefit plans may no longer exclude from participation an employee hired within five years of the plan's normal retirement age. However, a defined benefit plan may provide that the normal retirement age for employees hired within five years of the plan's normal retirement age will be five years after the employee becomes a participant in the plan. P.L. 99-509 applies not only to plans of employees who are subject to ADEA, but also to ERISA plans and tax qualified retirement plans.

P.L. 99-509 is effective for plan years beginning on or after January 1, 1988 with respect to employees who complete at least one hour of service after that effective date. For plans maintained pursuant to collective bargaining agreements ratified before March 1, 1986, the effective date of (a) the later of, January 1, 1988 or the termination of the collective bargaining agreement, or (b) January 1, 1990.

#### V. GLASS - STEAGALL ACT.

Generally, the Glass-Steagall Banking Act of 1933 generally prohibits banks from becoming involved in the sale and marketing of securities. The Comptroller of the Currency issued a ruling approving a bank collective investment fund to create a collective investment trust, enabling individual IRA owners to purchase units of beneficial interest in stock portfolios managed by the bank.

The Comptroller's rulings have been upheld in the Second Circuit and the District of Columbia Circuit. Investment Company Institute v. Clarke, 793 F.2d 220 (CA2, 1986); Investment Company Institute v. Conover, 790 F.2d 925 (C.A.D.C. 1986).

#### V. FIDUCIARY RESPONSIBILITY AND PROHIBITED TRANSACTIONS, UNDER ERISA.

- A. DOL Information Letter of August 1, 1986 Concerning "Sweep Services". Attachment 1.

The issue presented in the Information Letter is the extent to which the practice of banks of "sweeping" idle cash balances of assets of employee benefit plans of which it is a fiduciary into its in-house short term investment vehicles violates the prohibited transaction provisions of Section 406(a) and (b) of ERISA. Generally, the Information Letter concludes that a bank engages in a violation of Section 406(b) of ERISA whenever it uses its fiduciary authority or control with respect to plan

funds to increase the amount of its compensation by determining the time and/or the amount of plan funds to be transferred into the sweep fund.

- B. DOL Advisory Opinion of August 29, 1986 Concerning Performance Based Fees for Investment Services. Attachment 2.
- C. ERISA Technical Release No. 86-1 concerning Soft Dollar and Directed Commission Arrangements, May 22, 1986. Attachment 3.
- D. Foltz v. U.S. News and World Report, Inc., 627 F. Supp 1143 (D. D.C. 1986). The court held that a nonfiduciary of an ERISA pension plan could have co-liability under ERISA with a fiduciary for violations of Title I of ERISA if the nonfiduciary "participates" in a breach of fiduciary duty by the fiduciary, even if the nonfiduciary does not gain from its conduct.

#### VII. MISCELLANEOUS.

- A. G.C.M. 39385, July 19, 1985. In determining whether or not to make retroactive its revocation of a favorable ruling with respect to qualified trusts, the employers, and the plan participants, in the case of a defective master plan sponsored by a bank, the Commissioner may consider the imposition on the plan sponsor (i.e., bank) of sanctions that are voluntarily agreed to by the sponsor of the master plan.
- B. Rev. Rul. 85-62, 1985-20 I.R.B. 34 (5/20/85). The subject of this ruling are arrangements under which an institution offers to pay interest in excess of the market rate on IRA contributions, but only if an accompanying deposit is made to another account such as a NOW or regular savings account (which may be paying relatively low interest). The IRS held that the substance of these arrangements is that the "excess" earnings on the IRA should be treated as earned in the first instance by the taxable savings account and then contributed to the IRA. Thus, the taxpayer may be subject to the 6% penalty on excess contributions to an IRA and may be subject to the 10% premature distribution penalty when the excess is withdrawn.
- C. ERISA Preemption of KRS 132.020 and 132.043. When Congress enacted ERISA, it attempted to create a uniform

system for regulating employee benefit plans. To assure that state laws would not interfere with this uniform system, ERISA included a preemption provision, Section 514. Section 514 states that ERISA "shall supersede any and all State laws insofar as they now or hereafter relate to any employee benefit plan" covered by Title I of ERISA. ERISA does not preempt state laws relating to insurance, banking, securities or criminal law, since these are specifically excluded from the preemption provisions under Section 514.

The phrase "relate to any employee benefit plan" has been the major source of court interpretation with regard to what state laws are preempted by ERISA. The Supreme Court used the statutory language of Section 514 and its legislative history to interpret the phrase "relate to" in its broadest statutory meaning. Shaw v. Delta Airlines, Inc., 463 U.S. 85 (1983). The Court held that a law related to an employee benefit plan, in the normal sense of that phrase, if it has a connection with or reference to such a plan. Shaw v. Delta Airlines, Inc., page 90. The Court did, however, refuse to draw a bright line between when state laws relate to any employee benefit plan and when "state actions may affect employee benefit plans in too tenuous, remote or peripheral a manner" to be preempted under Section 514. Therefore, courts must continue to interpret whether a state law "relates to" employee benefit plans in such a way as to be preempted by ERISA.

1. Preemption of KRS 132.043. KRS 132.040 imposes a tax of 1/10th of one cent on each \$100 of interest an individual has in a retirement plan. The statute further sets up a procedure for payment of the tax on behalf of the individual by the plan administrator, trustee, etc. While the issue has not been judicially determined, there appears to be little doubt that KRS 132.043 "relates to" any employee benefit plan covered by Title I of ERISA under the Shaw test. The statute covers an individual's interest in any retirement plan which is exempt from federal income taxes. Furthermore, it sets up procedures for the plan's fiduciaries to follow for payment of the tax. Moreover, since the statute serves no function other than taxation of retirement plans, it clearly does not regulate one of the excluded areas. National Carriers Conference Committee v. Heffernan, 454 F. Supp. 914 (1978, DC Conn.) and Northwest Airlines, Inc. v. Roemer, 603 F. Supp. 7 (1984 DC Minn.).

Note that, if a retirement plan is subject to KRS 132.043, subsection (2) provides that no other tax shall be assessed by the state or by any county,

city, school district or other taxing district on any such right or interest or against the holder of any such right or interest.

2. Preemption of KRS 132.020. KRS 132.020 imposes an ad valorem tax of \$.25 per \$100 value of money, stock, notes, bonds, accounts and other credits. This tax is not assessed directly against employee benefit plans nor exclusively against assets of plans, however, the tax does apply to employee benefit plan assets.

The tax is paid by the trustee. Therefore, this tax indirectly "relates to" employee benefit plans. A U.S. District Court in California held that a similar tax was preempted by Section 514 of ERISA as it related to employee benefit plans. General Motors Corporation v. California State Board of Equalization, 600 Fed. Supp. 76 (1984), which involved an insurance franchise tax which was assessed against insurance policies held by an employee benefit trust. The District Court held that this tax impeded the discretion of the plan fiduciary to fund plan benefit guarantees. The same argument could be made for the ad valorem tax imposed by KRS 132.020, as a plan fiduciary may be more likely to invest plan assets in other forms to avoid the ad valorem tax.



## ATTACHMENT 1

Text

**LABOR DEPARTMENT INFORMATION LETTER ON THE APPLICATION OF THE PROHIBITED TRANSACTION PROVISIONS TO 'SWEEP SERVICES' OFFERED BY BANKS**

Mr. Robert S. Plotkin  
 Assistant Director  
 Division of Banking Supervision  
 and Regulation  
 Board of Governors of the  
 Federal Reserve System  
 Washington, D.C. 20551

Dear Mr. Plotkin:

Aug. 1, 1986

This is in response to your letter requesting our views regarding the application of the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (ERISA) to certain "sweep services" provided to employee benefit plans by banks acting as trustees and/or investment managers. Under such arrangements, banks transfer ("sweep") idle cash balances of customer accounts, including plan accounts, into short term interest-bearing investment vehicles such as money market funds or bank-affiliated short-term collective investment funds. You have specifically asked whether such "sweep services" would qualify for the statutory exemptions provided by sections 408(b)(2), 408(b)(6) and/or 408(b)(8) of ERISA.

You indicate that the bank regulatory agencies for many years have been advising the institutions subject to their supervision of their duty to institute cash management procedures and to productively invest trust funds that are temporarily in their custody. Recent technological advances have permitted increased investment returns to trust accounts by the sweeping of once idle cash balances into interest-bearing investment vehicles. You further state that typically, as compensation for its sweep services, a bank retains as its fee a portion of the daily interest generated by the sweep fund, which fee is calculated as a percentage of the daily invested cash balance. In the case of an employee benefit plan, you believe that this compensation retained by a bank may violate the prohibited transaction provisions of ERISA in the absence of an applicable statutory exemption.<sup>1</sup>

Section 406(a) of ERISA provides, in pertinent part, that a fiduciary of an ERISA plan shall not cause the plan to engage in a transaction which the fiduciary knows or should know constitutes a direct or indirect: (1) sale or exchange, or leasing of any property between the plan and a party in interest; (2) furnishing of goods, services, or facilities between the plan and a party in interest; or (3) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 3(14) defines the term "party in interest" to include a fiduciary and a person providing services to the plan. In addition, section 406(b) provides that a fiduciary with respect to a plan shall not: (1) deal with the assets of the plan in its own interest or for its own account; (2) act on behalf of or represent a party whose interests are adverse to those of the plan; or (3) receive consideration from a third party in connection with a transaction involving plan assets.

<sup>1</sup> Your request appears to be limited to the situation where the bank fiduciary sweeps idle cash balances into its in-house short-term investment vehicles. Accordingly, our response focuses on that situation and does not address the sweep of cash balances into short-term vehicles maintained by parties unrelated to the bank.

ERISA section 408(b)(2) exempts from the prohibitions of section 406(a) the payment by a plan to a party in interest, including a fiduciary, for a service (or a combination of services) if: (1) the service is necessary for the establishment or operation of the plan; (2) the service is furnished under a contract or arrangement which is reasonable; and (3) no more than reasonable compensation is paid for the service. Accordingly, the mere provision of cash sweep services by a bank or similar institution would be exempt from the prohibitions of ERISA section 406(a) if the conditions of the exemption described in section 408(b)(2) were met.<sup>2</sup>

With respect to the prohibitions in section 406(b), regulation 29 CFR 2550.408b-2(a) indicates that ERISA section 408(b)(2) does not contain an exemption for an act described in ERISA section 406(b) (relating to conflicts of interest on the part of fiduciaries) even if such act occurs in connection with a provision of services which is exempt under section 408(b)(2). As explained in regulation 29 CFR 2550.408b-2(e)(1), if a fiduciary uses the authority, control, or responsibility which makes it a fiduciary to cause the plan to enter into a transaction involving the provision of services when such fiduciary has an interest in the transaction which may affect the exercise of its best judgment as a fiduciary, a transaction described in section 406(b) would occur, and that transaction would be deemed to be a separate transaction from the transaction involving the provision of services and would not be exempted by section 408(b)(2).

As a general matter, a bank engages in violations of section 406(b)(1) whenever it uses its fiduciary authority or control with respect to plan funds to increase the amount of its compensation by determining the timing and/or the amount of plan funds to be transferred into the sweep fund.<sup>3</sup> Conversely, section 29 CFR 2550.408b-2(e)(3) indicates that if a bank provides sweep services without the receipt of additional compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services within the meaning of 29 CFR 2550.408c-2(b)(3)), then the provision of sweep services by the bank would not, in itself, constitute a violation of section 406(b) of ERISA. Moreover, the provision by a bank of investment management services, including sweep services, under a single fee arrangement which is calculated as a percentage of the market value of the total assets under management would not, in itself, constitute an

<sup>2</sup> The Department notes that, although section 408(b)(2) of ERISA provides relief for the furnishing of goods in the course of, and incidental to, the furnishing of services to a plan, the statutory exemption for services does not extend to underlying investment transactions, such as sales or extensions of credit otherwise described in section 406 of ERISA. Rather, section 408(b)(2) provides relief from the restrictions of section 406(a) only for those service transactions which satisfy the conditions of section 408(b)(2) and the regulations thereunder. For example, if a bank fiduciary sells repurchase agreements to a plan under a sweep service arrangement, section 408(b)(2) may provide relief for the provision of such sweep service, but does not provide relief for the acquisition of the repurchase agreements from the bank.

<sup>3</sup> In this regard, the Department expresses no opinion as to whether the underlying investment transaction itself is the subject of statutory or administrative relief. See, for example, sections 408(b)(4) and 408(b)(8) of ERISA.



act described in section 406(b)(1) of ERISA because the bank would not be exercising its fiduciary authority or control to cause a plan to pay an additional fee.

The following examples illustrate the application of the provisions of section 408(b)(2) of ERISA to sweep service arrangements. The examples assume that the underlying investment transactions otherwise comply with applicable statutory exemptions.

(1) A plan enters into a standing arrangement with its bank investment manager which authorizes the bank to exercise its discretion to sweep idle cash balances into the bank's money market fund. For this service, the bank will charge the plan a fee calculated as a percentage of the daily invested cash balance in the money market fund. In effect, the bank would be using its fiduciary authority to cause the plan to pay an additional fee for a service performed by the bank in violation of section 406(b)(1) of ERISA. Although there would be initial approval of the arrangement by the plan, thereafter the bank would have total discretion to transfer plan funds into the money market fund and to determine how long the plan funds remain in such fund, thereby increasing its compensation. In this respect, we note that a bank which exercises its fiduciary authority in a manner which contravenes section 406(b)(1) cannot avoid liability simply by obtaining the consent of an independent plan fiduciary after disclosure to that fiduciary. See 29 CFR §2550.408b-2(f), Example (2).

(2) Bank A proposes to provide investment management services, including sweep services, to plans under a single fee arrangement which is calculated as a percentage of the market value of the plan funds under management. There will be no separate charges for the provision of sweep services. Under these circumstances, the provision by Bank A of investment management services, including sweep services, would not, in itself, constitute a violation of section 406(b)(1) because the bank would not be using its fiduciary authority or control to cause a plan to pay additional fees for a service furnished by the Bank. We are assuming for purposes of this example that the total fees to be paid by a plan are reasonable in light of the investment management services received by that plan.

(3) Trustee Bank B proposes to enter into an arrangement with a plan for the provision of sweep services under the following circumstances. The Bank would have a standing authorization whereby, at the close of each business day, the Bank would be required to sweep all uninvested cash in excess of \$100 into the Bank's money market fund. For this service, the Bank will charge the plan a fee calculated as a percentage of the daily invested cash balance in the money market fund. Investment Manager C, who is unrelated to the Bank, is the plan's investment manager as described in section 3(38) with the power to acquire or dispose of the plan's assets. C has sole discretion as to when money will be withdrawn from the fund. The plan's arrangement with the Bank is subject to immediate termination without penalty and requires that the Bank notify the plan no less than 30 days prior to any change in the fees to be charged for its provisions of sweep services. This arrangement does not violate section 406(b)(1) because the Bank would not be exercising any of its fiduciary authority or control to cause the plan to pay an additional fee.

You further indicate that some banks have been relying on the exemption provided by section 408(b)(6) of ERISA. Section 408(b)(6) exempts from the prohibitions of section 406 the provision of certain ancillary services by a bank or

similar financial institution supervised by the United States or a State to a plan for which it acts as a fiduciary if the conditions of 29 CFR 2550.408b-6(b) are met. Such ancillary services include services which do not meet the requirements of ERISA section 408(b)(2) because the provision of such services involves an act described in section 406(b)(1) or (b)(2) of ERISA. Section 2550.408b-6(b) requires that such services must be provided at not more than reasonable compensation; under adequate internal safeguards which assure that the provision of such service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority; and only to the extent such service is subject to specific guidelines issued by the bank or similar financial institution which meet the requirements of section 2550.408b-6(c). To date, no regulations have been issued clarifying that section. However, the Department has stated that the condition contained in section 408(b)(6)(B) requiring "specific guidelines" is satisfied (in the absence of such regulations) if the ancillary services are provided in accordance with specific guidelines issued by the bank or similar financial institution, and if adherence to the guidelines would reasonably preclude such bank or institution from providing the services in an excessive or unreasonable manner and in a manner that would be inconsistent with the best interests of the participants and beneficiaries. (See 47 FR 14806, April 6, 1982.)

A bank which is a fiduciary to a plan may receive additional fees for additional services rendered only if such services are "ancillary services." In the Department's view, the question of whether short-term cash management services constitute "ancillary services" within the meaning of section 408(b)(6) depends on the expectations of the parties as evidenced by the terms of the governing instrument and applicable Federal banking law. Thus, for example, the Department believes that where a plan appoints a bank trustee or investment manager with complete discretion to manage the assets placed in its control, and no provision for short-term cash management is made under the terms of the governing instrument, the plan does so with the expectation that such person will minimize uninvested cash balances and maximize the plan's rate of return in accordance with evolving technology for short-term cash management. However, where, for example, a plan appoints an independent investment manager to manage plan assets, the provision by a custodial trustee bank of sweep services for any idle cash balances may constitute an "ancillary service" within the meaning of section 408(b)(6). At the present time, the Department is not prepared to conclude that section 408(b)(6) is available in all cases for the arrangements described in your letter.

You further indicate that some banks appear to be relying on the exemption provided by ERISA section 408(b)(8) to invest plan funds in collective trust funds maintained by such banks. Section 408(b)(8) of ERISA provides an exemption for any transaction between a plan and a common or collective trust fund maintained by a bank or trust company supervised by a State or Federal agency, if (a) the transaction is a sale or purchase of an interest in the fund, (b) the bank or trust company receives not more than reasonable compensation, and (c) the transaction is expressly permitted by the instrument under which the plan is maintained, or by a fiduciary (other than the bank or trust company, or an affiliate thereof) who has authority to manage and control the assets of the plan. The Department has been unwilling to indicate the extent to which section 408(b)(8) provides relief from the prohibitions of section 406(b) of ERISA (See 44 FR

44291 n. 3, July 27, 1979). However, if the bank does not exercise its fiduciary authority to cause a plan to pay an additional fee or other compensation in connection with the acquisition by a plan of an interest in a collective trust fund or for the provisions of services under such fund, the investment would not, in itself, involve acts described in section 406(b)(1) of ERISA.

We hope these comments have been helpful. However, if

you should have any further questions or if we can provide any further assistance, please feel free to contact Ivan Strasfeld at (202) 523-8671.

Sincerely,

Alan D. Lebowitz  
Deputy Administrator for  
Program Operations



## ATTACHMENT 2

**LABOR DEPARTMENT ADVISORY OPINIONS ON PAYMENT BY PLANS OF PERFORMANCE-BASED  
COMPENSATION TO INVESTMENT MANAGERS**

Mr. Charles B. Schaffran  
Shulte, Roth & Zabel  
900 Third Avenue  
New York, NY 10022

Aug. 29, 1986  
OPINION NO. 86-20A  
Sec. 406(b), 404(a), 405

Re: BDN Advisers, Inc.  
Identification Number: F-3257A

Dear Mr. Schaffran:

This is in response to your request for an advisory opinion on behalf of BDN Advisers, Inc. (BDN) that the payment of incentive compensation to BDN by employee benefit plans will not result in a violation of section 406(b) of the Employee Retirement Income Security Act of 1974 (ERISA) or section 4975 of the Internal Revenue Code of 1954 (the Code).<sup>1</sup>

You represent that BDN is a corporation registered as an investment adviser under the Investment Advisers Act of 1940. BDN will manage plan investments in securities on a discretionary basis for individual accounts and/or as general partner of limited partnerships having plan investors. The decision to retain BDN and to pay an incentive fee will be made by a plan fiduciary who is independent of BDN. Plans retaining BDN as investment manager (or investing in limited partnerships to which BDN is a general partner) will be large plans having total plan assets of \$50,000,000 or more, and no plan will be permitted to place more than ten percent of its total assets under BDN's management.<sup>2</sup>

BDN's fee structure will consist of an "incentive fee" and, in most instances, a "base fee." You contemplate that the base fee, subject to arm's-length negotiation in the case of each client, will be a percentage of the average of the account's net asset value at the beginning and end of each quarter during which BDN serves as investment manager and will be paid on the first day of the following quarter. The base fee will be charged irrespective of whether BDN has earned an incentive fee for the same period.

The incentive fee, if any has been earned, will be paid by the client at the end of each year. You anticipate that this fee will be a percentage, subject to arm's length negotiation in the case of each client, of the "net capital appreciation" of the client's assets. "Net capital appreciation" is defined to mean the increase in the value of the assets in the client's account from the beginning of each year of investment management through the valuation date which is set forth in the contract pursuant to which BDN is retained.

<sup>1</sup> Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Therefore, the references in this letter to specific sections of ERISA refer also to the corresponding sections of the Code.

<sup>2</sup> You further indicate that plans of this size generally operate through investment committees, whose members are often senior financial officers of the corporate plan sponsor who have considerable business and investment acumen. These committees take an active role in determining where and in what fashion plan assets should be invested.

In calculating net capital appreciation on all securities (including any securities for which market quotations are not readily available), all realized and unrealized gains and losses experienced during the year, as well as income received during the year, will be taken into account.<sup>3</sup> In the event that the assets in the client's account have not appreciated during the year, no performance fee will be paid to BDN.

You anticipate that BDN will generally invest plan assets in securities for which market quotations are readily available within the meaning of Rule 2a-4(a)(1) under the Investment Company Act of 1940 (17 CFR §270.2a-4).

For purposes of calculating BDN's fee, securities which are listed on a national securities exchange will be valued based on their last sales price on the national securities exchange on which such security is principally traded or, if trading in such securities on such exchange was reported on the consolidated tape, the last sales price on the consolidated tape (or, in the event that the valuation date is not a date upon which such exchange was open for trading, on the last prior date on which such exchange was so open).

In the event that no sales of securities listed on a national securities exchange occurred on either of the foregoing dates, such securities shall be valued based on the mean between the last "bid" and "asked" prices on the national securities exchange on which such securities are principally traded, or, if "bid" and "asked" prices in such securities were reported on the consolidated tape, the mean between the last "bid" and "asked" prices on the consolidated tape (or, in the event that the valuation date is not a date upon which such exchange was open for trading, on the last prior date on which such exchange was so open). Securities which are not listed on a national securities exchange shall be valued based upon the mean of their representative last closing "bid" and "asked" prices unless they were included in the NASDAQ National Market, in which case they shall be valued based upon their last sales prices (if such prices are available).

For securities for which market quotations are not readily available, valuation will be made by the plan's custodian, trustee or other qualified party selected by the plan, which party will be independent of BDN. The plan will have the exclusive authority to terminate the party who will value these securities. The valuation by the independent party will be binding upon BDN.<sup>4</sup>

<sup>3</sup> You represent that the base fee paid to BDN will be subtracted from the appreciation in the client's account in order to arrive at "net capital appreciation."

<sup>4</sup> For purposes of this opinion, the Department assumes not only that the custodian, trustee or other qualified party selected by the plan is independent of BDN but also that it will make independent valuations of the securities on behalf of the plan. In this respect, the issue of whether a person is independent of an investment manager and the issue of what constitutes an independent valuation are factual questions to be resolved on the basis of all the surrounding facts and circumstances. The Department ordinarily does not issue advisory opinions on inherently factual issues. See section 5.01 of ERISA Procedure 76 1 (41 FR 36281, August 27, 1976).

You represent that the right of a plan to terminate an investment management agreement will meet the requirements of the Department's regulation section 29 CFR 2550.408(b)-2(c), which requires that service contracts must be terminable by plans "on reasonably short notice under the circumstances."

In the event that an investment management agreement is terminated during the first year, BDN will be paid a fee based upon a percentage of assets under management which will be negotiated in advance and set forth in the investment management agreement. In the event that an investment management agreement is terminated on other than an anniversary date, net capital appreciation will be determined for the period from the commencement of the preceding full year of management of the client's assets through the termination date. BDN's incentive fee for the prior year will be readjusted in accordance with such calculation. Should the net capital appreciation for the new period be less than the net capital appreciation which had previously been calculated for the prior year, BDN will refund to the client any excess fee it had received.

You represent that BDN's incentive compensation arrangement will comply with the terms and conditions of SEC Rule 205-3 governing performance compensation arrangements (50 FR 40556 (1985) (to be codified at 17 CFR §275.205-3)). You further state that the total fee paid to BDN for each year's performance (the base fee plus the incentive fee) will in no case exceed reasonable compensation for services performed by BDN.

You have asked for an advisory opinion that the payment by plans to BDN of an incentive fee in accordance with the arrangement described above will not constitute a violation of section 406(b) of ERISA.

Section 406(a)(1)(C) and (D) of ERISA provides that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest or transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 406(b)(1) of ERISA provides that a fiduciary with respect to a plan shall not deal with plan assets in his own interest or for his own account. Section 406(b)(2) of ERISA provides that a fiduciary with respect to a plan shall not in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants and beneficiaries.

Section 3(14) of ERISA defines the term "party in interest" to include a fiduciary and a person providing services to a plan.

Section 408(b)(2) of ERISA exempts from the prohibitions of section 406(a) any contract or reasonable arrangement with a party in interest, including a fiduciary, for office space, or legal, accounting or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore. Regulations issued by the Department of Labor (the Department) clarify the terms "necessary service" (29 CFR 2550.408b-2(b)), "reasonable contract or arrangement" (29 CFR 2550.408b-2(c)) and "reasonable compensation" (29 CFR 2550.408b-2(d) and 2550.408c-2) as used in section 408(b)(2). In this regard, you have not requested an opinion that the proposed provision of services by BDN complies with the requirements of section 408(b)(2) of ERISA. As a general matter, whether the requirements of this section are met in each case involves questions which are inherently factual in nature. As noted

above, the Department ordinarily does not issue opinions on such matters.

With respect to the prohibitions in section 406(b), the regulation under section 408(b)(2) of ERISA (29 CFR 2550.408b-2(a)) states that section 408(b)(2) of ERISA does not contain an exemption for an act described in section 406(b) even if such act occurs in connection with a provision of services which is exempt under section 408(b)(2).

As explained in regulation section 29 CFR 2550.408b-2(e), the prohibitions of section 406(b) are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility which makes them fiduciaries when they have interests which may conflict with the interests of the plans for which they act. Thus, a fiduciary may not use the authority, control, or responsibility which makes him a fiduciary to cause a plan to pay an additional fee to such fiduciary, or to a person in which he has an interest which may affect the exercise of his best judgment as a fiduciary, to provide a service. However, regulation section 29 CFR 2550.408b-2(e)(2) provides that a fiduciary does not engage in an act described in section 406(b)(1) of ERISA if the fiduciary does not use any of the authority, control, or responsibility which makes him a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which the fiduciary has an interest which may affect the exercise of his best judgment as a fiduciary.

You represent that BDN's fee will be based upon a percentage of the net appreciation of plan assets, taking into account both realized and unrealized gains and losses during a pre-established valuation period. You further represent that investments will be made in securities for which market quotations are readily available or that persons appointed by the plan and independent of BDN will make an independent valuation of securities for which market quotations are not readily available.

Based on the representations contained in your submissions, it is the Department's view that the payment of an incentive fee pursuant to the arrangement described above would not, in itself, constitute a violation of section 406(b)(1) of ERISA. The amount of compensation which BDN would earn depends solely on the changes in value of the securities in the individual account or limited partnership, as determined by readily available market quotations or independent appraisals. Therefore, in the situation you describe, it appears that BDN would not be exercising any of its fiduciary authority or control to cause a plan to pay an additional fee. Moreover, it does not appear that BDN would be acting on behalf of, or representing, a person whose interests are adverse to the plan merely because it enters into an agreement to provide investment management services pursuant to the arrangement described above. Accordingly, based on your representations, it is the Department's view that payment of an incentive fee pursuant to such arrangement would not, in itself, constitute a violation of section 406(b)(2) of ERISA. However, because violations of sections 406(b)(1) and 406(b)(2) could occur in the course of the provision of services by BDN, the Department is not prepared to rule that the described arrangement, in operation, would not violate those sections. Thus, for example, the Department is not addressing issues relating to a fiduciary's

<sup>1</sup> We note that you represent that BDN will not be a market maker with respect to securities in which it causes plan assets to be invested.

allocation of investment opportunities among accounts over which he has discretion.

ERISA's general standards of fiduciary conduct also would apply to the proposed arrangement. Section 404 requires, among other things, a fiduciary to discharge his duties respecting a plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion. Accordingly, the plan fiduciary must act prudently with respect to the decision to enter into an incentive compensation arrangement with an investment manager, as well as to the negotiation of the specific formula under which compensation will be paid. The Department further emphasizes that it expects a plan fiduciary, prior to entering into an incentive compensation arrangement, to fully understand the compensation formula, and the risks associated with this manner of compensation, following disclosure by the investment manager of all relevant information pertaining to the proposed arrangement. In addition, such plan fiduciary must be capable of periodically monitoring the actions taken by the manager in the performance of its investment duties. Thus, in considering whether to enter into an arrangement of the kind described in your letter, a fiduciary should take into account its ability to provide adequate oversight of the investment manager. Finally, we also note that, under section 405(a) of ERISA, any plan fiduciary (including an investment manager) will have co-fiduciary liability for any breach of fiduciary responsibility of another plan fiduciary: (1) if he knowingly participates in or conceals such breach; (2) if by his failure to comply with section 404(a)(1), he enables another fiduciary to commit such a breach; or (3) if he has knowledge of the breach of another fiduciary and he fails to make a reasonable effort to remedy the breach.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 relating to the effect of advisory opinions. This letter relates only to those issues that you expressly raised in your request.

Sincerely,  
/s/Dennis M. Kass  
Assistant Secretary

Aug. 29, 1986  
OPINION NO. 86-21A  
Sec. 406(b), 404(a), 405

Mr. John J. Cleary  
Goodwin, Procter & Hoar  
Exchange Place  
Boston, MA 02109

Re: Batterymarch Financial Management  
Identification Number: F-3355A

Dear Mr. Cleary:

This is in response to your request for an advisory opinion on behalf of Batterymarch Financial Management (Batterymarch) that the payment of incentive compensation to Batterymarch by employee benefit plans will not result in a violation of section 406 of the Employee Retirement Income Security Act of 1974 (ERISA) or section 4975 of the Internal Revenue Code of 1954 (the Code).<sup>1</sup>

<sup>1</sup> Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Therefore, the references in this letter to specific sections of ERISA refer also to the corresponding sections of the Code.

You represent that Batterymarch is registered as an investment adviser under the Investment Advisers Act of 1940. Batterymarch presently receives compensation for the provision of investment management services to individual plan accounts based solely on a percentage of assets under management. Batterymarch proposes to give each client plan which has aggregate assets of at least \$50,000,000<sup>2</sup> the option to pay Batterymarch an incentive fee as an alternative to its standard assets under management fee arrangement. The decision of whether to engage Batterymarch as an investment manager pursuant to the incentive fee arrangement will be made by an independent plan fiduciary.

Client plans which elect to enter into an incentive fee arrangement with Batterymarch would pay Batterymarch a "fulcrum fee" which measures the time-weighted total rate of return<sup>3</sup> on the account (including both realized and unrealized gains and losses, and income) in relation to the performance of the Standard and Poor's (S&P) 500 Index over a one-year computation period commencing on the date the incentive fee arrangement becomes effective. During the computation period, each of these plans will pay quarterly fees for Batterymarch's services in accordance with the fee schedule based upon a percentage of assets under management (Base Fee). At the end of the computation period, on a set valuation date, Batterymarch's performance with regard to each plan account will be measured. If that performance exceeds the S&P 500 Index by more than 100 basis points, Batterymarch will be entitled to a bonus calculated as a percentage of the Base Fee. This bonus will be paid by the plan to Batterymarch in equal installments during the four quarters following the initial computation period. Conversely, if Batterymarch's performance during the S&P 500 Index, the plan would receive a credit against fees for services performed by Batterymarch in the following year. This credit will be applied in equal quarterly installments over the four quarters following the computation period. The incentive fee schedule is as follows:

Incentive Fee Schedule

Client's Return vs. S&P 500	Fee Bonus
Plus 0 - 100 Basis Points	0% (of Base Fee)
101 - 300	5%
301 - 400	10%
401 - 500	20%
501 or greater	30%
	<u>Fee Credit</u>
Minus 0 - 300 Basis Points	5% (of Base Fee)
301 - 400	10%
401 - 500	20%
501 or greater	30%

<sup>2</sup> You represent that if Batterymarch manages assets of a number of different plans which are maintained by a single plan sponsor and its affiliates (typically invested on a commingled basis through a master trust), Batterymarch will consider all of such plans to be a single plan for purposes of determining whether the \$50,000,000 threshold has been satisfied.

<sup>3</sup> You represent that "time weighted rate of return" is a method of calculating the rate of return directly attributable to the performance of an investment manager by "neutralizing" contributions and withdrawals of money by plan sponsors which affect the overall amount of plan assets managed by the investment manager. This measurement methodology is recognized by the Bank Administration Institute and is widely used throughout the investment industry.

You represent that securities in which Batterymarch will invest plan assets will be almost exclusively securities for which market quotations are readily available within the meaning of Rule 2a-4(a)(1) under the Investment Company Act of 1940 (17 CFR 270.2a-4), although securities for which market quotations are not readily available may comprise a small percentage (typically no more than one percent) of plan account holdings.

Batterymarch will compute the rate of return on its client plans' accounts as of the last day of the computation period by performing mathematical computations on raw data provided to it by pricing services. Interactive Data Services, Inc., a pricing service, obtains objective information regarding securities for which market quotations are readily available from the National Quotations Bureau tape and provides this information to Batterymarch without charge.

A security listed on a national securities exchange or on the NASDAQ National Market system will be valued based on its last sales price on the national securities exchange on which such security is principally traded. In determining the value, the absolute last sales price on whatever date the last prior sale on that exchange occurred is used.

Securities which are traded in the over-the-counter market (other than securities listed on the NASDAQ National Market) will be valued on the basis of the mean between their last "bid" and "asked" prices.

Each client plan electing the incentive fee arrangement will select (and will have the exclusive authority to terminate) the pricing service, independent of Batterymarch, to value securities for which market quotations are not readily available. Batterymarch will pay the fee of such pricing service.\*

Computation of the total return (taking into account appreciation or depreciation, and income) for the S&P 500 during the computation period will be performed by Batterymarch using purely mathematical computations based upon objective raw data.

Either Batterymarch or plans electing the incentive compensation arrangement may terminate the investment management contract upon sixty days' notice. If the investment management contract is terminated by either party prior to the end of any one-year computation period, the incentive fee will not apply to that period, and Batterymarch's fee for that period will be limited to the Base Fee. However, if a plan continues the investment management relationship beyond the initial one-year period and terminates at any time during a succeeding one-year period, the plan would be obligated to pay to Batterymarch any remaining bonus which had been earned in the preceding computation period, but would forfeit any remaining fee credit accrued during such preceding computation period. If Batterymarch continues the relationship beyond the initial period and terminates the relationship during a succeeding period, any remaining bonus payments with respect to the prior period would

\* For purposes of this opinion, the Department assumes not only that the pricing service is independent of Batterymarch but also that it will make independent valuations of the securities on behalf of the plan. In this respect, the issue of whether a person is independent of an investment manager and the issue of what constitutes an independent valuation are factual questions to be resolved on the basis of all the surrounding facts and circumstances. The Department ordinarily will not issue advisory opinions on inherently factual issues. See section 5.01 of ERISA Procedure 76-1 (41 FR 36281, August 27, 1976). However, in the Department's view, the independence of a pricing service and the independence of its valuations are not necessarily affected by Batterymarch's payment of the pricing service's fee under the circumstances you describe.

remain due and Batterymarch would be liable to pay the client any remaining fee credit. Such payments would be due within ten days after termination of the investment management contract.

Up to thirty days prior to the end of any computation period, a plan will have the option to elect the incentive fee arrangement or the assets under management fee arrangement for the next computation period. Plans which choose to determine Batterymarch's fees under the assets under management fee arrangement will be permitted to switch to the incentive fee arrangement at any time and trigger the start of a new one-year computation period to begin on the first day of the next calendar quarter.

You represent that Batterymarch's incentive fee arrangement will comply with the terms and conditions of SEC Rule 205-3 governing performance compensation arrangements (50 FR 40556 (1985) (to be codified at 17 CFR §275.205-3)). You further state that the total fee paid to Batterymarch for each year's performance (the Base Fee adjusted, as applicable, by a penalty or bonus) will in no case exceed reasonable compensation for services performed by Batterymarch.

You have asked for an advisory opinion that the payment by plans to Batterymarch of an incentive fee in accordance with the arrangement described above will not constitute a violation of section 406 of ERISA.

Section 406(a)(1)(C) and (D) of ERISA provides that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest or transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 406(b)(1) of ERISA provides that a fiduciary with respect to a plan shall not deal with plan assets in his own interest or for his own account. Section 406(b)(2) of ERISA provides that a fiduciary with respect to a plan shall not in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants and beneficiaries.

Section 3(14) of ERISA defines the term "party in interest" to include a fiduciary and a person providing services to a plan.

Section 408(b)(2) of ERISA exempts from the prohibitions of section 406(a) any contract or reasonable arrangement with a party in interest, including a fiduciary, for office space, or legal, accounting or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore. Regulations issued by the Department of Labor (the Department) clarify the terms "necessary service" (29 CFR 2550.408b-2(b)), "reasonable contract or arrangement" (29 CFR 2550.408b-2(c)) and "reasonable compensation" (29 CFR 2550.408b-2(d) and 2550.408c-2) as used in section 408(b)(2).

The provision of investment management services by Batterymarch to plans would be exempt from the prohibitions of section 406(a) of ERISA provided the conditions of section 408(b)(2) are met. Whether the conditions are met in each case involves questions which are inherently factual in nature. As noted above, the Department generally will not issue opinions on such questions. Therefore, plan fiduciaries must determine, based on all the relevant facts and circumstances, whether the conditions of section 408(b)(2) are satisfied.

With respect to the prohibitions in section 406(b), the regulation under section 408(b)(2) of ERISA (29 CFR 2550.408b-2(a)) states that section 408(b)(2) of ERISA does

not contain an exemption for an act described in section 406(b) even if such act occurs in connection with a provision of services which is exempt under section 408(b)(2).

As explained in regulation section 29 CFR 2550.408b-2(e), the prohibitions of section 406(b) are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility which makes them fiduciaries when they have interests which may conflict with the interests of the plans for which they act. Thus, a fiduciary may not use the authority, control, or responsibility which makes him a fiduciary to cause a plan to pay an additional fee to such fiduciary, or to a person in which he has an interest which may affect the exercise of his best judgment as a fiduciary, to provide a service. However, regulation section 29 CFR 2550.408b-2(e)(2) provides that a fiduciary does not engage in an act described in section 406(b)(1) of ERISA if the fiduciary does not use any of the authority, control, or responsibility which makes him a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which the fiduciary has an interest which may affect the exercise of his best judgment as a fiduciary.

You represent that Batterymarch's fee will be based upon its performance in relation to the Standard & Poor's 500 Stock Index, a predetermined index, taking into account both realized and unrealized gains and losses during a pre-established valuation period. You further represent that investments will be made in securities for which market quotations are readily available or that persons appointed by the plan and independent of Batterymarch will make an independent valuation of securities for which market quotations are not readily available.

Based on the representations contained in your submissions, it is the Department's view that the payment of an incentive fee pursuant to the arrangement described above would not, in itself, constitute a violation of section 406(b)(1) of ERISA. The amount of compensation which Batterymarch would earn depends solely on the changes in value of the securities in the individual account, as determined by readily available market quotations or independent appraisals, by comparative reference to a predetermined index.<sup>2</sup> Therefore, in the situation you describe, it appears that Batterymarch would not be exercising any of its fiduciary authority or control to cause a plan to pay an additional fee. Moreover, it does not appear that Batterymarch would be acting on behalf of, or representing, a person whose interests are adverse to the plan merely because it enters into an agreement to provide investment management services pursuant to the arrangement described above. Accordingly, based on your representations, it is the Department's view

<sup>2</sup>We note that you represent that Batterymarch will not be a market maker with respect to securities in which it causes plan assets to be invested.

that payment of an incentive fee pursuant to such arrangement would not, in itself, constitute a violation of section 406(b)(2) of ERISA. However, because violations of sections 406 (b) (1) and 406 (b) (2) could occur in the course of the provision of services by Batterymarch, the Department is not prepared to rule that the described arrangement, in operation, would not violate those sections. Thus, for example, the Department is not addressing issues relating to a fiduciary's allocation of investment opportunities among accounts over which he has discretion.

ERISA's general standards of fiduciary conduct also would apply to the proposed arrangement. Section 404 requires, among other things, a fiduciary to discharge his duties respecting a plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion. Accordingly, the plan fiduciary must act prudently with respect to the decision to enter into an incentive compensation arrangement with an investment manager, as well as to the negotiation of the specific formula under which compensation will be paid (including, where relevant, the choice of an appropriate index in relation to which the investment manager's performance is to be compared). The Department further emphasizes that it expects a plan fiduciary, prior to entering into an incentive compensation arrangement, to fully understand the compensation formula, and the risks associated with this manner of compensation, following disclosure by the investment manager of all relevant information pertaining to the proposed arrangement. In addition, such plan fiduciary must be capable of periodically monitoring the actions taken by the manager in the performance of its investment duties. Thus, in considering whether to enter into an arrangement of the kind described in your letter, a fiduciary should take into account its ability to provide adequate oversight of the investment manager. Finally, we also note that, under section 405(a) of ERISA, any plan fiduciary (including an investment manager) will have co-fiduciary liability for any breach of fiduciary responsibility of another plan fiduciary: (1) if he knowingly participates in or conceals such breach; (2) if by his failure to comply with section 404 (a) (1), he enables another fiduciary to commit such a breach; or (3) if he has knowledge of the breach of another fiduciary and he fails to make a reasonable effort to remedy the breach.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 relating to the effect of advisory opinions. This letter relates only to those issues that you expressly raised in your request.

Sincerely  
/s/Dennis M. Kass  
Assistant Secretary



## ATTACHMENT 3

Text

**ERISA TECHNICAL RELEASE NO. 86-1, LABOR DEPARTMENT STATEMENT ON POLICIES  
CONCERNING SOFT DOLLAR AND DIRECTED COMMISSION ARRANGEMENTS**

**May 22, 1986**

This statement reflects the views of the Pension and Welfare Benefits Administration (PWBA) with regard to "soft dollar" and directed commission arrangements pursuant to its responsibility to administer and enforce the provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Investment managers, plan sponsors and other members of the pension community which provide services to employee plans have expressed a great deal of interest in the application of the fiduciary responsibility provisions of ERISA to these arrangements.

"Soft dollar" and directed commission arrangements typically involve situations in which an investment manager of an employee benefit plan or other plan fiduciary purchases goods or services with a portion of the brokerage commission paid by a plan to a broker for executing a securities transaction. Prior to the elimination of fixed commission rates on stock exchange transactions, investment managers often purchased additional services with commission dollars beyond simple execution, clearance and settlement of securities transactions. After the elimination of fixed commission rates in May 1975, Congress, as part of the Securities Acts Amendments of 1975, added Section 28(e) to the Securities Exchange Act of 1934 (the 1934 Act) to address the practice whereby brokers provided investment managers with brokerage and research services. The Securities and Exchange Commission (the Commission) administers the 1934 Act and has exclusive authority to interpret the scope of Section 28(e) and the terms used therein.

Section 28(e) of the 1934 Act provides generally that no person who exercises investment discretion with respect to securities transactions will be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of paying brokerage commissions for effecting a securities transaction in excess of the amount of commission another broker-dealer would have charged, if such person determined in good faith that the commission was reasonable in relation to the value of brokerage and research services provided by the broker-dealer. The limited safe harbor provided by Section 28(e) is available only for the provision of brokerage and research services to persons who exercise investment discretion with respect to an account as that term is defined in Section 3(a)(35) of the 1934 Act. The Commission has indicated that if a plan fiduciary does not exercise investment discretion with respect to the securities transaction or uses "soft dollars" to pay for non-research related services, the transaction falls outside the protection afforded by Section 28(e) of the 1934 Act and may be in violation of the securities laws and the fiduciary responsibility provisions of ERISA.

It has come to the attention of PWBA that ERISA fiduciaries may be involved in several types of "soft dollar" and directed commission arrangements which do not qualify for the "safe harbor" provided by Section 28(e) of the 1934 Act. In some instances, investment managers direct a portion of a plan's securities trades through specific broker-dealers, who then apply a percentage of the brokerage commissions

to pay for travel, hotel rooms and other goods and services for such investment managers which do not qualify as research within the meaning of Section 28(e).<sup>1</sup> In other instances, plan sponsors who do not exercise investment discretion with respect to a plan direct the plan's securities trades to one or more broker-dealers in return for research, performance evaluation, other administrative services or discounted commissions. The Commission has indicated that the safe harbor of Section 28(e) is not available for directed brokerage transactions.<sup>2</sup>

A fiduciary for an ERISA plan, such as a trustee or investment manager, must meet the fiduciary responsibility standards set forth in part 4 of Title I of ERISA. These standards are designed to help ensure that the fiduciary's decisions are made in the best interests of the plan and are not colored by self-interest.

Section 403(c)(1) provides, in part, that the assets of a plan shall be held for the exclusive purpose of providing benefits to the plan's participants and their beneficiaries and defraying reasonable expenses of administering the plan. Section 404(a)(1) sets forth a similar requirement on how a plan fiduciary must discharge his duties with respect to the plan, and provides further that such fiduciary must act prudently and solely in the interest of the participants and beneficiaries. These basic provisions are supplemented by the *per se* prohibitions of certain classes of transactions set forth in section 406 of ERISA.

Section 406(a)(1)(D) of ERISA prohibits a fiduciary of an ERISA plan from causing that plan to engage in a transaction if he knows or should know that the transaction would constitute a direct or indirect transfer to, or use by or for the benefit of, a party in interest, of any assets of that plan. Section 3(14) includes, within the definition of "party in interest" with respect to a plan, any fiduciary with respect to that plan. Thus, section 406(a)(1)(D) would not only prohibit a fiduciary from causing the plan to engage in a transaction which would benefit a third person who is a party in interest, but it also would prohibit the fiduciary from similarly benefiting himself. In addition, section 406(b)(1) specifically prohibits a fiduciary with respect to a plan from dealing with the assets of that plan in his own interest or for his own account. Section 406(b)(3) supplements these provisions by prohibiting a plan fiduciary from receiving any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

When investment management responsibility has been properly delegated to an investment manager, the manager is responsible for all aspects of the investment process.<sup>3</sup> The

<sup>1</sup> See Securities Exchange Act Release No. 34-23170 (April 23, 1986).

<sup>2</sup> See Section VI of Securities Exchange Act Release No. 34-23170 (April 23, 1986).

<sup>3</sup> Section 405 of ERISA limits the liability of certain plan fiduciaries if management of plan assets has been properly delegated to an investment manager.



manager, in those cases, is required to act prudently both with respect to a decision to buy or sell securities as well as with respect to the decision concerning who will execute the transaction. If such a delegation has occurred, the named fiduciary of the plan is not liable for the particular acts or omissions of the manager but has oversight responsibility to periodically review the investment manager's performance.

Where an investment manager has entered into a "soft dollar" arrangement, Section 28(e) of the 1934 Act does not relieve anyone other than the person who exercises investment discretion from the applicability of the fiduciary provisions of ERISA. Therefore, the fiduciary who appoints the investment manager is not relieved of his ongoing duty to monitor the investment manager to assure that the manager has secured best execution of the plan's brokerage transactions and to assure that the commissions paid on such transactions are reasonable in relation to the value of the brokerage and research services provided to the plan.<sup>4</sup>

It is PWBA's understanding that where a plan sponsor or other plan fiduciary directs the investment manager to execute securities trades for the plan through one or more specified broker-dealers, the direction generally requires the investment manager to execute a specified percentage of the plan's trades or a specified amount of the plan's commission business through the particular broker-dealers, consistent with the manager's duty to secure best execution for the transactions.

A plan sponsor's decision to direct brokerage transactions must be made prudently and solely in the interest of the participants and beneficiaries. In directing a plan's brokerage transactions, the sponsor has an initial responsibility to determine that the broker-dealer is capable of providing best execution for the plan's brokerage transactions. In addition, the sponsor has an ongoing responsibility to monitor the services provided by the broker-dealer so as to assure that the manager has secured best execution of the plan's brokerage transactions and that the commissions paid are reasonable in relation to the value of the brokerage and other services received by the plan.

In considering "soft dollar" and directed commission arrangements, ERISA's prohibited transaction provisions also must be taken into account. A fiduciary with respect to an ERISA plan is generally prohibited, by section 406(b)(1), from causing the plan to engage in a transaction if the fiduciary has an interest in the matter which may affect the fiduciary's best judgment as a fiduciary. For example, an employer which is the named fiduciary for its plan and which does not exercise investment discretion would normally be prohibited from directing the plan's brokerage transactions through a designated broker-dealer who agrees to utilize a portion of the brokerage commissions received from the plan to procure goods or services for the benefit of the employer. (As previously noted, Section 28(e) is unavailable for such brokerage transactions.) Each use of the broker-dealer that results in the receipt of goods and services by the employer following that designation would create an additional violation of sections 406(a)(1)(D) and 406(b)(1) of ERISA. In addition, where the relief provided by Section 28(e) is unavailable, the receipt by a fiduciary (i.e., the employer) of goods or services for its own personal account from a party (i.e., the broker-dealer) dealing with a

<sup>4</sup> In PWBA's view, an investment manager's responsibility to seek best execution under the circumstances requires the manager to consider not only the cost of the commissions for the transaction but the quality and reliability of the execution.

plan in connection with a transaction involving the assets of the plan would, in the opinion of PWBA, constitute a violation of section 406(b)(3). Such an arrangement would also violate sections 403(c)(1) and 404(a)(1) to the extent that the employer is benefiting from its use of its position.

However, where an investment manager directs brokerage transactions through a designated broker-dealer to procure goods and services on behalf of the plan, and for which the plan would be otherwise obligated to pay, such use of brokerage commissions ordinarily would not violate the fiduciary provisions of ERISA, provided that the amount paid for the brokerage and other goods and services is reasonable, and the investment manager has fulfilled its fiduciary duty to obtain best execution for the plan's securities transactions. This result does not depend on the availability of the "safe harbor" under Section 28(e) for these transactions.

In applying the fiduciary responsibility provisions of ERISA to the various "soft dollar" and directed commission arrangements that fall outside of the protection of Section 28(e), it is apparent to PWBA that issues are raised under section 406 of ERISA whenever there is an inducement for the investment manager or other plan fiduciary to direct plan brokerage transactions through particular broker-dealers. The following examples illustrate the application of the fiduciary responsibility provisions of ERISA to "soft dollar" and directed commission arrangements:

(1) Employer X instructs the master trustee of its plan to direct all plan brokerage transactions through Broker-Dealer B. Part of the commissions are rebated to the master trustee to reduce its fees. The plan provides that administrative costs, including the fees of the master trustee, are to be paid by the plan. Under these circumstances, this transaction would not, in itself, constitute a violation of the prohibited transaction provisions of ERISA since the "soft dollars" are being used for the exclusive benefit of the plan which generated the commissions. However, in order to act prudently under section 404(a)(1) of ERISA, Employer X would be obligated to initially determine that Broker-Dealer D is capable of providing best execution of the plan's brokerage transactions. In addition, Employer X must also periodically monitor the execution of the plan's brokerage transactions and evaluate whether the brokerage commissions paid by the plan are reasonable in light of the total services received by the plan. Moreover, Employer X would be obligated to assure that the arrangement does not result in the payment of unreasonable compensation to the master trustee.

(2) Money Manager A enters into an arrangement with Broker-Dealer B whereby Money Manager A would direct brokerage on behalf of its managed plan accounts which would generate fees of \$500,000 per year to Broker-Dealer B. In return, Broker-Dealer B would provide bookkeeping services that do not constitute research under Section 28(e) for the general corporate purposes of Money Manager A. Money Manager A has engaged in an act prohibited by sections 406(a)(1)(D), 406(b)(1) and 406(b)(3) of ERISA since Money Manager A has exercised its fiduciary authority over plan assets to benefit itself. Such a transaction would also violate the exclusive purpose provisions of sections 403(c)(1) and 404(a)(1) of ERISA. In these circumstances, the relief provided by Section 28(e) would not be available because the "soft dollars" are paid for services other than research.

(3) The named fiduciaries of Plan P retain Money Manager C to manage part of the assets of Plan P. Money

Manager C directs the plan's brokerage transactions through Broker-Dealer D. In return, Broker-Dealer D will provide research on tax-exempt securities to Money Manager C. Although tax-exempt securities would not be a suitable investment for Plan P, Money Manager C has determined that this research would be useful to his managed accounts as a whole. Money Manager C's arrangement with Broker-Dealer D is therefore encompassed by Section 28(e) of the 1934 Act. However, in

retaining Money Manager C, the named fiduciaries of Plan P are required under section 404(a)(1) of ERISA to periodically review the execution secured by Money Manager C and ensure that the brokerage commissions paid by Plan P to Broker-Dealer D are reasonable. The foregoing discussion is intended to provide general guidance as to the nature of the analysis applicable to these situations. The discussion should not be viewed as expressing an opinion with respect to any specific case.

FEDERAL CONSUMER LAWS AND REGULATIONS  
AFFECTING BANKS AND BANK COUNSEL:  
SELECTIONS

By

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\* \* AN OVERVIEW \* \*

During the past 20 years an entire body of law -- commonly referred to as CONSUMER CREDIT LAW -- has developed on the Federal level. Any bank which makes consumer loans or which purchases consumer paper from dealers must be aware of this body of federal law. The effect is felt in two ways:

1. Before the transaction. Banks must be aware of the obligations and duties before transactions take place, as these laws affect the credit granting analysis and decision, the form and content of the contracts and documents and practically all operational procedures.

2. Collectibility of Accounts. While all banks face the possibility of a suit or a class action filed against them (and the potential wrath of their regulator) some banks first learn of the federal laws and feel the effect of those laws by a counterclaim in a simple debt collection action. At best, a successful counterclaim will result in a recoupment or set-off against a valid debt. At worst, such counterclaim may result in an affirmative recovery against the bank.

The following material is intended merely as a summary of the major federal statutes and regulations which may affect banks in their consumer lending activities.

CAVEAT

From time to time in the following material, reference is made to certain Kentucky statutes. However, the material does not address all Kentucky law which may modify or enlarge a bank's duties and responsibilities. As a general proposition, the federal law governs, unless state law confers greater rights and privileges on the consumer.

## EQUAL CREDIT OPPORTUNITY ACT - REGULATION B

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### AN OVERVIEW - THE BIG PICTURE

Very often banks and their attorneys overlook the involvement of the Equal Credit Opportunity Act and Regulation B in day to day business operations. To achieve compliance and avoid the possibility of costly litigation, the following general propositions should be understood and remembered:

1. While the Equal Credit Opportunity Act is one of several titles in the Federal Consumer Credit Protection Act, ECOA is not limited to consumer credit transactions. Commercial and business credit are also covered by the act (with the exception of four rather minor requirements).
2. Regulation B issues are present in the general operations of a bank and the requirements and limitations of the regulation apply to all aspects of those operations, from the initial decision to grant the credit, through in-house collection activity and to the ultimate legal collection of the indebtedness.
3. Under the expanded definition of "applicant" in the revised regulation, persons who guarantee the debts of another are also covered and have a direct cause of action under the act if there is a violation.
4. A bank which meets the detailed technical requirements of the act and regulation does not automatically achieve compliance. Unlike some statutes under which it is possible to "checklist" all requirements and thus ensure compliance, this act does not lend itself to compliance efforts based solely on meeting its technical requirements. Very often a "change of attitude" is required.

#### I. SOURCE OF LAW AND REFERENCES.

- A. The Act. 15 U.S.C. Section 1691 et seq.
- B. Regulation B. 12 C.F.R. 202.  
On March 25, 1985, the Federal Reserve Board issued proposed revisions to Regulation B and also published a proposed Official Staff Commentary, intended to replace the many staff letters and official interpretations existing before those revisions and generally following the practices established under Regulation Z, in the issuance of Official Staff Commentary. On November 20, 1985, the Federal Reserve Board published and issued



the final revisions to Regulation B and the final version of the Official Commentary. The revisions became effective December 16, 1985, but banks had a grace period until October 1, 1986, when compliance with the new Regulation B became mandatory.

## II. GENERAL RULE PROHIBITING DISCRIMINATION.

The Federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race; color; religion; national origin; sex; marital status; age (provided that the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act.

## III. SUBSTANTIVE PROVISIONS OF THE ACT AND REGULATION.

### A. Applications. Neither the act nor the regulation require written applications.

1. An application is defined as "any oral or written request for an extension of credit that is made in accordance with the procedures established by a creditor for the type of credit requested."
2. Some form of written application will be required for the types of credit subject to the data collection requirements of Regulation B Section 202.13, i.e., certain types of dwelling-related loans.

### B. Information which May be Taken on Applications (Regulation B, Section 202.7).

1. Marital Status. A bank cannot ask for the marital status of the applicant if individual, unsecured credit is applied for. Marital status may be asked if: The credit is to be secured; the credit involves more than one applicant; or business or agricultural credit is being sought.
2. Alimony and Child Support. The bank may not inquire whether income revealed in an application is derived from alimony, child support or maintenance unless the bank first discloses that such income need not be revealed unless the application so desires.

3. Titles. Courtesy titles may be asked for but only if the request is preceded by a statement that the use of such titles is optional.
4. Age. May be asked for on an application but may only be used as it relates to a "pertinent element of credit worthiness."
5. Names Under Which An Applicant May Apply for Credit. An applicant may apply for credit in his or her birth given last name; his or her married name; or any combination of the two.
6. Dependants. Information can be asked only about the number and age of dependants, but only if the bank consistently asks this question of all applicants, both male and female.
7. Information About Spouses. Information about spouses may be requested only if the spouse is to be a user of the account; if the spouse is to be jointly liable on the obligation; or if the application is relying on the spouses income. Information about a former spouse may be requested if the applicant has already indicated that he or she is relying upon alimony, maintenance or child support as a basis for repaying the credit.
8. Income from Part-time Employment. Cannot be disregarded out of hand, although the creditor may consider if the income is likely to continue.
9. Income From Public Assistance Programs. May not be automatically written off but must be considered the same as income from any other source.
10. Permanent Residence or Immigration Status. May be asked in Kentucky in some applications, since state law restricts the rights of aliens to convey and mortgage real property.

C. Cosigners. The bank cannot require a cosigner at all (whether spouse or not) if the applicant qualifies under the bank's normal standards of credit worthiness for the type and amount of credit requested.

1. If the bank's credit standards require a cosigner with respect to a particular transaction, the bank may not request or suggest that the applicant's spouse be the cosigner but rather must leave it up to the applicant to chose the cosigner.

D. Adverse Action and Notification.

1. Adverse action is considered to have occurred when an application is rejected; when the bank offers to extend credit but only on terms more burdensome to the applicant; or when the bank offers to grant less credit than was requested and the applicant refuses to accept the lesser amount.
2. A bank is required to notify an applicant whether it has accepted or rejected the application within 30 days after receiving a "completed application." The notification must be in writing (in a business credit situation, the written notice must be sent only if the applicant requests it, in writing, within 30 days after the creditor rejects the application).
  - (a) If an application is incomplete, the bank must notify the applicant in writing.
  - (b) If an application is "withdrawn" by the applicant the safe course for the creditor is to send the adverse action notice.
3. The adverse action notification must list and disclose the factors which truly relate to the reason for the denial of the credit and no factor may arbitrarily be excluded. According to some courts, the disclosures should be made with the idea that the applicant is to be informed of the "minimal adjustments" needed for credit approval and to explain "all interactions among factors that might follow" from the adjustments.

E. The Effects Test. In general, the effects test is a rule that originated from the Equal Employment Opportunity area. Basically, this test, which has been incorporated into Regulation B, provides that the bank cannot use or consider any information in evaluating a credit application if such information would have the effect of discrimination on a prohibited basis.

1. Under this test, the intentions of the bank are irrelevant and the result is the only thing that is important.
2. Almost all loan criteria are suspect under this test and even the Federal Reserve gave up trying to define the applicability of the rule. In drafting Regulation B, the Board elected to merely incorporate the effects test into the Regulation and leave it to the courts to interpret how it should be applied.

F. Certain Business Credit Exemptions.

1. Business Credit is defined as credit extended primarily for business, commercial or agricultural purposes.
2. The only sections of the Regulation not applying to business credit are:
  - (a) The bank may inquire as to marital status (but may not use it as a criteria in making the credit decision).
  - (b) The section relating to the furnishing of credit information to credit bureaus does not apply.
  - (c) The record retention requirement (25 months following the application) does not apply.
  - (d) The bank has no affirmative duty to notify of adverse action in writing, unless requested by the applicant. However the official commentary makes it clear that a bank which denies business credit or takes other adverse action is required to notify the applicant in some manner.

IV. CIVIL REMEDIES AND PENALTIES.

- A. The act specifically grants jurisdiction to the United States District Courts and provides for recovery of damages.
1. Actual Damages. Courts have generally held that actual damages may include injury to credit reputation, mental anguish, humiliation and embarrassment.
  2. Punitive Damages. May be recovered up to an amount of \$10,000 in individual suits and \$500,000 or 1% of the net worth of the creditor (whichever is less) in class action suits. Several courts considering the issue have held that punitive damages may be awarded even if actual damages are not recovered.
  3. Court Costs and Attorney Fees. Specifically authorized and allowed by the act.
  4. In determining punitive damage to be awarded in class actions, the act provides that the court must look at the following:

- (a) The frequency and persistence of violations of the act by the creditor.
- (b) The number of customers effected by the violations.
- (c) Whether the violations were intentional.

B. Statute of Limitations. The Statute of Limitations is two years from the date of the violation. However, violations of the act could occur after the loan is made and even during the collection process. The concept of using Regulation B violations as a "recoupment" or "set-off" after the passing of the Statute of Limitations has generally been upheld.

V. UPDATE: 1986 - 1987

A. On December 1, 1986, the Federal Reserve Board published its first proposed revisions to the Official Commentary to Regulation B. 51 F.R. 43372. It is anticipated that the first proposed update will be adopted in final form in March 1987.

The changes and additions are few and there are only two which are potentially of interest to banks. First, a new comment 9(a)(1)-3 would be added to explain that a bank may deny an application missing information that the applicant needs to provide on the ground that the application is incomplete. Of course, the bank has the option of providing a notice of incompleteness as contemplated by the model form.

A new comment 13(a)-5 would be added to explain the types of transactions which are excluded from the data collection requirements of Section 202.13 of the Regulation. Specifically the comment provides that "home improvement loans, open-end home equity loans, and second mortgages (unless the second mortgage is to purchase a principal dwelling)" are not subject to the requirements of the cited section.

B. Generally, there are no cases which had significant impact. One case of interest, U.S. vs. Meadors (CA-7 1985) CCH Consumer Credit Guide, Paragraph 96376, held that a wife who had signed as a guarantor on her husband's loan could not assert a violation of Reg. B since under the facts she was neither required nor requested to sign but did so as her own voluntary act.

One other case might prompt a review of the bank's procedures on Adverse Action Notices. In Jochum v. Pico Credit Corporation of Westbank, Inc., (CA-5 1984)

730 Fed. 2d 1041, the court held that a lender's refusal to consummate a loan, intended for home improvement purposes, because the lender found three recorded judgments which prevented it from achieving a second mortgage status, constituted adverse action under Reg. B and obligated the lender to send an adverse action notice.

THE FTC CREDIT PRACTICES RULE

Effective March 1, 1985

I. REFERENCE SOURCES.

- A. The Rule. FTC Trade Regulation Rule on Credit Practices. 49 F.R. 7740 (March 1, 1984).
- B. Administrative History of the Rule. FTC Initial Notice of Rulemaking, 40 F.R. 16347 (April 11, 1975); Final Notice of Rulemaking, 42 F.R. 32261 (June 24, 1977).

II. SCOPE OF THE RULE.

- A. The rule covers only "consumer" transactions which are defined as credit extended to a natural person who seeks to acquire goods, services or money for personal, family or household use.
- B. Both sellers and lenders, which are under the jurisdiction of the Federal Trade Commission, are covered by the rule.
- C. Banks and subsidiaries which are governed by the Federal Reserve Board are covered under a separate rule, as are members of the Federal Home Loan Bank System.

III. UNFAIR CREDIT PRACTICES UNDER THE RULE AND THUS PROHIBITED.

- A. Taking a non-possessory security interest in household goods other than a purchase money security interest.
- B. Collecting a delinquency charge on a payment which otherwise is a full payment for the applicable period and is timely paid, when the only delinquency is attributable to a late fee or delinquency charge assessed on an earlier installment.
- C. Taking an assignment of wages or other earnings unless:
  - 1. It is revocable at the will of the debtor, or
  - 2. It is pursuant to a preauthorized payment plan or payroll deduction plan, or
  - 3. It applies only to wages already earned at the time of the assignment.
- D. Obtaining an executory waiver or any other limitation of exemption from attachment, execution or other process on real or personal property, unless the waiver

applies only to property subject to a security interest given in connection with the obligation.

- E. Obtaining a cognovit or confession of judgment, warrant of attorney, or other waiver of the right to notice and the opportunity to be heard in the event of a lawsuit.

IV. UNFAIR OR DECEPTIVE COSIGNER PRACTICES UNDER THE RULE.

- A. Misrepresenting the nature or extent of cosigner liability.
- B. Obligating a cosigner unless the cosigner is informed as to the nature and extent of his liability prior to becoming obligated.
- C. To prevent the above abuses, the rule provides a method to completely insulate the creditor from liability. To receive the full protection of this section, the creditor must deliver a separate document to a cosigner prior to the time that the cosigner executes the actual document which legally obligates him. The language and content of the required notice is mandated by the rule. The following language appears in the rule:

You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility.

You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount.

The creditor can collect this debt from you without first trying to collect from the borrower. The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of your credit record.

This notice is not the contract that makes you liable for the debt.



THE FEDERAL RESERVE BOARD CREDIT PRACTICES RULE

(Regulation AA)

Effective January 1, 1986

I. REFERENCE SOURCES.

- A. The Law. The Federal Trade Commission Act (15 U.S.C. Subsection 41 et seq.) requires the Federal Reserve Board to adopt rules substantially similar to Federal Trade Commission rules, unless the Board finds that there is no necessity for a similar rule.
- B. The Rule. Federal Reserve System: Unfair or Deceptive Acts or Practices - Credit Practices. 50 F.R. 16695 (April 29, 1985). In publishing the Rule, the Federal Reserve Board also furnished a very limited analysis and interpretation in the same material.
- C. The Staff Guidelines. The staff of the Federal Reserve Board published guidelines in a question and answer form addressing many issues created under the original rule, on November 14, 1985, 50 F.R. 47036. Note: Technical corrections were later published at 50 F.R. 49524, some of which changed the effect of the material in the original guidelines.

II. SCOPE OF THE REGULATION.

- A. The rule applies to all banks and their subsidiaries, except savings banks that are members of the Federal Home Loan Bank System. Compliance is to be enforced by the Comptroller of the currency, the Federal Reserve System or the FDIC, depending upon the identity of the bank involved.
- B. Only "consumer" transactions are covered. The credit must be extended to a natural person who seeks or acquires goods, services or money for personal, family or household use other than the purchase of real property. The Rule applies to the content of all documentation, all actions of the bank in connection with extending the credit, and all enforcement proceedings, which appears to make it broader in scope than the FTC Rule.

III. UNFAIR CREDIT PRACTICES UNDER THE REGULATION.

- A. Obtaining a cognovit or confession of judgment, warrant of attorney, or other waiver of the right to notice and the opportunity to be heard in the event of a suit or judicial process thereon.

- B. Obtaining an executory waiver or any other limitation on the customer's right of exemption from attachment or execution, unless that waiver applies only to property subject to a security interest given in connection with the obligation.
- C. Taking a non-possessory security interest in household goods other than a purchase money security interest.
- D. Collecting a delinquency charge on a payment which otherwise is a full payment for the applicable period and is timely paid, when the only delinquency is attributable to a late fee or delinquency charge assessed on an earlier installment.
- E. Taking an assignment of wages or other earnings unless:
  - 1. It is revocable at the will of the debtor, or
  - 2. It is pursuant to a preauthorized payment plan or payroll deduction plan, beginning at the time of the transaction, or
  - 3. It applies only to wages already earned at the time of assignment.

IV. UNFAIR OR DECEPTIVE PRACTICES INVOLVING COSIGNERS.

- A. The bank is prohibited from:
  - 1. Misrepresenting the nature or extent of cosigner liability to any person, and
  - 2. Obligating a cosigner unless that cosigner is informed prior to becoming obligated of the nature of his liability.
- B. A clear and conspicuous disclosure statement must be given in writing to a cosigner before he becomes obligated. The disclosure statement must be substantially similar to the "model form" appearing in the Regulation. Unlike the FTC Rule, the disclosure may be either in a separate document or included in the documents evidencing the consumer credit obligation. The model language adopted by the Federal Reserve Board is as follows:

You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility.

You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount.

The bank can collect this debt from you without first trying to collect from the borrower. The bank can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of your credit record.

This notice is not the contract that makes you liable for the debt.

V. UPDATE: 1986-1987.

On October 30, 1986, the Federal Reserve Board published an update to the Staff Guidelines on this rule, effective November 1, 1986. 51 F.R. 39646. Generally, the update clarified many questions that arose after the implementation of the original rule. Some of the areas addressed are summarized as follows:

- A. A lease transaction is covered only if the transaction qualifies as a "credit sale" as defined under Regulation Z.
- B. If a partnership or corporation cosigns on a consumer credit obligation, a cosigner notice is not required. Likewise, where a bank and an automobile dealer, for example, enter into an agreement whereby the bank purchases a consumer credit contract from the dealer and the dealer guarantees the obligation, the bank is not required to provide the cosigner notice to the dealer.
- C. There is no distinction under the rule between a renewal and refinancing. Therefore a refinancing or a renewal entered into after the effective date of the rule is subject to the rule and therefore may not contain a contract provision prohibited by the rule.
- D. A bank may not include any of the prohibited provisions in a separate guaranty agreement if the signer of that guaranty agreement is obligating himself to pay an underlying consumer credit obligation subject to the rule.
- E. A waiver of exemption provision, even if generally qualified, is not permitted. For example a clause that states "I waive my state property exemption to the

extent the law allows" is prohibited by the rule because it is an overly broad waiver.

- F. A cosigner notice must be given at the time a guarantor becomes obligated on the guaranty, that is at the time the guaranty is executed. If the guaranty is continuing in nature and encompasses other debts and obligations to the consumer to be incurred in the future, new notices need not be given upon the granting of those subsequent loans. Likewise, the notice is not required on all future advances made as part of an open-end credit plan.

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THE FEDERAL HOME LOAN BANK BOARD CREDIT PRACTICES RULE

Effective January 1, 1986

I. REFERENCE SOURCES.

A. The Law. The Federal Trade Commission Act (15 U.S.C. Subsection 41 et seq.) requires the Federal Home Loan Bank Board to adopt rules substantially similar to Federal Trade Commission rules, unless the Board finds that there is no necessity for a similar rule.

B. The Rule. The Federal Home Loan Bank board: Prohibited Consumer Credit Practices, 12 C.F.R., Subchapter B, Part 535.

II. COMPARISON OF THE RULE WITH REGULATION AA. There are several technical differences between the two rules but they are substantially similar.

## TRUTH-IN-LENDING - REGULATION Z

### I. SOURCE OF THE LAW AND REFERENCES.

- A. The Act. 15 U.S.C. 1601 et seq.
- B. Regulation Z. 12 C.F.R. 226.
- C. Official Staff Commentary.

SPECIAL NOTICE: The original Truth-In-Lending Act was signed into law in 1968. During the first ten years following its enactment, millions of dollars were expended by creditors in complying with this complex law and the basic problems were consistently compounded as the law underwent drastic changes and various courts reached differing interpretations. Millions of dollars were spent on the prosecution and defense of more than 13,000 suits which were brought in Federal Courts alone and on countless additional suits and counterclaims filed in state courts. On March 31, 1980, the so-called Truth-In-Lending Simplification and Reform Act was signed into law. The original effective date of Simplification was April 1, 1982, but creditors were permitted to begin voluntary compliance on April 1, 1981. The mandatory effective date was later extended by Congress to October 1, 1982. Thus proper analysis of Truth-In-Lending issues must first start with the date of the transaction. If the transaction date is prior to April 1, 1981, the "old" law governs; after October 1, 1982, the "new" law governs; during the 18 month interim, the form of the creditor's disclosures and procedures will usually determine which law governs. At the present there are still many existing transactions governed by the old law. However, the material in this outline deals with only the "new" law.

### II. SCOPE OF THE STATUTE AND REGULATION.

- A. General. Creditor is defined as a person who both (1) regularly extends consumer credit which is payable by agreement in writing in more than four installments or for which the payment of a finance charge is or may be required and (2) is the person to whom the debt arising from the credit transaction is initially payable on the fact of the evidence of the indebtedness. The transaction must involve an extension of consumer credit, defined as credit extended primarily for personal; family or household purposes (Reg. Z Section 226.2(a)(12)) subject to a finance charge or payable in more than four installments and extended "on a regular basis by the creditor" (Reg. Z Section 226.2(a)(17)(i)).

1. Even though the plan may not involve a finance charge or an agreement to repay in four installments, if a credit card is involved, several sections of the act and regulation are triggered, including the rules covering issuance of credit cards, the liability of a card holder for unauthorized use and the rules regarding billing error resolution (Reg. Z Section 226.12(a) and (b)).
- B. Exemptions from Coverage. Certain transactions are exempted from coverage (Reg. Z Section 226.3).
1. Business, commercial, agricultural or organizational credit.
  2. Credit over \$25,000 unless it is secured by real property or a dwelling.
  3. Public utility credit.
  4. Securities or commodities accounts.
  5. Certain home fuel budget plans.
  6. Certain student loan credit.
- C. Types of Credit Extensions. The act and regulation clearly recognize two different types of credit transactions and set out separate and different disclosure requirements applying to each type. It is imperative that a correct conclusion be reached as to which type of credit extension is involved.
1. Open-End Credit is defined as a credit extension 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 is generally made available to the extent that any outstanding balance is repaid. (Reg. Z Section 226.2(a)(20)).
  2. Closed-End Credit is defined as consumer credit other than "open-end credit" as defined in the regulation. (Reg. Z Section 226.2(a)(10)).
- D. Two Basic Disclosures Required on All Types of Credit.
1. Finance Charge. Finance Charge is defined as the cost of consumer credit expressed as a dollar amount and includes any charge payable by the consumer or imposed directly or indirectly by the

creditor as an incident to or a condition of the credit extension. (Reg. Z Section 226.4(a)).

2. Annual Percentage Rate. For closed-end disclosure purposes, defined as "a measure of the cost of credit, expressed as a yearly rate, that relates to the amount and timing of value received by the consumer to the amount and timing of payments made." (Reg. Z Paragraph 226.22(a)(i)). For open-end disclosure purposes, annual percentage rate is defined as "a measure of the cost of credit, expressed as a yearly rate." (Reg. Z Section 226.14(a)). While the definitions are basically the same they recognize that open-end transactions require a simple interest method of calculation while closed-end transactions could include calculation of interest either on the simple interest method or the precomputed method.

E. General Disclosure Requirements.

1. Closed-End Credit. The creditor must make disclosures, clearly and conspicuously, in writing, in a form that the consumer may keep; they must be grouped together and segregated from everything else; and must not contain information which is not directly related to the required disclosures. (Reg. Z Section 226.17).
2. Open-End Credit. The requirements basically track the closed-end requirements except that the disclosures need not be "segregated" from all other information. (Reg. Z Section 226.5).

F. Specific Disclosure Requirements.

1. Closed-End Credit. The regulation mandates some 18 items which must be included in the segregated disclosures, if they are applicable to a particular transaction (Reg. Z Section 226.18). The disclosures are summarized as:
  - (a) Identification of the Creditor.
  - (b) Amount financed.
  - (c) Itemization of Amount Financed.
  - (d) The Finance Charge.
  - (e) The Annual Percentage Rate. Special disclosures if the interest rate is a variable one.
  - (f) Payment schedule.



- (g) Total of payments.
- (h) Total sale price (if a credit sale, as defined, is involved).
- (i) Pre-payment penalties.
- (j) Late payment charges.
- (k) Security Interest.
- (l) Insurance.
- (m) Certain security interest charges.
- (n) Contract reference.
- (o) Assumption policy (required only if the transaction is a "residential mortgage transaction" as defined).
- (p) Required deposit balance.

2. Open-End Credit. Disclosures must be given generally at two different times. Disclosures are required in an initial disclosure statement prior to the first transaction and disclosures are also required on each periodic statement.

- (a) The initial disclosure statement must contain certain information relating to the finance charge, and the method by which it will be calculated; must specify the amount of charges other than a finance charge that may be imposed as part of the plan; must disclose the fact that the account is or will be secured, with a description of the collateral; and must refer to or contain a statement of the consumer's rights under the Fair Credit Billing Act. (Reg. Z Section 226.6).
- (b) Periodic Statement. A creditor is required to deliver periodic statements and some eleven disclosures must be included, if applicable. The possible disclosures include: The previous balance; identification of each transaction; credits to the account; periodic rates; periodic rates applied to the account; the balance on which the finance charge is computed; the amount of the finance charge; the annual percentage rate; other charges to the account during the billing cycle; the closing date of the billing cycle and the new balance; the

free ride, if any; and the address to which the consumer may send notice of billing errors. (Reg. Z Section 226.7).

G. RIGHT OF RESCISSION. The act and regulation provide for a right of rescission if the extension of credit involves a security interest on the consumer's principal dwelling.

1. Closed-End Credit. The right to rescind exists for 3 days following the delivery of the rescission notice, delivery of all material disclosures or 3 years following consummation, whichever occurs first. (Reg. Z Section 226.23).
2. Open-End Credit. A right to rescind exists when the plan is opened; a security interest is added to secure an existing plan; or when an increase in the credit limit on the plan is implemented. (Reg. Z Section 226.15). The original version of simplification set out a right to rescind each and every transaction (suspended until October 1, 1985). However, this right was removed by amendment to the act prior to its implementation date.

### III. CIVIL REMEDIES AND PENALTIES.

#### A. Damages.

1. Actual Damages.
2. Automatic Civil Penalty. Equal to twice the amount of the finance charge with a minimum recovery of \$100 and a maximum of \$1,000. However, the automatic penalty will be awarded only for the specific disclosure violations set out in the act.
3. Reasonable Attorney Fees in a successful action plus court costs. (15 U.S.C. 1630(a)).
4. Class Actions are specifically authorized and the total recovery is limited to \$500,000 or 1% of the creditor's net worth, whichever is less. In addition to actual damages the courts are mandated to consider other relevant factors including the frequency or persistency of the creditor's failure to comply, the resources of the creditor, the number of persons adversely affected and the extent of which creditors failure to comply was intentional. (15 U.S.C. 1630(a)(2)).

B. Defenses Available to the Creditor.

1. A creditor is not liable if, within 60 days after discovering an error but prior to institution of a suit or receipt of a written notice from the consumer about the error, he makes adjustments to the account and insures that the consumer will not be required to pay charges greater than those disclosed. (15 U.S.C. Section 1630(b)).
2. A creditor is not liable for a violation if he can establish that the violation was not intentional and resulted from a "bona fide error and notwithstanding the maintenance of procedures reasonably adopted to avoid any such error." (15 U.S.C. Section 1630(c)).
3. There is generally a one year statute of limitations on actions brought for a disclosure violation. (15 U.S.C. Section 1630(e)). However a consumer against whom an action to collect a debt is brought more than one year after the date of the occurrence of the violation may assert a truth-in-lending based violation as a matter of defense or by recoupment or set-off in that action. Generally, the date when the statute of limitation begins to run is the date of consummation of the transaction as defined in the regulation (Reg. Z Section 226.2(a)(13)).
4. Multiple Recovery - Multiple Violations. There are literally dozens of potential violations possible in every closed-end disclosure statement or initial or periodic statement under an open-end account. The act is very specific and provides that multiple violations in a single instrument can result only in a single recovery by a person. However if a creditor continues to use an open-end periodic statement after a recovery has been decreed, that could give rise to subsequent recoveries. (15 U.S.C. Section 1630(g)).

IV. UPDATE: 1986 - 1987.

- A. Refinancings and Recision Prior to Recent Amendment. The prior Regulation exempted original creditors from providing the right of recision in certain refinancings secured by the consumer's principal dwelling. A refinancing was exempt where no new advances of money were made by the creditor. The proposed amendment expanded the scope of the exemption to include the costs associated with the refinancing and in addition

extended the exemption to any other creditors who refinanced the existing indebtedness.

On December 17, 1986, the Federal Reserve Board published a final amendment to Regulation Z (51 F.R. 45296) and the amendments to the Official Commentary (51 F.R. 45342). The changes were effective December 6, 1986, but reliance by creditors is optional until October 1, 1987. The final adopted version did not extend the exemption to anyone other than the original creditor. It did however expand the number of transactions which will be eligible for the exemption. Generally, the new amendment provides that the right of rescission shall only apply to the extent of the amount which the new Amount Financed exceeds the unpaid principal balance, any earned unpaid finance charge on the existing debt and "amounts attributed solely to the cost of the refinancing or consolidation." The new Official Commentary explains that these amounts would include charges, such as attorney fees and title examination and insurance fees, bona fide and in a reasonable amount, as well as insurance premiums and other charges that are not finance charges. Any charges which qualify as finance charges however would be considered as new money and thus subject to the right of rescission.

B. Variable Rate Mortgages.

1. At the present time, four federal agencies require lenders under their jurisdiction to make certain disclosures in adjustable rate mortgage transactions. The disclosures vary from agency to agency.
2. On August 11, 1986, the Federal Financial Institutions Examination Counsel (FFIEC) approved a proposal to standardize the disclosure requirements among the various federal agencies. Generally two type of disclosures were considered: distribution of an educational booklet about adjustable rate mortgages; and a more detailed description of the variable rate feature along with a historic example of the designated index.
3. On November 11, 1986, the Federal Reserve Board formally proposed amendments to Regulation Z (51 F.R. 42241) and at the same time formally published proposed changes to the Official Commentary to Regulation Z (51 F.R. 42248). It is anticipated that these changes will be adopted in April 1987 with compliance optional until October 1, 1987.

4. If the proposals are adopted, several new forms and procedures will be required.
- (a) The new amendments will apply to all closed-end transactions secured by the consumer's principal dwelling (both purchase money loans as well as home equity loans). An open-end credit line secured by the consumer's principal dwelling will not be covered by the amendments.
  - (b) Both the ARM brochure and the detailed disclosure must be provided when an application form is first furnished to the consumer or before the payment of a non-refundable fee, whichever is earlier. The disclosures must reflect the program features, not the terms of the individual transaction. The specific handbook developed by the Board and the FHLBB may be used to fulfill the requirement or the creditors may provide a "suitable substitute" in its place.
  - (c) The disclosures must include, as applicable:
    - [i] The fact that the interest rate, payment or term can change.
    - [ii] A description of the index or formula used in making the adjustments and a source of information about it.
    - [iii] An explanation of how the interest rate and payment will be determined.
    - [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.
    - [vi] The frequency of interest rate and payment changes.
    - [vii] Any rules relating to changes in the interest, interest rate, payment amount and outstanding loan balance including for example any limitations on the rate or payment, negative amortization and interest rate carryover.

- [viii] A conspicuous statement that there are not limitations on payment or interest rate increases.
  - [ix] A 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. The example must be based on index values beginning in 1977 and updated annually until a 15 year history is shown.
  - [x] An explanation of how the consumer may calculate the payments for the loan to be borrowed based on the most recent payment shown in the example.
  - [xi] In loans subject to overall limitations, a statement of the maximum interest rate and payment for a \$10,000 loan originated at the most recent interest rate shown in the example.
  - [xii] The fact that the loan program contains a demand feature.
  - [xiii] The type of information that will be provided in notices of adjustments and the timing of such notices.
  - [xiv] A statement that disclosure forms are available for the creditors other variable rate loan programs.
- (d) The disclosures given to the consumer at the time of consummation must refer to the earlier ARM information and state that the transaction involves an adjustable rate feature.
- (e) A new requirement would be added: a subsequent disclosure form. The new section would require notice of the adjusted payment amount, interest rate, index rate, and loan balance. The creditor also would be required to disclose the extent to which any increase in the interest rate has not been fully implemented at the adjustment date. Creditors would be required to send consumer's notice at least 30 but not more than 120 days before the effective date of each scheduled interest rate adjustment.

C. Sixth General Update to the Official Commentary.

1. On December 1, 1986, the Federal Reserve Board published its proposed update to the Official Commentary. 51 F.R. 43373. It is anticipated that it will be adopted in March 1987 and compliance will be optional until October 1, 1987.
2. The proposed changes and new material include the following:
  - (a) An addition to clarify that the open-end credit definition does not require that a finance charge be included or that the possibility of a finance charge exists for a plan to qualify as an open-end credit plan.
  - (b) An amendment to clarify that in an open-end credit plan, one time charges imposed when an account is opened, such as a loan origination fee, may not be treated as a participation fee.
  - (c) A revision to make it clear that an application fee or membership fee for an open-end account could be charged prior to giving the initial disclosure statement, provided that it is refunded if the consumer rejects the plan.
  - (d) A revision to clarify issues which have arisen regarding obtaining a security interest in the consumer's deposit account, in order to avoid the restrictions prohibiting an offset against that account. The security interest must not be the functional equivalent of a right of setoff and as a result, routinely including contract language that indicates such a security interest will not avoid the restriction. For a security interest to qualify the following conditions must be met:
    - [i] The consumer must be aware that granting a security interest is a condition to obtain the account and the agreement must specifically indicate an intention to grant such an interest, such as a separate signature or initials or otherwise separating the security agreement from the contract terms.
    - [ii] The security interest must be obtained and enforceable only through procedures

which are equally available to other creditors.

- (e) A revision to clarify that if a transaction involves separate interest and principal payments at different intervals, the creditor may disclose the two series of payments separately in the payment schedule and may use an abbreviated payment schedule for the interest payments.
- (f) A modification to clarify the circumstances in which the addition of a security interest to a pre-existing closed-end obligation is rescindable. For instance, if a transaction was previously exempt because it was over the \$25,000.00 limit, and a security interest in the consumer's principal dwelling is added to that transaction, then the consumer does have the right to rescind the addition of that security interest even if the existing obligation is satisfied and replaced by a new obligation.



## THE FTC "HOLDER-IN-DUE COURSE RULE"

(16 C.F.R. Section 433 - Compare with KRS 367.610)

### Introduction.

From the viewpoint of the financing bank, the conduct of the seller is extremely important. What warranty obligations has the seller undertaken? Are there other causes of action between the seller and the buyer, such as fraud, misrepresentation, etc.? Consider the effect of the following provision inserted into the contract between the seller and the buyer:

### "NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER."

### I. REFERENCE SOURCES.

- A. The Act. The Federal Trade Commission Act. 15 U.S.C. Section 41 et seq.
- B. The Rule. FTC "Trade Regulation Rule on Preservation of Consumers' Claims and Defenses." 16 C.F.R. Section 433.
- C. Administrative History. FTC "Statement of Basis and Purpose" for the Rule. 41 F.R. 53506 (November 18, 1975).
- D. Enforcement. FTC "Statement of Enforcement Policy" for the Rule. 41 F.R. 34594 (August 16, 1976).
- E. Staff Guidelines. FTC "Staff Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses." 41 F.R. 20022 (May 14, 1976).
- F. Proposed Amendments. FTC Proposed Amendment to Rule. 44 F.R. 65771 (September 21, 1979).

### II. THE HOLDER-IN-DUE COURSE DOCTRINE.

- A. Negotiable Instruments. The "Holder-In-Due Course" Doctrine has existed for centuries and banks have "purchased or discounted" negotiable instruments knowing that if they take the instrument for value, in good faith and without notice of a claim or defense on the part of any person, courts would uphold their right to collect from the maker of that instrument. The same basic concept is codified in KRS 355.3-302(1).

B. Retail Installment Contracts. The drafters of the Uniform Commercial Code early recognized that the shift in financing of goods and services was away from negotiable instruments and that the retail installment contract device was in wide-spread use. KRS 355.9-206 allows a buyer to agree that he will not assert a claim or defense which he might have against the seller over against the assignee of the contract. Such an agreement is generally enforceable if the assignee takes the assigned contract for value, in good faith and without notice of claims or defenses.

C. The FTC Rule Changed the Law in All States.

Since May 14, 1976, all consumer credit contracts must contain the mandated language or notice which appears at the beginning of this material. Since the quoted language becomes a contract provision, the buyer has obviously not agreed to waive his right to assert claims and defenses against the assignee but to the contrary, the assignee is agreeing to permit the assertion of such claims or defenses to the extent allowed under the rule and the language of the notice.

### III. SCOPE OF THE FTC RULE.

A. Coverage Only to Consumer Transactions. The rule applies only to consumers, defined as a natural person who seeks to acquire goods or services for personal, family or household use.

B. The FTC has opined, and the courts are likely to adopt, that a determination of whether goods or services are being sought or acquired "for personal, family or household use" will involve the same criteria as set out in the Truth-In-Lending Act. See the official commentary to Regulation Z, 12 C.F.R. 226, Section 3(a)(2).

C. The Purchase of Goods or Services are Covered. The rule specifically covers services as well as goods. However, sales of real property are not covered and the mere fact that a security interest in real property is taken does not mean the transaction does not involve consumer goods or services.

D. Retail Installment Contracts Assigned to a Financer. The rules specifically provides that the contract between the buyer and the seller must contain the mandated notice. While the financer is not directly covered by the rule, fit is common place for the financer to furnish the particular form to the seller. As a practical matter, the financers will want to be

certain that the mandated notice is included in the contract to avoid possible liability to the seller.

- E. Purchase Money Loans. Again there is no direct liability on the financier but the rule does declare it to be an "unfair or deceptive act or practice" for the seller to accept proceeds of a purchase money loan unless the financier's note contains the mandated notice. The definition of "Purchase Money Loan" under the rule is different from the commonly accepted definition. The definition in the rule provides coverage for an advance to a consumer which is applied in whole or substantial part, to the purchase or lease of goods or services from a seller (a) refers consumers to the lender or (b) is affiliated with the lender by control contract or business arrangement.

#### IV. PROPOSED AMENDMENTS.

- A. The most recent amendments were proposed on September 21, 1979, and adoption is still pending. The proposed amendments would enlarge the scope of the rule and make it an unfair or deceptive act or practice for a creditor, as well as a seller, to directly or indirectly take a consumer credit contract which fails to contain the mandated notice.
- B. Form of the Notice. The form of the notice would be changed to the following:

"This credit contract finances a purchase. All legal rights which the buyer has against the seller arising out of this transaction, including all claims and defenses, are also valid against any holder of this contract. The right to recover money from the holder under this provision is limited to the amount paid by the buyer under this contract. A claim is a legally valid reason for suing the seller. A defense is a legally valid reason for not paying the seller. A holder is anyone trying to collect for the purchase."

#### V. UPDATE: 1986-1987.

One recent case affirms a proposition that is consistently argued "against" by consumer lawyers. The issue is whether or not the FTC Rule and its "effect" applies to a financier who accepts assignment of a Retail Installment Contract which does not contain the mandated notice. In Vietnam Veterans of America, Inc. vs. Guerdon Industries, Inc., U.S.D.C. Del. 1986, 644 F. Supp. 951, the court held that while the seller may be guilty of a trade practice violation, the rule had no effect on contracts which lack

the required notice. The court correctly analyzed that by its own terms, the rule does not create claims or defenses but rather provides only that failure to include the notice shall be an unfair deceptive act.

In the discussion on this issue, it is clear the court felt that even if the contracts had contained the required notice, the rule did not create any new cause of action but rather it was incumbent to prove that a cause of action existed independently against the original seller.

## THE FTC USED CAR RULE

Effective May 9, 1985

### I. REFERENCE SOURCES.

- A. The rule was published November 19, 1984, in 49 F.R. 45725.
- B. The Federal Trade Commission published an extensive Commentary and Analysis in the material immediately preceding the rule as published in the Federal Register.

### II. SCOPE OF THE RULE.

- A. The rule covers all sellers of motor vehicles who sell or offer to sell a used motor vehicle five or more times in any 12 month period. It is not limited to a motor vehicle dealer as defined by state law. A used vehicle is one which has been driven more than the limited use necessary to move or road test it prior to delivery to a consumer. Thus, the rule does apply to a typical new car dealer's inventory of demonstrators, executive cars, etc. Under the definition, a "bank or financial institution" is not covered. If a bank uses or has a subsidiary company dispose of its repossessed vehicles, that company is probably covered under the rule.
- B. Compliance with the rule requires an understanding of basic warranty law and the effect and implications of the Magnuson-Moss Consumer Product Warranty Act. The rule requires special compliance procedures in the area of written warranties, implied warranties and "service contracts" as defined in Magnuson-Moss.

### III. SUBSTANTIVE PROVISIONS OF THE RULE.

- A. Additions to sales contract. All used car sellers must include two required sentences in their contract of sale. The contract may be a separate document or it could be the Retail Installment Contract which the financier later buys.

(NOTICE: The financier must be certain that this mandated provision is included in the dealer's documentation.)

- B. A "Window Form". Must be properly completed and displayed on the side window of every used car offered for sale. The original of that window form must be given to the consumer at the time the sale is consummated.

## WARRANTIES IN THE SALE OF GOODS

### I. WARRANTIES UNDER THE UNIFORM COMMERCIAL CODE.

- A. Scope and Coverage. The warranties in the Uniform Commercial Code extend to the sale of goods as defined in KRS 355.2-102. Generally, the courts have enlarged the scope of UCC coverage to cover the sale of services as well as goods, particularly where the two are sold "as a package." See Riffe v. Black, Ky. App., 548 S.W.2d 175 (1977); T-Birds, Inc. v. Thoroughbred Helicopter, E.D. Ky., 540 Fed. Supp. 548 (1982).
- B. The Four Commercial Code Warranties.
1. The Warranty of Title. KRS 355.2-312. This warranty exists even though nothing is said. A seller warrants that it has title to the goods conveyed and has full right to transfer title free from the claims of others. Nick's Auto Sales v. Ratcliff Auto Sales, Ky. App. 591 S.W. 2d 709 (1979).
  2. The Express Warranty. KRS 355.2-313. An express warranty must be "created" by a seller but may take either a verbal or written form. An express warranty is an affirmation of fact or promise by a seller, a description of the goods or a sample or a model, which must be part of the basis of the bargain between the seller and the buyer. The seller must have the intention of extending a warranty. Overstreet v. Norden Laboratories, Inc., 6 CCA, 669 Fed. 2d 1286 (1982); Bell v. Louisville Motors, Inc., Ky. App., 573 S.W.2d 371 (1978).
  3. The Implied Warranty of Merchantability. KRS 355.2-314. A sale of goods includes the implied warranty of merchantability, provided that the seller is a merchant dealing in that class of goods. Nothing need be said by the merchant and the warranty arises by operation of law. Reliance by the buyer is not necessary. Generally, to be merchantable, goods must be fit for the ordinary purpose for which such goods are used. Riffe v. Black, supra. Belcher v. Hamilton, 475 S.W.2d 483 (1971).
  4. The Implied Warranty of Fitness for a Particular Purpose. KRS 355.2-315. Even though nothing is discussed between the buyer and seller, this implied warranty applies to all sellers who at the time of sale know or have reason to know of the

particular purpose for which the goods are acquired. However, reliance by the buyer is necessary. A high level of knowledge on the part of the buyer may negate this warranty. Price Brothers Company v. Philadelphia Gear Corporation, 649 F.2d 416 (6th Cir. 1981).

C. Seller's Ability to Exclude or Modify Warranty Responsibilities.

1. Implied Warranties may be excluded from the sale. Language to exclude the implied warranties must be conspicuous and in the case of the implied warranty of merchantability, the actual word "Merchantability" must be used. KRS 355.2-316. Childers and Ventors v. Sowards, Ky. 460 S.W.2d 343 (1970); Greg Coats Cars, Inc. v. Casey, Ky. App. 576 S.W.2d 251 (1978).
2. In some circumstances, a warranty agreement may modify or limit the remedies available to an aggrieved buyer. Likewise, the buyer's right to recover consequential damages may be limited or excluded unless such is unconscionable. Cox Motor Company v. Castle, Ky. 402 S.W.2d 429 (1966); Waterworks and Industrial Supply Company v. Wilburn, Ky. 437 S.W.2d 951 (1968). Circumstances may however cause an exclusion or limited remedy to fail of its "essential purpose." This has been the ultimate weapon used by many courts in recent consumer type warranty litigation and if the court so holds, all of the rights and remedies under the code are triggered. Ford Motor Company v. Mayes, Ky. App., 575 S.W.2d 480 (1978); Carboline Company v. Oxmoor Center, (1985).

D. Rights and Remedies of a Buyer for Breach of Warranty. The rights and remedies of the Buyer will vary depending upon which of the four UCC warranties are breached. The rights and remedies may include:

<u>NAME</u>	<u>KRS</u>
Rejection of the Goods	KRS 355.2-601 & 2-602
Revocation of Acceptance	KRS 355.2-608
Retention of Goods and Recovery of Primary Economic Loss	KRS 355.2-714
Cost of "Cover"	KRS 355.2-712

Difference between Market  
and Contract Price

KRS 355.2-713

Incidental and Consequential  
Damages

KRS 355.2-715

II. THE FEDERAL MAGNUSON-MOSS WARRANTY ACT - CONSUMER PRODUCTS.  
(15 U.S.C. 2301)

A. Overview.

1. The act applies to all consumer products manufactured on and after July 4, 1975. The term Consumer Product is defined as "any tangible personal property which is distributed in commerce and which is normally used for personal, family or household purposes (including any such property intended to be attached to or installed in any real property without regard to whether it is so attached or installed)." 15 U.S.C. 2301(1).
2. The test of whether or not a product is a consumer product and thus covered by the Act is not determined by the use of a particular product by the user but rather by a determination of the Federal Trade Commission as to the normal use for such product.
3. If a written warranty is given by a seller or manufacturer, the act applies. It does not however require a seller or manufacturer to give a warranty.
4. A written warranty is defined as:
  - (a) "Any written affirmation of fact or written promise made in connection with the sale of a consumer product by a supplier to a buyer which relates to the nature of the material or workmanship and affirms or promises that such material or workmanship is defect free or will meet a specified level of performance over a specified period of time, or
  - (b) Any undertaking in writing in connection with a sale by a supplier of a consumer product to refund, repair, replace or take other remedial action with respect to such product in the event that such product fails to meet the specifications set forth in the undertaking, which written affirmation, promise, or undertaking becomes part of the basis of the



bargain between the supplier and a buyer."  
(15 U.S.C. 2301(6)).

5. The act relies on state law to define "implied warranties" as no definition is in the act.
6. Service contracts are defined as a "written agreement to perform maintenance or repair services on a consumer product for a specified period." The act also applies to service contracts. The chief distinction between a service contract and a written warranty is that it is not part of the basis of the bargain between the buyer and seller but is something in addition, which the buyer pays for and is entered into at the time of sale or within 90 days thereafter. (15 U.S.C. 2301(8)).

B. Substantive Requirements of the Act.

1. Written warranties on consumer products costing more than \$10.00 at retail must be clearly and conspicuously designated as either: Full (statement of duration) Warranty, OR Limited Warranty.
  - (a) The act requires a seller or manufacturer to remedy a defect within a reasonable time and without charge after notice of a defect or malfunction if a full warranty has been given. Remedy is defined to mean repair or replacement with a new consumer product which is identical or reasonably equivalent to the warranted consumer product. If it is not commercially practical or possible to repair the product within a reasonable time and the warrantor is unable to provide a replacement, then a full refund of the actual purchase price must be made. 15 U.S.C. 2304.
  - (b) Any written warranty which does not meet the federal full warranty requirements is a limited warranty under the act. 15 U.S.C. 2303(A)(2).
2. A seller may not disclaim or modify an implied warranty arising under state law if that seller has included a written warranty with the sale or within 90 days from the time of the sale enters into a service contract covering the product. 15 U.S.C. 2301(7), 15 U.S.C. 2308(A).
3. Any attempt to modify or limit the implied warranty is deemed ineffective for the purposes of federal and state law. 15 U.S.C. 2308(C).

4. However, a warrantor who offers a limited warranty may limit the duration of the implied warranties to the same time period as the Limited Warranty conditioned upon the requirement that the limitation is conscionable and clearly disclosed on the face of the written warranty. 15 U.S.C. 2308(b).
- C. Warranty Tie-Ins Prohibited. The act prohibits conditioning warranties on the use of any article or service which is identified by brand, trade or corporate name in connection with a purchase product, unless the article or service is provided without charge under the warranty. 15 U.S.C. 2302(c).
- D. A "Laundry List" is Contained in the Act Setting Forth Specific Disclosures. Any warranty covered by the act must meet the disclosure requirements. Failure to comply with result in civil liability.
- E. Civil Remedies.
  1. Any consumer who is damaged for failure of supplier, warrantor or service contractor to comply with any obligation under the act or under a written warranty, implied warranty, or service contract, may bring suit for damages and other equitable relief. 15 U.S.C. 2310(d)(1).
  2. Jurisdiction is granted to any court of competent jurisdiction in any state court or in a district court of the United States, if the amount in controversy on an individual claim is more than \$25.00 and if the amount in controversy is more than \$50,000, and in a class action suit and the class numbers at least 100. 15 U.S.C. 2310(c)(1).
  3. If the consumer succeeds in an action under the act, he may recover attorney fees, unless the Court in its discretion shall determine that such an aware of attorney fees is inappropriate. 15 U.S.C. 2310(d)(2).
  4. Only the warrantor actually making a written affirmation of fact, promise or undertaking shall be deemed to have created a written warranty, and any rights arising thereunder may be enforced only against such warrantor and no other person. 15 U.S.C. 2310(f).

THE FEDERAL FAIR DEBT COLLECTION PRACTICES ACT

Effective March 20, 1978

I. REFERENCE SOURCES.

- A. The Statute. 15 U.S.C. 1692 et seq.
- B. The FTC has issued numerous unofficial Staff interpretative letters, some of which have been published in CCH Consumer Credit Guide.
- C. In March 1986, the Federal Trade Commission published proposed Official Staff Commentary interpreting the Fair Debt Collection Practices Act. 51 F.R. 8019. The FTC proposed a comment period which expired May 6, 1986. Since that time the final commentary has not been adopted or released. The reason is probably that on July 7, 1986, the "Attorney-at-Law" exemption was removed from the Act. As a result, the final and adopted version of the Official Staff Commentary will probably be much more detailed than that published in March 1986.

II. SCOPE OF THE STATUTE.

- A. The Definition of Debt Collector. Any person who uses any instrumentality of interstate commerce or the mails in any business, the principal purpose of which is the collection of any debt, or who regularly collects or attempts to collect, directly or indirectly, debts owed, due or asserted to be owed or due to another. In addition, any creditor, who in the process of collecting his own debts, uses any name other than his own which would indicate that a third person is collecting or attempting to collect such debts.
- B. Coverage Limited To Consumer Debts. Coverage of the act is limited to the collection of consumer debts, which are defined as those incurred primarily for family, personal or household purposes but also includes those reduced to a judgment.
- C. ATTORNEYS ARE NOW COVERED. Effective July 7, 1986, an amendment to the act removed attorneys at law from the exemption portion of the Act. Thus, attorneys who fall within the above definition must concern themselves with the provisions of this act and failure to do so could result in the civil penalties and liabilities created by the Act.

\*\* SPECIAL CAVEAT \*\*

THE REMOVAL OF THE ATTORNEY EXEMPTION HAS CAUSED SOME MAJOR PROBLEMS AND CREATED NUMEROUS QUESTIONS FOR ATTORNEYS IN PRIVATE PRACTICE AS WELL AS IN-HOUSE COUNSEL. JUST HOW FAR THE FEDERAL TRADE COMMISSION AND/OR THE COURTS WILL GO IN APPLYING THE PROVISIONS OF THE ACT TO THE PRACTICE OF LAW REMAINS TO BE SEEN. SOME OF THOSE ISSUES HOWEVER WILL BE ADDRESSED IN QUESTION FORM THROUGHOUT THE FOLLOWING MATERIAL UNDER THE HEADING S Q:

- D. Exemptions from Coverage. Some persons who would otherwise be covered under the definition are exempted from the act, as follows:
1. An officer or an employee of a creditor while collecting debts for the creditor in the name of the creditor.
  2. An officer or an employee of the United States or any state to the extent of collecting the debts due the government.
  3. A person collecting or attempting to collect any debt owed to the extent that such activity concerns a debt which was not in default at the time it was obtained by such person, or is incidental to a bona fide fiduciary obligation or escrow arrangement.
- E. Special Coverage for Certain Forms. Suppliers and users of deceptive forms are covered. The act makes it unlawful to design, compile and furnish any form knowing that such form will be sued to create the false belief in a consumer that a person other than the creditor is participating in the collection of a debt, when in fact such person is not so participating. Liability for violation of this provision attaches to all persons, not only debt collectors as defined in the act. 15 U.S.C. 1692 j and k.

S Q: May an attorney write a special "attorney letter" for a client which states that an account has been placed with the attorney for collection and that the debtor may avoid suit by contacting the client immediately, when in fact the attorney is merely writing the letter as a courtesy to the client and the account has not been placed with the attorney for collection? If contacted by the debtor, the attorney will merely refer the debtor to the client and will not accept payment or arrangements.

S Q: If a creditor has salaried attorney employees, may those employees write debt collection letters on "attorney letterheads"? The proposed Official Commentary prohibits such activity if the stationery indicates the attorneys are employed by someone other than the creditor or are separate or independent from the creditor.

### III. SUBSTANTIVE PROVISIONS.

#### A. Validation of Debt. 15 U.S.C. 1692g.

1. Within 5 days after the initial communication with a consumer, a debt collector shall, unless the following information is contained in the initial communication or the consumer has paid the debt, send the consumer written notice containing specified information.
  - (a) The amount of the debt.
  - (b) The name of the creditor to whom the debt is owed.
  - (c) The statement that, unless the consumer within 30 days after receipt of the notice disputes the validity of the debt, or any portion thereof, the debt will be assumed to be valid.
  - (d) The statement that if a consumer notifies the debt collector within the 30 day period that the debt is disputed, the debt collector will obtain a verification of the debt or a copy of the judgment against the consumer, and that information will be mailed to the consumer. Also, a statement that upon the consumer's written request, the debt collector will provide the name and address of the original creditor, if different from the current creditor.
2. If the consumer notifies the debt collector in writing within the 30 day period, the debt collector shall cease the collection of the debt, or any disputed portion hereof, until the verification is obtained and a copy of such verification is mailed to the consumer.
3. The proposed Commentary establishes that the Act imposes no particular requirements as to the form, sequence, location or type size of the notice and that the debt collector may condense and combine

the required disclosures, as long as the notice provides all required information. If the collector's first communication with the consumer is oral then the disclosures may be made orally (a risk worth taking?).

S Q: The proposed Commentary states that a formal legal action against a consumer is not a "communication in connection with collection of any debt." Assuming then the attorney does not write the debtor a letter but merely files a suit, at what point in the legal proceedings, if any, are the notice provisions of the Act triggered.

4. The Official Commentary also states that so long as the notice requirements are met, the debt collector need not cease normal collection activities until a notice from the consumer is received. Such permitted action also includes the right to report the debt to a credit bureau.

#### B. Limitations on Communications.

1. The word "communication" is defined as the "conveying of information regarding a debt directly or indirectly to any person through any medium." Proposed Commentary explains that the definition includes oral and written transmission of messages which refer to a debt but does not include situations where the debt collector does not convey information regarding a debt, such as a request to a third party for the consumer to return a telephone call or a request to a third party for information about the consumer's assets, if the debt collector does not reveal the existence of the debt.
2. Communication with the Debtor. If the consumer notifies the debt collector in writing that he refuses to pay a debt or that he wishes the debt collector to cease further communication, the collector must not communicate further with the consumer except to advise the consumer that the action is being terminated, or that the collector will invoke specific remedies.

A debt collector may not communicate with a consumer at any time or place which is unusual or known to be inconvenient (8:00 a.m. - 9:00 p.m. is presumed to be convenient); where he knows the consumer is represented by an attorney with respect to the debt; or at the debtor's place of employment if he knows the employer prohibits such

contacts. The proposed Commentary states that this section applies to "communicate" in its commonly accepted meaning, whether or not the debt is specifically mentioned.

S\_Q: Does this section limit the times that a sheriff may serve a summons? May a summons be served at the debtor's place of employment?

3. Communication with Third Parties. 15 U.S.C. 1692c. Without the prior consent of the consumer, the debt collector may not communicate with any person other than the consumer, his attorney, a consumer reporting agency, the creditor, the attorney of the creditor, or the attorney of the debt collector.

S\_Q: Assume that the attorney may talk to the debtor's employer to make arrangements for payment, if the telephone contact was initiated by the employer as a result of a wage garnishment. Assume payment arrangements are made and the debtor makes voluntary payments. After a six month period, the employer calls the attorney and asks the status. May the attorney respond? May the attorney discuss the situation with the employer and arrange for voluntary withholdings of moneys for payment on the account?

4. Acquisition of Location Information. 15 U.S.C. 1692b.

(a) The term "location information" means a consumer's place of residence and his telephone number or his place of employment.

(b) In contacting any person other than the debtor to acquire location information, the debt collector is prohibited from doing a number of things.

[i] May not state that the consumer owes a debt;

[ii] Must identify himself and state that it is confirming or correcting location information and, only if expressly requested, identify his employer;

[iii] May not communicate with a person more than once unless requested to do so by that person and unless the collector reasonably believes that the earlier

response of such person is erroneous or incomplete;

[iv] May not use any language or symbol on any envelope or in the contents of any communication that indicates the debt collector is in the debt collection business or that the communication relates to the collection of a debt.

S Q: May the envelope state that the attorney is "an attorney"?

C. Prohibited Practices.

1. Harassment or Abuse. 15 U.S.C. 1692d.

(a) General Rule. A debt collector may not engage in any conduct, the natural consequences of which is to harass, oppress or abuse any person in connection with collection of the debt.

(b) The act lists certain actions as falling within this prohibition. For example: Use of threat or use of violence; use of obscene or profane language; publication of a list of consumers who allegedly refused to pay debts; causing a telephone to ring or engaging any person in telephone conversations repeatedly or continuously; placement of telephone calls without meaningful disclosure of the caller's identity.

2. False or Misleading Representations. 15 U.S.C. 1692e.

(a) General Rule. A debt collector may not use any false, deceptive or misleading representations or means in connection with the collection of any debt.

(b) The act lists certain actions which fall within this prohibition: For example, false representation of the character, amount or legal status of the debt; false representation of the non-payment will result in arrest, imprisonment, seizure, garnishment, etc.; threat to take any action that cannot be taken; use or distribution of written communications which simulate or falsely represent to be documents issued by a court or other governmental agency; use of



any false representations to collect or attempt to collect a debt or information.

- (c) According to the proposed Commentary, a statement that legal action has been recommended is a representation that legal action may be taken, since such a recommendation implies that the creditor will act on it at least some of the time. Lack of intent may be inferred when the amount of the debt is so small as to make the action totally unfeasible or when the debt collector is unable to take the action because the creditor has not authorized him to do so.

3. Unfair Practices. 15 U.S.C. 1692f.

- (a) General Rule. A debt collector may not use unfair or unconscionable means to collect or attempt to collect any debt.
- (b) The act lists certain activities which constitute unfair practices. For example: Collection of any amount not expressly authorized by the agreement or allowed by law; acceptance of a post-dated check of more than 5 days, subject to a restriction; solicitation of a post-dated check for the purpose of threatening criminal prosecution; causing charges to be made to any person for communications such as telephone calls or collect telegram fees; taking or threatening judicial action to effect disposition of property if there is no present right for the creditor to possess said property.

IV. CIVIL REMEDIES AND PENALTIES. 15 U.S.C. 1692k.

- A. The act specifies and permits specific damages recoverable against a party who violates the act.
1. Actual damages sustained as a result of the violation.
  2. Automatic penalty recovery (similar to Truth-In-Lending) in an amount that the court may allow, not to exceed \$1,000.
  3. Court costs and attorney fees.
- B. The act specifically allows class actions and permits recovery of such amount for each plaintiff as could be recovered for actual damages without regard to a minimum individual recovery, but not to exceed the

lesser of \$500,000 or 1% of the net worth of the debt collector.

- C. Statute of Limitations: One year from the date on which the violation occurs. Action may be brought in any Federal Court without regard to the amount in controversy.

REVOLVING CREDIT INVOLVING HOME EQUITY:  
STATE LAW CONSIDERATIONS

By

David C. Pottinger  
Morgan and Pottinger  
Louisville, Kentucky

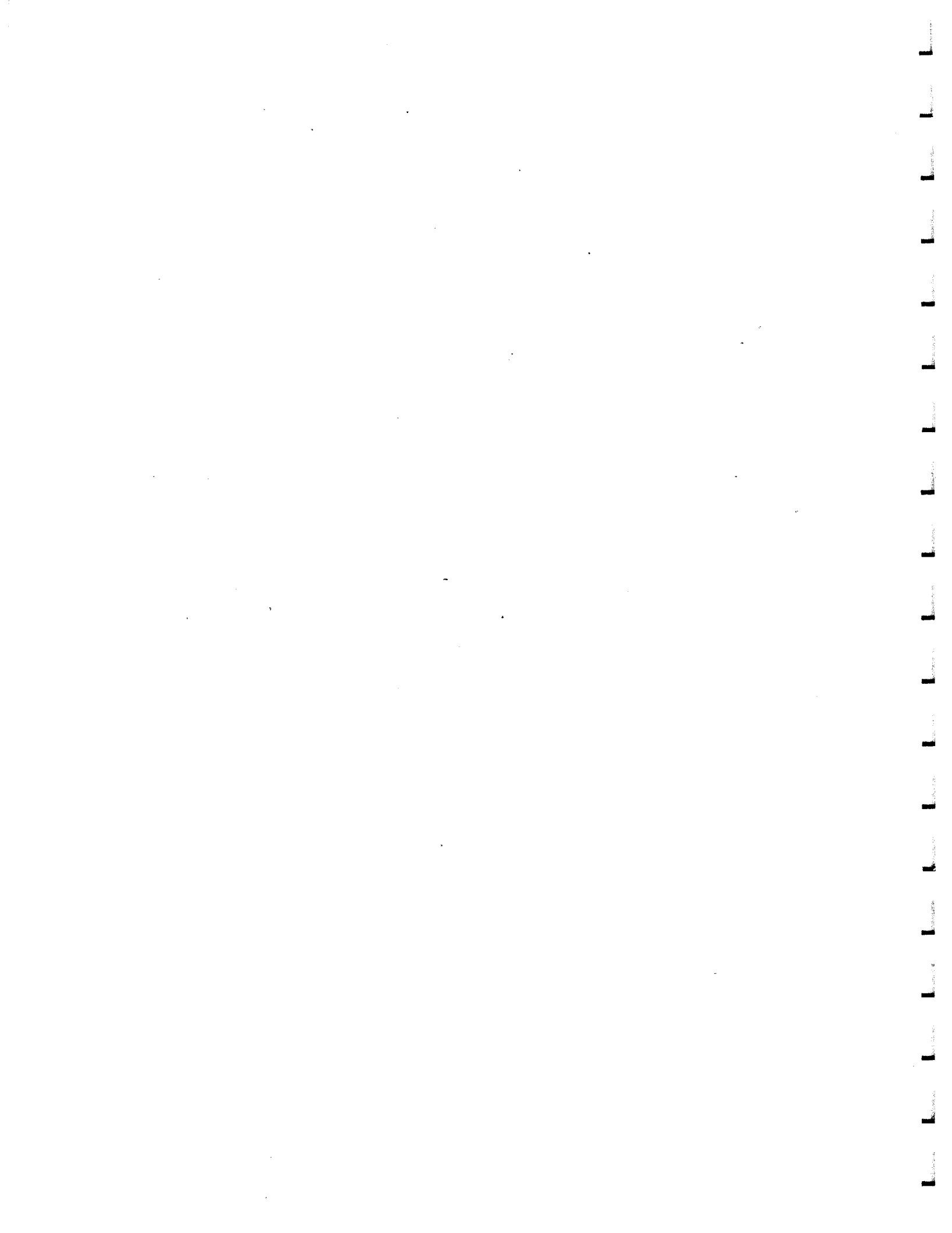


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SPECIAL NOTE

A REAL ESTATE SECURED - REVOLVING CREDIT PLAN IS A "NEW PRODUCT" - NEW IN THE SENSE THAT IT COMBINES TWO SEPARATE AND WELL ESTABLISHED LENDING CONCEPTS. THE FIRST, A REVOLVING LINE OF CREDIT, HAS GENERALLY BEEN AVAILABLE IN MOST BANKS COMMERCIAL DEPARTMENTS FOR YEARS AND HAS MORE RECENTLY BECOME AVAILABLE TO CONSUMERS THROUGH THE FAMILIAR CREDIT CARD. THE SECOND CONCEPT, SECURING A TRANSACTION BY A REAL ESTATE MORTGAGE, HAS BEEN AROUND FOR AN EVEN LONGER PERIOD AND GENERALLY REPRESENTS THE MOST SECURE TYPE OF LOAN FOR THE BANK. WHEN THESE TWO CONCEPTS ARE COMBINED, THE RESULT IS A "NEW PRODUCT" - NEW IN THE SENSE THAT THE ISSUES AND PROBLEMS RESULTING FROM THE COMBINATION HAVE GENERALLY NOT YET BEEN TESTED OR REVIEWED BY ANY COURT. IN THE ABSENCE OF SUCH JUDICIAL INTERPRETATION, IT IS NOT POSSIBLE TO OFFER FIRM AND FIXED OPINIONS ABOUT THE MANY POTENTIAL ISSUES.

THE PRIMARY PURPOSE OF THIS MATERIAL IS TO ALERT THE USER TO SELECTED STATUTES AND LEGAL CONCEPTS WHICH ARE FELT TO BE RELEVANT OR WORTHY OF CONSIDERATION IN EVALUATING AND DECIDING WHETHER TO IMPLEMENT A REAL ESTATE SECURED - REVOLVING CREDIT PLAN. THE MATERIAL IS LIMITED IN SCOPE TO AN EXAMINATION FROM THE PERSPECTIVE OF A BANK AND ASSUMES THAT THE BASIC LENDING PROGRAM WILL BE COVERED BY THE FEDERAL TRUTH-IN-LENDING ACT AND REGULATION Z. THIS MATERIAL DOES NOT SPECIFICALLY ADDRESS THE REGULATION Z REQUIREMENTS

## REVOLVING CREDIT INVOLVING HOME EQUITY

### STATE LAW CONSIDERATIONS

#### I. THE FOUNDATION FOR A PROGRAM.

A bank must first decide whether it is necessary to base its plan on a particular statute and if so, must then consider the appropriate statute for its authority to maintain the program. Generally, it appears that there are three such possibilities in Kentucky.

##### A. The Kentucky Bank Revolving Credit Plan Statute (KRS 287.710 - 287.770).

##### 1. Important Definitions within the statute. (KRS 287.710)

- a) "Bank" means a bank organized under the banking laws of Kentucky or of the United States, or any assignee of a bank's rights under a revolving credit plan.
- b) "Extend credit" or "extension of credit" means the right granted by a bank to defer payment of debt, incur debt and defer its payment, or purchase goods, services or anything else and defer payment thereof, pursuant to a revolving credit plan.
- c) "Finance Charge" means the sum of all charges, direct or indirect, imposed by the bank as an incident to an extension of credit, which includes interest in any amount payable under a point, discount or other system of additional charges, etc. The term does not include amounts collected by the bank which are fees or charges prescribed by law for filing fees, taxes, etc.
- d) "Revolving credit plan" means an arrangement under which [i] the bank extends credit for the purchase of goods, services or anything of value or makes loans, from time to time; [ii] the unpaid balances of purchases and the principal of loans obtained and the finance and other appropriate charges are debited to the debtor's account; [iii] a finance charge is not



pre-computed but is computed on the outstanding balance of the account from time to time; and [iv] the bank renders a bill or statement at regular intervals (which need not be a calendar month) the amount of which is payable by and due from the debtor on a specified date or, at the debtor's option, may be paid in installments.

2. Finance Charges and Rates. (KRS 287.740)

- a) The finance charge must be computed on either the average daily unpaid balance of the account during the billing cycle or on the balance on the same date of each billing cycle.
- b) A variation of not more than four days from billing cycle to billing cycle shall be deemed "the same day of each billing cycle."
- c) The bank may receive, contract and collect a finance charge not in excess of 1-3/4% per month, computed as above. Presumably, this translates to an annual percentage rate of 21%.
- d) The statute does not expressly state that the interest rate must be fixed, nor does it state that the rate may vary during the term of the plan.

3. Additional Fees, Charges and Costs. In addition to the charges described above, the plan may provide for: (KRS 287.750)

- a) Annual fees not to exceed \$20.00;
- b) Delinquency charges not to exceed \$5.00 each month if payments are not made when due;
- c) "All fees and closing costs incurred in connection with the taking of a mortgage on real estate, if bona fide and not retained by the bank";
- d) Reasonable attorney fees and court costs if the Account is referred to an attorney for collection and the attorney is not a salaried employee of the bank.

4. Limitation on Charges. Except for the charges and fees expressly provided for in the statute, no further amounts may be directly or indirectly charged, contracted for, or received by the bank for an extension of credit or forbearance of collection of debt pursuant to a revolving credit plan. (KRS 287.760)
5. Other Statutory Requirements.
  - a) For each billing cycle in which there is an outstanding balance or during which a charge is imposed, the bank must send a statement to the debtor. The statement must contain the information required by the Federal Truth-In-Lending law. (KRS 787.730(1))
  - b) Each statement must contain a "legend" to the effect that the debtor may at any time pay the balance owing on the account. (KRS 287.730(1))
  - c) A "free ride" is not required unless some portion of the charges on the account are incurred by use of a credit card (which has a specific definition under the statute). Charges for purchases from third parties made with a credit card are entitled to a 30 day "free ride." (KRS 287.730(2))
  - d) The statute appears to approve the concept of a "change of terms" of the plan as it provides that the plan may take the form and contain the provisions as "the bank may from time to time establish and the debtor may accept." (KRS 287.720(1))
  - e) Before the account is opened, the bank must mail or deliver a statement of the provisions of the plan, which must include the information as required by the Federal Truth-In-Lending law. (KRS 287.720(2))
  - f) If two or more persons covered by the plan have the same residence, the provisions of the plan and the billing statements may be sent to only one of such persons. (KRS 287.720(2)) (Note:

Check this against corresponding Truth-In-Lending requirement.)

6. Statutory Penalties for Violations.

- a) A bank which violates any provision of the statute, except as a result of an accidental or bona fide error, shall be barred from the recovery of any finance charges permitted by the statute. In addition, the debtor or his legal representative may recover from the bank any amounts paid to the bank as finance charge provided that an action is commenced against the bank within two years from the date such violation first occurred. In any event, the bank may recover an amount equal to the principal of extensions of credit under the plan. (KRS 287.990(13))
- b) Any bank which willfully makes charges in excess of those permitted by the statute is guilty of a misdemeanor and upon conviction is subject to punishment by a fine not exceeding \$500.00 or by imprisonment of not more than six months, or both. (KRS 287.990(12))
- c) The statute also provides: "Notwithstanding the provisions of ... this section, any failure, other than a willful and intentional failure, to comply with the provisions of ... (the statute) ... may be corrected during the billing cycle next succeeding the receipt by the bank of written notice thereof from the debtor, and if so corrected, the bank shall not be subject to any penalty under ... (this statute)." (KRS 287.990(14))

B. Other Specific Kentucky Statutes. It is now generally accepted that national banks are not subject to the specific rate limitations and other limitations set out by specific state banking statutes. Under the most favored lender doctrine, national banks are allowed to charge the highest rate allowed to any lender in the state for a specified class of loans (12 U.S.C. 85; 12 CFR 7.7310). Under this doctrine, there is one school of thought to the effect that if a bank bases its activities on a specific state statute to obtain a higher rate, it must also accept the limitations

set out in that statute. State banks in Kentucky may charge any rate that national banks may charge (KRS 287.2140 and several federal statutes).

1. The Kentucky Credit Union Statute (KRS 290).
  - a) The statute expressly permits "a self-replenishing line of credit, and loan advances may be granted to the member within the limit of such line of credit." (KRS 290.495)
  - b) The statute states that security within the meaning of the statute may include "assignment of an interest in real ... property." (KRS 290.475)
  - c) The interest rate on loans shall be determined by the Board of Directors but may not exceed two percent (2%) "per month on unpaid balances." (KRS 290.435)
  - d) In addition, charges may be assessed "in accordance with the bylaws, for failure to meet ... obligations to the credit union in a timely manner." (KRS 290.445)
  - e) While this statute does not specifically refer to the recovery of attorney fees on collection, the general Kentucky statute appears to allow recovery of such if proper provisions are inserted into the agreement. (KRS 411.195)
  - f) The credit union statute does not appear to specifically address the issues dealing with methods of computing the finance charge, a change in terms, mandatory requirements in the initial agreement or periodic statement, nor does it specifically provide for the collection of "closing costs" in real estate secured transactions.
2. It does not appear feasible to base a revolving credit plan on other Kentucky statutes. For example, it is not likely that a bank could pattern a program under the provisions of the Consumer Loan Statute (KRS 288), the Industrial Loan Statute (KRS 291), the Retail Charge Agreement Statutes (KRS 271), or the Pawnbroker's Statute (KRS 226).

C. The General Usury Statute (KRS 360.010).

1. It may be possible to base a revolving credit plan on the general usury statute, even though it is arguable that such a plan was not contemplated by the drafters of that statute. A recent case from the Kentucky Supreme Court appears to support such an argument. See Duff vs. Bank of Louisville & Trust Company, Ky. Sup. Ky., 705 S.W.2d 920 (1986).
2. The statute states that the "legal rate of interest" is eight percent (8%) per annum but any party may agree, in writing, for payment of interest in excess of that rate.
3. Limitation on Interest Rate.
  - a) If the "original principal amount" is \$15,000.00 or less, the rate may not exceed four percent (4%) in excess of the discount rate in effect at the Federal Reserve Bank in the district where the transaction is consummated or 19%, whichever is less.
  - b) If the original principal amount is in excess of \$15,000.00 then the parties may agree, in writing, to any rate.
  - c) What is the "original principal amount" for the purposes of a revolving credit plan? Is the applicable interest rate determined by the amount of the credit line, the amount of the initial draw or the amount of each draw? Compare the position of the Kentucky Attorney General in Opinion 79-169 with the logic and conclusion in Section 226.3(b)(2) of the Official Commentary to Regulation Z.
4. Civil Penalty for Excessive Interest. A Bank which takes, receives, reserves, or charges a rate of interest greater than is allowed, when knowingly done, shall not be allowed to collect any interest on the obligation. In addition, if a greater rate of interest has been paid, the debtor or his legal representative may recover twice the amount of the interest paid provided that an action is commenced within two years from the time the usurious transaction occurred. (KRS 360.020(1))

5. The statute does not address other issues under a revolving credit plan, such as the method of computing the finance charge, whether the rate may be fixed or variable, if the terms of the agreement may be changed from time, required contents of the initial agreement and the periodic statement, and the collection or recovery of closing costs in real estate related transactions.
6. While the statute does not specifically refer to the recovery of attorney fees on collection, the general Kentucky statute appears to allow recovery of such if proper provisions are inserted into the agreement.  
(KRS 411.195)

II. THE PHILOSOPHY AND OPERATION OF A REVOLVING CREDIT PLAN.

- A. Banks are accustomed to handling closed-end loans involving a note or other debt instrument signed under the supervision of a bank officer. In this type of program, once the "paperwork" is done the loan officer's job is usually completed.
- B. A revolving credit plan, however, is not a one-step operation. In addition to developing a new or modified set of loan policies, the bank must also educate and prepare its officers to handle the mechanics of the program, which continue long after the initial agreement.
  1. The bank must develop or evaluate and purchase an initial agreement which usually doubles as the Federal Truth-In-Lending Disclosure Statement.
  2. The bank must develop or evaluate and purchase a real estate mortgage which has been specially drafted for use with a revolving credit plan.
  3. The bank must prepare and furnish the necessary right of rescission notices at various stages during the plan as required by Regulation Z.
  4. The bank must develop or evaluate and obtain a periodic statement form, and in addition have or acquire the operational capability of completing and processing that form in a timely and accurate manner.

5. In addition, the bank must have error resolution and other procedures in place to comply with the mandates of Regulation Z.
6. Finally, the bank must establish and monitor its procedures relative to release of the mortgages obtained under the plan.

### III. BASIC DECISIONS AND THE INITIAL AGREEMENT.

The form, contents and layout of the initial agreement are extremely important to the bank since it is the contract between the bank and the debtor, and as such governs the rights and responsibilities of each. It must also reflect the bank's policies on many points and in many areas, some of which are not relevant to closed-end lending. The questions in this section are intended to merely summarize some of the matters which perhaps should be addressed both as a matter of policy and as a desired contract term.

- A. Are the parties properly identified?
- B. Is the date of the agreement clearly specified?
- C. Must the plan have a "due date" or a "maturity date"?
  1. Is the balance of the account due in full on the maturity date?
  2. Is the maturity date the last day that funds will be advanced on the account?
  3. Is the maturity date the last day that funds will be advanced permitting the debtor additional time within which to pay the balance?
- D. Does the agreement specify a maximum credit limit?
  1. Is that maximum credit limit subject to change?
  2. May the bank make advances on the account which will take the balance over the maximum credit limit, and if so, what is the effect of that action?
- E. How may the account be "accessed"?
  1. May the account be accessed through especially encoded checks, through an ATM, by telephone direction, by direct teller contact? May it be accessed by a credit card

- or used to fund an overdrawn checking account?
2. Are the especially encoded checks treated the same as "regular" checks?
  3. Does the bank have any responsibilities if it erroneously refuses to pay a specially encoded check?
- F. Is there a minimum amount on each draw under the account?
- G. At the time the account is opened, is an initial advance required?
- H. Is there an annual fee on the account?
1. If so, when is the fee posted to the account?
  2. Is it payable directly by the debtor?
  3. If the fee is added to the balance of the account, is it then subject to the application of a finance charge?
- I. Is there a late charge? If so, what is the amount and on what day is it assessed?
- J. Are there other initial charges connected with the account, such as "real estate related" charges? If so, what is the nature and amount of those charges?
1. When are they due?
  2. May they be added to the account?
- K. What finance charge or interest will the bank charge and will it be added to the balance on the account?
1. Is there a maximum limit on the rate of the finance charge?
  2. Will the finance charge be computed on a fixed or a variable rate?
  3. If a variable rate, is there both a floor and a ceiling? By law or by agreement.
  4. What method is used to compute the finance charge?



5. If the account can be accessed by a credit card, is the "free ride" specifically contracted for?
- L. At what point in time does the account "come into existence"?
- M. When is the bank required to release its real estate mortgage securing the account?
1. What must the bank do if the debtor requests a "partial release"?
  2. What if the debtor requests a "full release" which clearly states that all advances after the date will be subordinate to other mortgages?
  3. What is the status of the real estate mortgage if the balance of the account is paid down to "zero" but the debtor has not requested that the account be terminated?
- N. Who can access the account?
1. If access can be accomplished by only one of several obligors, are all clearly liable for the acts of the others?
  2. Is liability clearly joint and several among all of the signers?
  3. To whom is the bank obligated to give notices, periodic statements, etc.?
- O. What payments are required under the plan?
1. How are the amounts of payments calculated?
  2. Is there a minimum payment?
  3. May the plan provide for payment of interest only?
  4. When are the payments due in relation to the end of each billing cycle or the statement date?
- P. What are the "events of default" under the agreement? Are "events of default" clearly set out?
- Q. What is the effect of the debtor's default?

- R. If there is a default and subsequent collection action, including a foreclosure action, is taken, does the agreement obligate the debtors to pay attorney fees? Does the agreement clearly provide that a finance charge will continue, and if so, at what rate?
- S. Does the bank have the right to cancel the agreement and refuse to make further advances? Under what conditions may it do so? If so, is the bank required to give notice to the debtors and if so, in what form and manner?
- T. May the debtors cancel the agreement? If so, what type of notice must they give the bank and what is the bank's obligation after it receives such notice? What if notice of cancellation is received from only one of several debtors?
- U. Does the bank have the right to require updated financial statements from the debtor from time to time?
- V. Does the agreement provide the desired waiver of rights by the debtor?
- W. Does the agreement specify the address to which notices to the debtors must be mailed or delivered?
- X. What are banks rights if debtor grants another mortgage to another creditor? What if bank feels its priority position is compromised?

#### IV. THE PERIODIC STATEMENT.

- A. Generally, Federal Truth-In-Lending law dictates the form and content of the periodic statement. However, careful consideration must also be given to any applicable state statute.
- B. Generally, the terminology on the periodic statement must be consistent with the terminology used in the initial agreement. It is possible that a pre-printed initial agreement may require additional matters be set out in the periodic statement form.
- C. Which came first, "THE CHICKEN OR THE EGG"? In the logical flow of developing a revolving credit program, the periodic statement should be designed to conform to the initial agreement (which generally reflects the policy decisions of the

bank). However, many banks have an existing computer program, either in-house or supplied by an outside service. Therefore in most instances, the initial agreement must be developed to conform to the existing computer program, if that program is in fact usable for a revolving credit plan.

V. THE SECURITY: THE MORTGAGE FORM AND POTENTIAL PROBLEMS. The following material is intended to pose some of the questions and issues which might arise. As the "new product" matures, certainly the list will grow. (Selected Kentucky statutes are included at the end of this outline.)

A. The Mortgage Form.

1. No County Clerk shall record a mortgage unless "the maturity of the obligations thereby secured which have already been issued or which are to be issued forthwith" is stated. The only exception is for obligations "due on demand." (KRS 382.330)
2. No County Clerk shall record a mortgage unless the name and address of the draftsman appears on the instrument. (KRS 382.335)
3. No County Clerk shall record a mortgage unless the post office address and the county and state of the residence of the person or corporation owning or holding the "evidence of indebtedness" is stated thereon. (KRS 382.430)
4. Generally, many (perhaps most) of the provisions found in a conventional real estate mortgage should be included in the form. Those may not alone be sufficient. For instance:
  - a) Does the form clearly state the "amount" of the indebtedness which is secured by the mortgage?
  - b) Does the mortgage clearly state the conditions under which the bank will release the mortgage?
  - c) Does the mortgage set out the obligations of the bank in the event the balance of the account is paid down to zero but the debtor does not request a release of the mortgage?

5. Most title examiners are not accustomed to seeing these special types of mortgages. Should the form be conspicuously identified?

B. Bank Must Release Mortgage When Debt "Satisfied".

1. The statute requires that a mortgagee file a formal release of a mortgage in the appropriate county clerk's office within thirty (30) days from the date of satisfaction of the mortgage (Note: the statute previously allowed a sixty (60) day period, but the time was shortened to thirty (30) days effective July 15, 1986). (KRS 382.365)
2. The statute does not define "satisfaction." May the parties contract as to when "satisfaction" occurs and the release is required?
3. If the mortgagee fails to record a release as required, an action may be maintained against it for a recovery of an automatic Fifty Dollar (\$50.00) penalty plus actual expenses, including attorney fees incurred in filing the suit.

C. Priority Issues. Who will win in a contest between the bank and a subsequent mortgagee, an execution creditor or a lienor?

1. Optional or Obligatory Advances? There is some case law authority in Kentucky to the effect that advances made by a creditor who is obligated to make those advances retains a priority secured position. Should a bank's revolving credit plan take an obligatory approach? See Percy Galbreath & Son, Inc. vs. Watkins, Ky. Ct. App. 560 S.W.2d 239 (1977) and cases cited therein.
2. The Kentucky Super-Priority Statute. (KRS 382.520)
  - a) The mortgage may specify additional indebtedness but must stipulate the maximum additional indebtedness secured by the mortgage. The mortgage lien thus authorized shall be superior to other liens subsequently created and recorded. (KRS 382.520(2))

- b) Debtor may request a release of the lien to "secure additional indebtedness as exceeds the balance of such additional indebtedness at the time of such request." How does this apply to a revolving credit plan?
  - c) The current Kentucky statute allows debtor to send written notice to bank requesting a full (?) or a partial (?) release of the mortgage. If bank fails to record its release within ten (10) business days after receipt of written request then debtor may record his notice as the release. Does that mean the debtor can draw up and record his own release? (KRS 382.520(3)(e))
  - d) A Debtor has the right to subordinate all advances on a line of credit type account after the notice, provided the notice meets certain specified requirements. (KRS 382.520(3)(c))
3. Federal Tax Liens. Generally, the Federal Tax lien will be superior to advances made more than forty-five (45) days after the notice of the Federal Tax Lien is filed. How does the bank protect itself? (26 U.S.C. 6323)

VI. SOME ADDITIONAL MATTERS FOR CONSIDERATION.

- A. The Equal Credit Opportunity Act and Regulation B. (15 U.S.C. 1691 et seq.; 12 CFR 202)
- 1. All bankers are generally familiar with the basic requirements of Regulation B and its rules concerning discrimination, the content and processing of applications, and the handling and content of adverse action notices applicable to all loans.
  - 2. As in all real estate secured transactions, a bank is likely to encounter particular problems with the rule which prohibits requiring a co-signer for an individually creditworthy person, or dictating the identity of the co-signer if one is required. It is quite probable that a married person will apply for a revolving credit plan account in his or her name only. In that event, assuming that the applicant is creditworthy, the bank may not require the

signature of the applicant's spouse on the initial agreement (the debt instrument) but may require the spouse's signature on the mortgage (very few preprinted mortgage forms provide for this possibility).

3. If the account is closed by the bank or if the credit limit is lowered, is an adverse action notice required?

B. The Electronic Funds Transfer Act - Regulation E.  
(Title IX, 15 U.S.C. 1601 et seq.; 12 CFR 205)

1. The general provisions of Regulation E dealing with disclosures, proper identification of transactions and limitations on customer liability may apply to real estate secured - revolving credit plans if the plan allows access to the account by certain devices triggering the regulation. In such instances, the bank must give special and additional consideration to the mandates of Regulation E.
2. Generally the bank may not require that the required payments be automatically deducted from the debtor's checking account.

C. The Federal Reserve Board Fair Credit Practices Rule and Regulation AA. (12 CFR 227; 15 FR 16.695)

1. The general requirements of the regulation which prohibit confessions of judgment, general waivers of exemption, pyramiding of late charges and the assignment of wages apply to real estate secured - revolving credit plans. (The exception is if the credit is used for the purchase of real property. See Section E for possible problems if the account can be used for that purpose.)
2. If a co-signer (as defined in the regulation) is to become obligated on the account, all of the requirements of the regulation dealing with the Co-signer Notice apply.

D. The Kentucky Guaranty Statute.

The 1986 Kentucky Legislature adopted what is now KRS 371.065. This somewhat unusual statute requires that certain information be included in all separate guaranty instruments. If the real

estate secured - revolving credit plan account is to be covered by a separate guaranty agreement, the requirements of this statute must be recognized and met.

E. The ARM Regulations of the Office of the Comptroller of the Currency. (12 C.F.R. 29.1)

National banks are subject to the ARM Regulations of the Office of the Comptroller of the Currency which generally apply to variable rate loans made to purchase or refinance one to four family dwellings. The typical real estate secured - revolving credit plan does not include the necessary disclosures and other requirements of the ARM Regulations. Therefore, it is necessary that a bank restrict or prohibit the use of such an account for the purpose of purchasing or refinancing a one to four family unit. Are such contractual provisions sufficient?

VII. THE LATEST DEVELOPMENTS.

(The following space is reserved for the user of this outline to keep track of future developments in this area. As with any "new product" these are bound to occur.)

SELECTED KENTUCKY STATUTES

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KRS 382.330.    INSTRUMENT NOT TO BE RECORDED UNLESS DATE OF MATURITY SHOWN - EXCEPTION. - No county clerk shall record a deed or deed of trust or mortgage covering real property by which the payment of any indebtedness is secured unless the deed or deed of trust or mortgage states the date and the maturity of the obligations thereby secured which have been already issued or which are to be issued forthwith. In the case of obligations due on demand, the requirement of stating the maturity thereof shall be satisfied by stating that such obligations are "due on demand."



KRS 382.335. INSTRUMENT NOT TO BE RECORDED UNLESS NAME AND ADDRESS OF DRAFTSMAN APPEARS THEREON - (1) No county clerk shall receive or permit the recording of any instrument by which the title to real estate or personal property, or any interest therein or lien thereon, is conveyed, granted, encumbered, assigned or otherwise disposed of; nor receive any instrument, provided by law, to be recorded as evidence of title to real estate; and shall not receive or permit any instrument, relating to the organization or dissolution of a private corporation, unless such instrument has indorsed on it, a printed, typewritten or stamped statement showing the name and address of the individual who prepared the instrument, and such statement is signed by such individual, provided, however, that the person who prepared the instrument may execute his signature by affixing a facsimile of his signature on the instrument. This subsection shall not apply to any instrument executed or acknowledged prior to July 1, 1962.

(2) No county clerk shall receive or permit the recording of any instrument by which the title to real estate or any interest therein is conveyed, granted, assigned or otherwise disposed of unless such instrument contains the mailing address of the grantee or assignee. This subsection shall not apply to any instrument executed or acknowledged prior to July 1, 1970.

(3) This section does not apply to wills.

(4) The receipt for record and recording of any instrument by the county clerk without compliance with the provisions of this section shall not prevent such record of filing of the instrument from becoming notice as otherwise provided by law, nor impair the admissibility of the record as evidence.

KRS 382.430. INSTRUMENT CONSTITUTING LIEN TO NAME PERSON LIABLE FOR TAXES THEREON. - (1) No mortgage, conveyance or other instrument or writing constituting a lien or other security for any note or other evidence of indebtedness shall be received for record by any county clerk unless such mortgage, conveyance or other writing gives the county and state of the residence and the post office address of the person or corporation owning or holding the note or other evidence of indebtedness, or liable for the payment of taxes thereon.

(2) Should there be an assignment of such note or other evidence of indebtedness, of record in the clerk's office, the assignment shall state the county and state of the residence and post office address of the assignee. Unless any assignment is made of record, the original holder or owner shall be liable for taxes as though no assignment had been made.

KRS 382.365. RELEASE OF LIEN WITHIN THIRTY DAYS OF SATISFACTION PROCEEDING AGAINST LIENHOLDER IN CIRCUIT COURT - LIABILITY OF LIENHOLDER WHEN LIEN NOT RELEASED. - (1) A holder of a lien on real property shall release the lien in the county clerk's office where the lien is recorded within thirty (30) days from the date of satisfaction.

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

(3) Upon proof of satisfaction of the lien being introduced, the court may enter a judgment releasing the lien. A lienholder that violates subsection (1) of this section shall also be liable to the owner of the real property for fifty dollars (\$50.00) and any actual expense including a reasonable attorney's fee incurred by the owner in securing the release of real property by such violation. The judgment shall be with costs including reasonable attorneys' fees.

KRS 382.520. RENEWAL, EXTENSION OR ADDITIONAL LOAN UNDER MORTGAGE ON REAL ESTATE - SUPERIORITY OF LIEN - RELEASE OF LIEN, WHEN. - (1) In all cases where a loan is secured by a real estate mortgage, the mortgage originally executed and delivered by the borrower to the lender shall secure payment of all renewals and extensions of the loan and the note evidencing it, whether so provided in the mortgage or not.

(2) The mortgage referred to in subsection (1) of this section may secure any additional indebtedness, whether direct, indirect, existing, future, contingent or otherwise, to the extent expressly authorized by the mortgage, if the mortgage by its terms stipulates the maximum additional indebtedness which may be secured thereby. Except as provided in subsection (3) of this section, the mortgage lien authorized by this subsection shall be superior to any liens or encumbrances of any kind created after recordation of such mortgage, even to the extent of sums advanced by the lender with actual or constructive notice of a subsequently created lien, provided, however, any mortgagee upon receipt of a written request of a mortgagor must release of record the lien to secure additional indebtedness as exceeds the balance of such additional indebtedness at the time of such request.

(3) (a) The written request referred to in subsection (2) of this section shall be signed by the mortgagor or his agent or attorney, and shall set forth a description of the real property to which the request relates, the date, parties to, the volume and initial page of the record of the mortgage referred to in subsection (1) of this section, and a description of the nature, amount and holder of the lien or encumbrance which the mortgagor intends to place upon such real property. Such request shall be deemed to have been received by the holder of the mortgage referred to in subsection (1) of this section only when delivered to such holder by certified mail, return receipt requested, at the address of the holder appearing of record on such mortgage or an assignment thereof;

(b) If within ten (10) business days after receipt of the written request referred to in this subsection, the holder of the mortgage referred to in subsection (1) of this section fails to release that amount of the lien to secure additional indebtedness to the extent described in such request, the mortgagor may record in the office of the county clerk in which the mortgage referred to in subsection (1) of this section is recorded by a copy of such written request upon payment of the same filing fee as provided for a release of a mortgage;

(c) If, after a copy of such written request is recorded, an advance is made by the holder of the mortgage referred to in subsection (1) of this section, the lien of such mortgage for the unpaid balance of the advance so made shall be subordinate to the

lien or encumbrance described in such request; provided, that any advance made pursuant to a line of credit shall not be subordinate to the lien or encumbrance described in such request unless such request specifically, and not by implication, describes such line of credit by account or other identifying number and states that any advance thereafter made pursuant to such plan is intended to be subordinated as aforesaid.



NON-CONSUMER  
REGULATORY PROBLEMS

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Section G





# **NON-CONSUMER REGULATORY PROBLEMS**

**COLLEGE OF LAW  
UNIVERSITY OF KENTUCKY**

## **SEMINAR ON LEGAL ISSUES FOR BANK COUNSEL**

**March 13-14, 1987**

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## NATIONAL BANK LENDING LIMITS

### I. Purpose of Lending Limits

The purpose of the lending limits statute and regulation is to promote safety and soundness in lending practices. The law and regulation prevent any one customer from borrowing an unduly large amount of the bank's funds. In certain situations, the regulations require combining of loans to more than one person, placing further restrictions on concentration of loans among related groups of customers. (12 USC 84; 12 CFR 32)

### II. General Rules

#### A. General Limitation - 15% of Unimpaired Capital and Surplus

Total extensions of credit to a borrower at one time may not exceed 15% of the bank's unimpaired capital and surplus. For example, if a bank has unimpaired capital and surplus of \$1,000,000, its total loans to any one person may not exceed \$150,000.

#### B. Additional Category - Loans Secured by Readily Marketable Collateral

A category calculated separately from the 15% limitation allows additional extensions of credit to a borrower if they are fully secured at all times by "readily marketable collateral." Loans in this category may not exceed 10% of the bank's unimpaired capital and surplus. "Readily marketable collateral" includes stocks, bonds, and debentures traded on a national securities exchange; OTC margin stocks as designated by the Federal Reserve; commercial paper; and negotiable certificates of deposit.

#### C. Example

Assume that ABC National Bank has unimpaired capital and surplus of \$1,000,000. It may lend one person \$150,000 under the general rule stated in Section II.A., and an additional \$100,000 under the rule stated in Section II.B. The second loan would have to be properly collateralized. If the market price of the collateral drops to \$50,000, the second loan must be paid down to \$50,000 or additional collateral must be pledged, within five business days.

### III. Combining Loans to Separate Borrowers

#### A. General Rule

Extensions of credit to one party will be combined with loans to another party for the purpose of applying the

lending limits, when (1) a "common enterprise" exists between the persons; or (2) the proceeds of the loans are to be used for the direct benefit of the other party.

B. Common Enterprise

Whether a common enterprise exists must be determined on a case-by-case basis. However, there are certain situations in which loans clearly must be combined.

1. Loans With Same Source of Repayment

A common enterprise exists between persons relying on the same source of repayment for extensions of credit. For example, the bank should combine loans to two individuals whose sole source of income is a corporation which the two individuals own.

2. Loans to Parties That are Financially Interdependent and Related Through Common "Control"

A common enterprise exists between two entities if (a) they are related through common "control", including cases in which one entity is controlled by another; and (b) there is substantial financial interdependence between the two entities.

a. Definition of "Control"

A person is considered to "control" an entity if the person controls 25% of the voting stock of the entity; or controls the election of a majority of the board of directors of the entity; or exercises a controlling influence over the management of the entity.

b. Example:

Assume that a bank's lending limit is \$150,000. Smith owns 25% of the voting securities of ABC, Inc. Smith is in the business of purchasing coal, and the sale of coal to Smith by ABC constitutes half of ABC's business. The bank has a \$75,000 loan already to Smith. The bank can only lend ABC, Inc. \$75,000 because the loans to Smith and ABC, Inc. would have to be combined for lending limits purposes.

3. Loans For Acquisition of a Business

A common enterprise exists where a bank extends loans to a group of otherwise unrelated persons for the purpose of the group's acquisition of a

business enterprise (or at least 50% of the voting stock of a business). For example, assume that a bank's lending limit is \$150,000. Smith borrows \$100,000, Jones borrows \$100,000 and Doe borrows \$50,000. They use the loans to purchase 51% of a company's voting stock. The three loans would have to be combined and the bank would be in violation of its lending limits.

C. Loans to Corporations

Loans to corporations may have to be combined under rules previously outlined. However, even if there is not a "common enterprise", the regulation imposes additional limitations on loans to members of a "corporate group." Such loans may not exceed 50% of the bank's unimpaired capital and surplus.

1. Definition of "Corporate Group"

A corporate group includes a person and all of its direct and indirect subsidiaries. A corporation is considered a subsidiary if a person or corporation owns more than 50% of its stock.

2. Example:

A owns more than 50% of the voting stock of Corporation X. Corporation X owns more than 50% of the voting stock of Corporation Y. Corporation Y is a subsidiary of both A and Corporation X. Therefore, the total loans by a national bank to A, Corporation X, and Corporation Y cannot exceed 50% of the bank's unimpaired capital and surplus.

D. Loans to Partnerships, Joint Ventures and Associations

Extensions of credit to a partnership, joint venture, or association shall be considered extensions of credit to each member of such partnership, joint venture or association. For example, assume that a bank's lending limit is \$100,000. It may extend \$50,000 of credit each to A and B, who are general partners in the partnership AB. The bank may also loan \$50,000 to the partnership. However, B is also a member of the partnership BC which wants to borrow \$15,000. The bank cannot make this loan because the loan to partnership AB has been attributed to B along with B's personal loan. When these loans are combined with the proposed loan to partnership BC, the bank would be in excess of its lending limits.

IV. Exceptions to Lending Limits--Selected Examples

A. Loans Secured by U.S. Obligations

Loans or extensions of credit secured by U.S. government obligations will not be subject to lending limits.

B. Discount of Installment Paper--Full Recourse

Extensions of credit arising from the discount of installment consumer paper with full recourse to the seller are considered extensions of credit to the seller, but are subject to a limitation of 25% of unimpaired capital and surplus.

C. Discount of Installment Paper--No Recourse

Installment consumer paper purchased from a dealer will be considered a loan to the maker of the paper, rather than the dealer, if (a) the bank has determined and can document that the financial condition of the maker is adequate to repay the obligation, and (b) an officer authorized by the bank's Board of Directors certifies in writing that the bank is relying primarily on the maker for repayment.

D. Federally Related Loans

Loans or extensions of credit to or secured by the unconditional guarantee or take-out commitment of a federal government agency will not be subject to lending limits.

E. Loans Secured by Deposit Accounts

Loans or extensions of credit secured by a segregated deposit account in the lending bank will not be subject to lending limits, if (1) the bank's security interest is perfected, which requires a formal assignment and a hold on the account; and (2) the bank has set up internal control procedures to prevent the release of the security.

V. Definition of Extension of Credit

The term "extension of credit" means any direct or indirect advance of funds to a person based upon the obligation of the person to repay the funds or which is repayable from property pledged by or on behalf of a person.

A. Examples of Extensions of Credit

The term "extension of credit" includes (1) obligations of makers and endorsers arising from the discount of commercial paper; (2) standby letters of credit; and (3) sales of federal funds with a maturity of more than one business day.

B. Exclusions From Definition of "Extension of Credit"

The term "extension of credit" does not include the following:

1. Obligations of a Guarantor

The obligation of a guarantor or endorser who does not receive any of the proceeds or the benefits of the extension of credit, so long as the guarantor or endorser is not engaged in a "common enterprise."

2. Federal Funds

The sale of federal funds with a maturity of one business day; or the sale of federal funds under a continuing agreement that has no specified maturity and requires no advance notice for termination.

3. Repurchase Agreements

Obligations under a repurchase agreement involving securities that are obligations of the U.S. government, or general obligations of a state or political subdivision of a state.

4. Non-Recourse Participations

The sale of a participation in a loan on a non-recourse basis.

5. Interest

Accrued or discounted interest, so long as the interest is not rolled over into principal of the loan.

## KENTUCKY STATE BANK LENDING LIMITS

### INTRODUCTION

Kentucky Revised Statutes (KRS 287.280) control a Kentucky state bank's lending limits for all types of borrowers. Federal Reserve Board Regulation "O" (12 CFR 215) also regulates loans to insiders of Kentucky state banks. Loans to affiliates of Kentucky state banks (the parent holding company, any other bank or non-bank subsidiary of the parent holding company and any company "interlocked" with a bank by means of common "control" of both the banking organization and the other company) are also governed by Section 23A of the Federal Reserve Act.

## KENTUCKY STATE BANK LENDING LIMITS

### I. APPLICABILITY

- A. The lending limits imposed by state law (KRS 287.280) govern loans by state banks to all types of borrowers (individuals, corporations, partnerships, trusts, estates, associations, etc.). However, certain additional restrictions apply to loans to a bank's insiders and will be discussed below.

### II. MAXIMUM DEBT

A. 20% Unsecured Maximum

A bank may loan on an unsecured basis to any one borrower no more than 20 percent of its capital stock actually paid in plus its actual amount of surplus.

B. 30% Secured Maximum

A bank may loan to any one borrower a maximum of 30 percent of its capital stock actually paid in plus its actual amount of surplus if the entire indebtedness is fully secured by "good collateral" having value, exclusive of all other encumbrances, in excess of the debt secured.

EXAMPLE: Assume that a Bank's current 20% Unsecured Legal Lending Limit is \$2,000,000 and Bank presently has an outstanding unsecured loan to Borrower in the amount of \$2,000,000. Bank wishes to lend Borrower an additional \$100,000. The additional \$100,000 loan will exceed the 20% Unsecured Legal Lending Limit



but will be within Bank's 30% Secured Legal Lending Limit. Once Borrower's loans will exceed the 20% Unsecured Legal Lending Limit, all of Borrower's loans with Bank must be fully secured. Therefore, the entire \$2,100,000 must be fully secured, not just the additional \$100,000.

D. Definitions (KRS 287.010)

1. "Capital Stock" means the sum of:
  - (a) The par value of all shares of the corporation having a par value that have been issued;
  - (b) The amount of consideration received by the corporation for all shares of the corporation that have been issued without par value except such part of the consideration as has been allocated to surplus in a manner permitted by law; and
  - (c) Such amounts not included in paragraphs (a) and (b) of this subsection as have been transferred to stated capital of the corporation, whether through the issuance of stock dividends, resolution of the bank's Board of Directors under applicable corporate law or otherwise by law.
2. "Surplus" means the amount of consideration received by the corporation for all shares issued without par value that has not been allocated to capital stock or the amount of consideration received by the corporation in excess of par value for all shares with a par value or both. (Surplus does not include undivided profits or allowance for loan loss reserves.)

E. Combining Indebtedness

1. The maximum debt permitted by Kentucky law includes all loans to a borrower plus all obligations of that borrower as guarantor or

surety to the bank for the indebtedness of others.

2. The total indebtedness of the borrower to a bank shall include the aggregate of all indebtedness to the bank of any partnership in which the borrower acts as a general partner.
3. The total indebtedness of the borrower shall include the aggregate of all indebtedness to the bank entered into for the benefit of such borrower.

F. Exceptions To Maximum Debt Limits (KRS 287.290)

1. The limitations and restrictions of KRS 287.280 do not apply to the following:
  - a. Obligations of the United States or of the state of Kentucky;
  - b. Obligations guaranteed as to principal and interest by the United States or the State of Kentucky; or certain other obligations secured by guarantees of the United States or certain of its agencies;
    - (1) However, the Commissioner of Financial Institutions may alter certain lending limit exceptions set forth in this subparagraph
  - c. Obligations of Kentucky counties and school districts incurred through borrowing in anticipation of the current year's tax receipts as authorized by KRS 68.320 and 160.540.
2. Federal Funds Transactions (808 KAR 1:020)
  - a. The sale and purchase of federal funds by state chartered banks is not subject to the maximum lending provisions of KRS 287.280.

## EXAMPLE

Assume Kentucky State Bank's balance sheet shows the following accounts:

Capital Stock or Stated Capital (100,000 shares, \$5 par value per share)	\$ 500,000
Surplus	500,000
Undivided profits	1,000,000
Capital Notes	100,000
Allowance for Loan Loss Reserves	<u>250,000</u>
	\$2,350,000

### LENDING LIMITS

(a) Unsecured Loans -- 20% Maximum

(1) No one borrower may have unsecured loans from Kentucky State Bank in excess of \$220,000 (20% of \$1,100,000, which consists of Kentucky State Bank's Capital Stock (\$500M), Surplus (\$500M) and Capital Notes (\$100M), but without Undivided Profits and Allowance for Loan Loss Reserves).

(b) Secured Loans -- 30% Maximum

(1) Kentucky State Bank may lend to any one borrower a maximum amount of \$330,000 (30% of \$1,100,000, which consists of Kentucky State Bank's Capital Stock (\$500M), Surplus (\$500M), and Capital Notes (\$100M), but without Undivided Profits and Allowance for Loan Loss Reserves); provided that when indebtedness exceeds 20 percent, the entire borrowing must be secured by good collateral with a value in excess of the indebtedness.

(c) Note that in calculating the 20 percent and 30 percent legal lending limit tests, Kentucky

State Bank's Undivided Profits of \$1 million, and its Allowance for Loan Loss Reserves of \$250,000, are excluded. If Kentucky State Bank wanted to increase its legal lending limit base to its borrowers, it could do so by moving part of the \$1 million in Undivided Profits to the Capital Stock account (which makes the portion so transferred unavailable for dividends). This can be done by resolution of the board of directors. See KRS 271A.105(4) and KRS 287.010(8)(c).

END OF EXAMPLE

## INSIDER LOANS

### I. DUAL COVERAGE -- STATE AND FEDERAL LAW

#### A. KRS and Regulation "O"

1. The regulation of loans by Kentucky state banks to insiders is complex because such loans are governed by both Kentucky statutory law (KRS 287.280) and the Financial Institutions Regulatory and Interest Rate Control Act of 1978, which is implemented by Federal Reserve Board Regulation "O" (12 CFR 215). In many areas the provisions of KRS and Regulation "O" are identical. In other areas where the provisions are not the same, the more restrictive of the two governs.

### II. LENDING LIMITS FOR INSIDER LOANS

#### A. Kentucky Insider Lending Limits

1. Under Kentucky law, the lending limits for a loan by a Kentucky state bank to an insider are the same as the lending limits for a loan to any other borrower (20% Unsecured or 30% Secured, calculated on bank's actual capital and surplus.)

#### B. Regulation "O" Insider Lending Limits

1. Regulation "O" incorporates the national bank lending limits which are set forth in 12 USC 84 (15% Unsecured plus additional 10% Secured). The national bank lending limits are more fully

discussed in a separate outline in the seminar materials.

- a. National bank lending limits are calculated on the bank's unimpaired capital and unimpaired surplus. Unimpaired surplus is very broadly defined to include undivided profits, loan loss reserves, other capital reserves and certain other items.

C. Types Of Insider Loans Regulated By Both Kentucky Lending Limits And Regulation "O" Lending Limits

Loans to the following types of insiders are regulated by both Kentucky lending limits and Regulation "O" lending limits. A bank should calculate its lending limits under both set of rules and must use whichever calculation produces the smaller lending limits. The Kentucky lending limits generally will be smaller than the Regulation "O" lending limits because Kentucky limits are percentages of actual capital and surplus while Regulation "O" limits are percentages of unimpaired capital and unimpaired surplus.

1. Banks own executive officers, or any related interests of those persons

- a. With respect to Kentucky banks which are members of the Federal Reserve System, Regulation "O" (at 12 CFR 215.5) prohibits loans to "executive officers" unless such loans are first mortgage loans, loans to finance the education of the executive

officer's children, or loans for any other purposes if the aggregate amount of such other loans does not exceed at any one time the higher of 2.5% of the bank's capital and unimpaired surplus or \$25,000, but in no event more than \$100,000.

2. Regulation "O" lending limits do not apply to a bank's own directors, or any related interests of that person unless the director is also an executive officer or principal shareholder of the bank.
3. Bank's principal shareholders, or any related interests of those persons.
4. Executive officers and principal shareholders of the bank's parent holding company and of all of its other subsidiaries, and the related interests of those executive officers and principal shareholders.

D. Definitions

1. "Executive Officers" are generally those individuals designated by board resolution as having major policy making functions. If there is no such resolution, the chairman of the board, the president, every vice-president, the cashier, the secretary, and the treasurer are considered executive officers.
2. "Principal Shareholders" are individuals, companies, partnerships, trusts or any other business entity that own or control

more than 10 percent of any class of voting securities of a bank, its parent holding company or any other subsidiary of the bank holding company.

a. The percentage is "more than 18 percent" rather than "more than 10 percent" if the bank is located in a city, town or village with a population less than 30,000.

3. "Related Interest" means any form of business entity that is "controlled" by a person or a political or campaign committee that is controlled by a person or the funds or services of which will benefit a person.
4. A person has "control" of a business entity or campaign committee if that person:
  - (1) Owns or controls 25 percent or more of the voting securities of the entity or committee;
  - (2) Controls the election of a majority of directors of the entity or committee, or
  - (3) Has the power to exercise controlling influence over the management of the entity or committee.
5. A person is presumed to have control if:
  - (1) The person is an executive officer or director of the entity and owns or controls more than 10 percent of



voting securities of that entity,

or

- (2) The person owns or controls more than 10 percent of voting securities of the entity and no other person owns or controls a greater percentage.

### III. OTHER REQUIREMENTS APPLICABLE TO INSIDER LOANS MADE BY KENTUCKY STATE BANKS

#### A. Non-Preferential Loans

##### 1. Applicability

KRS and Regulation "O" both have a substantially similar non-preferential loan rule.

This rule applies to loans by state banks to:

- a. Bank's own directors, executive officers, principal shareholders and their related interests.
- b. Directors, executive officers and principal shareholders of the bank's parent holding company and all of its other subsidiaries and the related interests of those persons.
- c. The bank's parent holding company and any other subsidiary of that holding company.

##### 2. Non-Preferential Loan Rule

A state bank may not grant extensions of credit to the above listed insiders nor permit such insiders to become obligated to it as guarantor or surety unless such indebtedness or obligation is made on

non-preferential terms. Therefore, such extensions of credit must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with those who are not insiders. Also, the loan must not involve more than the normal risk of repayment or present other unfavorable features.

B. Prior Board Approval

1. Applicability

KRS and Regulation "O" both have a substantially similar prior board approval rule. This rule applies to loans by state non-member banks to:

- a. Bank's own directors, executive officers, principal shareholders and their related interests.
- b. Directors, executive officers and principal shareholders of the bank's parent holding company and all of its other subsidiaries and the related interests of those persons.
- c. The bank's parent holding company and any other subsidiary of that holding company.

2. Prior Board Approval Rule

A state bank may not grant extensions of credit to the above listed insiders in any amount which exceeds a threshold amount, unless the extension is approved in advance by a majority of the entire board of directors, with the interested insider abstaining from participating directly or indirectly

in the approval process. In order to fully comply with this requirement, the interested party should leave the board room while the loan is being discussed and voted upon.

- a. Threshold Amount: Prior board approval is required if the loan to the insider, when aggregated with any outstanding credit to that person and to all related interests of that person, will exceed (i) the greater of \$25,000 or five percent of the lending bank's actual capital and surplus, or (ii) in any event exceeds \$500,000.
- b. A line of credit must be reviewed and reapproved at least every 14 months.
- c. For purposes of calculating aggregate indebtedness under the prior board approval rule, any indebtedness of \$5,000 or less is excluded if incurred under a credit card, check credit, interest bearing overdraft or similar open end credit plan if no specific prior individual clearance is required and if the indebtedness is incurred under terms no less favorable than those offered to the general public.

D. Overdrafts -- Regulation "O" Rule

1. Applicability

This rule applies to overdrafts by an executive officer or director of the state bank on an account at that bank.

2. Overdraft Rule

A bank may not pay an overdraft on an executive officer's or director's account at the bank unless it is paid in accordance with:

- a. A written, pre-authorized interest-bearing credit plan that specifies the method of payment, or
- b. A written, pre-authorized transfer from another account of the account holder at the bank.

3. A bank may also pay an overdraft if:

- a. It is "inadvertent,"
- b. It, together with any other outstanding overdrafts, does not exceed \$1,000,
- c. The overdraft paid is not outstanding for more than five business days, and
- d. The bank charged the executive officer or director its regular fee for paying overdrafts.

E. Recordkeeping Requirements -- Regulation "O" Rule

1. The state bank must keep a record of:

- a. All executive officers, directors, principal shareholders and their related

interests, and

b. The amount and terms of all extensions of credit to these insiders and their related interests.

2. The state non-member bank must request annually that these insiders identify their related interests.

NOTE: This outline has been written for the purpose of setting forth the various lending limit requirements imposed by state and federal law upon Kentucky state banks. Please keep in mind that Regulation "O" requirements are applicable to any loan made by a bank to insiders at another affiliated bank (one which is also owned by the same holding company). This outline, however, does not present a comprehensive list of all Regulation "O" requirements. It only presents those which are applicable to state banks which are not members of the Federal Reserve System. There are certain additional Regulation "O" requirements that apply to national banks and to state banks which are members of the Federal Reserve System.

## DIRECTORS' LIABILITY FOR LENDING LIMIT VIOLATIONS

### I. STATE-CHARTERED BANKS

- A. Loans in excess of the "20% limit," if not adequately secured, will result in director liability for the entire loan. See Wickliffe v. Turner, Ky., 157 S.W. 1125 (1913).
1. Directors may also be liable for the whole debt if they "negligently take collateral security or a mortgage which is insufficient under the statute." See Wickliffe, Supra, at 573.
- B. Loans in excess of the 30% limit will subject directors to liability for the amount in excess of the limit. Cunningham v. Shellman, Ky., 175 S. W. 1045 (1915); See also Wickliffe, Supra; and Scott's Ex'rs v. Young, Ky., 21 S.W.2d 994 (1929).
- C. Liability is for directors who "knowingly" violate, or knowingly permit any officer or employee of the bank to violate..." the lending limits. In such case, the directors "shall be jointly and severally liable to the creditors and stockholders for any loss or damage resulting..." KRS 287.990(5).
- D. Under the above cited cases, suit may be brought against directors by creditors, depositors and shareholders.
- E. Under KRS 287.990(18), any officer or director who violates the lending limit provisions of KRS 287.280(1) and (3) "shall be fined not less than one hundred dollars (\$100) nor more than five hundred dollars (\$500) for each violation; and any officer or director who violates the provisions of KRS 287.280(2) shall be fined not less than five hundred dollars (\$500) nor more than two thousand dollars (\$2,000) for each violation. The fine shall be assessed by the Commissioner by written notice." (Query: Does this mean that the scienter element in KRS 287.990(5) need not be present in order to levy a fine?)

Also, under KRS 287.990(15) and 287.690, the Commissioner would appear to have the authority to order banks and their directors and officers to cease and desist from lending limit violations and to assess a fine of up to \$1,000 per day for each day a violation continues.

The FDIC appears to have similar authority under 12 USC 1730 and 12 USC 1818.

### II. NATIONAL BANKS

- A. If directors "knowingly violate, or knowingly permit any of the officers...to violate" the lending limit statutes,

"every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association...shall have sustained." 12 USC 93(a); See also 12 USC 84

1. Where loans were made without the knowledge of or participation by directors, they may not be personally liable. See Corsicana Nat'l Bank v. Johnson, 251 U.S. 68, 64 L.Ed. 141, 405 S.Ct. 82 (1919); and Holman v. Cross, 75 F.2d 909 (6th Cir. 1935); provided the director has not neglected the duty to investigate. See Prudential Trust Co. v. Brown, Mass., 171 N.E. 42 (1930)
  2. It has been held that non officer directors were not guilty of a knowing violation of the statute where loans were made to an investment banking firm which, when aggregated with loans to persons later discovered to be officers of that firm were excessive. See Atherton v. Anderson, 86 F.2d 518 (6th Cir. 1936); revd. on other grounds, 302 U.S. 643.
- B. Where there are a number of loans involved, it has been held that only the funds paid out by the bank after the total borrowings have reached the lending limit are regarded as the damages sustained. See First National Bank v. Keller, 318 F. Supp 339 (N.D. Ill. 1970)
- C. Where the violative loan was the result of a single transaction, it has been held that the entire amount loaned, plus interest and less salvage, constitutes damages. See Corsicana Nat'l Bank v. Johnson, Supra. (The court noted that it could not presume that the borrower would have agreed to a loan under the lending limit had the excessive loan been rejected).
- D. Even if a bank director is not liable under the statute because he did not have knowledge of the bank's loans, his negligence in failing to supervise the bank's affairs may subject him to liability under a common law negligence doctrine. See 11 ALR Fed at 613.
- E. Directors may be sued for lending limit violations by a receiver, by shareholders, by regulators or by the bank itself. See 11 ALR Fed at 613.
- F. Directors have been held to have a right of contribution against other directors. Cache Nat. Bank v. Hinman, 626 F. Supp 1341 (D. Colo. 1986).
- G. Under 12 USC 93(b), the Comptroller can assess a civil money penalty against a national bank or an officer or director for a violation of a number of provisions of Chapter 12 of the U.S. Code, including 12 USC 84.

1. The penalty may be up to \$1,000 per day for each day during which the violation continues. It may be "assessed and collected by the Comptroller of the Currency by written note."
2. In determining the amount of the penalty, the Comptroller must take into account the financial resources and good faith of the bank or person charged, the gravity of the violation, the history of previous violations, and such other matters as justice may require. 12 USC 93(b)(1).
3. This penalty can be levied against officers as well as directors; and, there appears to be no scienter requirement in the statute. Also, the penalty may be assessed regardless of whether the bank suffers any damage or loss. See Glidden, National Bank Lending Limits: Interpretative Issues and Practical Considerations, Banking Law J., Sept.-Oct., 1984, at 575.

H. del Junco v. Conover, 682 F.2d 1338 (9th Cir. 1982)

1. This case held that directors must see to it that an unsecured, legal loan is paid off prior to secured, illegal loans.
2. Directors were held liable for (a) the illegal loans; (b) the collection costs of the illegal loans; (c) interest on the illegal loans; and (d) attorney fees paid by the bank for the directors' defense against the Comptroller's cease and desist action.
3. The Comptroller's ability to use the 12 USC 1818(b) cease and desist route and avoid the "knowingly" standard of 12 USC 94 was called into question, but held moot in this particular case.
4. Should the principles of this case not also apply to lending limit violations of state-chartered banks? Are you ever totally safe until all of the borrowers' debt is paid off or sold?

Example: First State Bank has a 30% limit of \$500,000 and made a \$500,000 loan to John Jones secured by a farm valued at \$1,000,000 at the time of the loan on 1/1/80. In 1982, First State made an illegal \$100,000 loan to Jones secured by \$200,000 worth of G.E. stock. Today, the farm land is worth \$250,000, and the G.E. stock is worth well over \$200,000. Should the directors be allowed to pay off the stock loan and remove their liability under the lending limit statute?



I. Larimore v. Comptroller of the Currency, 789 F. 2d 1244  
(7th Cir. 1986)

1. The Comptroller, in this case, sought to impose personal liability upon a bank's directors under 12 USC 1818(b) for violations of the lending limit statute. He ordered the directors to indemnify the bank for all losses that had been incurred or that might occur as a result of the excessive loans.
2. The court held that the Comptroller did not have the authority to unilaterally impose personal liability against a bank director and must first institute an action to seek damages in the proper district court under 12 USC 93(a). The district court must then determine if the director has "knowingly" violated the banking laws. (Query: Would the Comptroller have the authority to levy fines under 12 USC 93(b), as opposed to imposing personal liability for damages, without going through the Courts? It appears so. See Larimore at 1253-1254. However, the statute does provide for a judicial appeals procedure).

III. Dealing With Lending Limit Violations

A. How To Remedy Violations:

1. Transfer of the borrower's notes to another corporation. See Corsicana Nat. Bank v. Johnson, Supra.
2. Transfer of all notes or just part?
3. Charging off the amount in excess of the lending limit will not cure the violation.
4. Release of guarantors or parties obligated on a separate loan that has been "aggregated" under the lending limit statutes will not cure the problem.
5. Reduction of the loan by the borrower to the bank's lending limit does not cure the violation. Director liability ceases only when the bank is completely repaid.

B. Liability avoidance Techniques.

1. Establishment of audit procedures to guard against lending limits violations.
2. Periodic reports to the board from auditors and counsel regarding the bank's lending limits under state and federal law, both to outside borrowers and to insiders; also, reports regarding the threshold amount for prior board approval of insider loans.

3. Proper notations in minutes regarding non-voting and non-participation by insiders in the discussion of their loans.

## TRANSACTIONS WITH AFFILIATES

### I. GENERAL RULE

- A. Section 23A of the Federal Reserve Act (12 USC 371c) applies to national banks and to state chartered insured banks.
- B. Section 23A is designed to protect banks from abuse in financial transactions with affiliates. It restricts "covered transactions" between a bank and its affiliates.

### II. AFFILIATE

- A. "Affiliate" includes:
  - 1. The parent holding company of a bank, or
  - 2. Any other bank or non-bank subsidiary of the parent holding company, or
  - 3. Any bank subsidiary of a bank
    - a. Non-bank subsidiaries of a bank are excluded from the definition of "affiliate." Therefore, transactions by a bank with its own non-bank subsidiaries are not restricted by §23A.
  - 4. Any company interlocked with a bank either through a shareholder or director interlock. A company is interlocked with a bank where:
    - a. A group of shareholders controls 25% or more of the shares of both a bank (or its holding company) and a company, or

- b. A majority of the directors of a bank (or its holding company) also constitute a majority of the directors of a company.

### III. COVERED TRANSACTIONS

- A. "Covered transactions" with respect to an affiliate include:
  1. A loan or extension of credit to the affiliate.
  2. A purchase of assets, including assets subject to an agreement to repurchase, from the affiliate.
  3. The issuance of a guarantee, acceptance or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.
  4. A purchase of securities issued by the affiliate.
  5. Accepting securities issued by an affiliate as collateral for a loan to any person or company.

### IV. RESTRICTIONS ON TRANSACTIONS WITH AFFILIATES

#### A. Special Lending Limits

1. A bank and its subsidiaries may engage in covered transactions with an affiliate only if:
  - a. In the aggregate, covered transactions with a single affiliate are limited to not more than 10 percent of the lending bank's capital stock and surplus, and

- b. Covered transactions by the bank and its subsidiaries with all affiliates combined are limited to not more than 20 percent of the lending bank's capital stock and surplus.

B. Collateral Requirements

- 1. Each covered transaction involving a loan or extension of credit to, or guarantee, acceptance or letter of credit issued on behalf of, an affiliate by a bank or its subsidiary must be secured at the time of the transaction by collateral having a market value equal to:
  - a. 100 percent if U.S. or Agency obligations or guarantees, or a segregated, earmarked deposit account with the lending bank..
  - b. 110 percent if State or political subdivision obligations.
  - c. 120 percent if other debt instruments, including receivables.
  - d. 130 percent if stock, leases or other real or personal property.
- 2. If any collateral is subsequently retired or amortized, it must be replaced by additional eligible collateral where needed to keep the value of the collateral relative to the amount of the outstanding transaction at least equal to the minimum percentage required at the inception of the transaction.
- 3. A bank is prohibited from taking its bank holding company stock as collateral for such transactions.

4. A bank is prohibited from accepting "low quality assets" as collateral for such transactions.

a. Low quality assets include those which are "classified," on "nonaccrual," more than 30 days past due, or "renegotiated."

C. Qualitative Requirements

1. The Qualitative Requirements apply to all covered transactions and all transactions which may otherwise be exempt from §23A requirements between a bank and its affiliates. The Qualitative Requirements are as follows:

a. All transactions between a bank and its affiliates must be on terms and conditions which are consistent with safe and sound banking policies.

b. A bank and its subsidiaries may not purchase a low-quality asset from an affiliate unless the bank or such subsidiary, pursuant to an independent credit evaluation, had committed itself to purchase such asset prior to the time such asset was acquired by the affiliate.

V. EXEMPTIONS

A. Special Lending Limits and Collateral Requirements do not apply to:

1. Transactions between sister bank subsidiaries within a multibank holding company which owns 80 percent or more of each sister bank.

2. Transactions between a bank and its bank subsidiary. NOTE: As discussed earlier, transactions between a bank and its non-bank subsidiaries are not restricted by Section 23A.
3. Deposits by a bank in an affiliated bank in the ordinary course of business.
4. A bank's giving immediate credit to an affiliate for uncollected items received in the ordinary course of business.
5. A bank's making a loan or extension of credit to, or issuing a guarantee, acceptance or letter of credit on behalf of an affiliate that is fully secured by
  - a. U. S. or Agency obligations or guarantees, or
  - b. A segregated, earmarked deposit account with the bank.
6. The purchase of securities issued by any affiliate company engaged in furnishing services to the bank or its holding company.
7. The purchase from affiliates of assets having a readily identifiable and publicly available market quotation at that market quotation.
8. The purchase of loans on a non-recourse basis from affiliated banks, subject to the rule that the purchase of low-quality loans

is prohibited unless the bank, subject to an independent credit evaluation, had earlier committed itself to purchase such loans.

9. The purchase from an affiliate of a loan or extension of credit that was originated by the bank and sold to the affiliate subject to a repurchase agreement or with recourse.



Financial Recordkeeping and Reporting of Currency  
and Foreign Transactions Act  
31 C.F.R. 103

A. PURPOSE

1. The regulations require a report to be filed of each deposit, withdrawal, exchange of currency or other payment (including loan payments) or transfer by, through or to a bank which involves a transaction in United States or foreign currency of more than \$10,000. (Multiple transactions by or for any person which in any one banking day total more than \$10,000 should be treated as a single transaction, if the financial institution is aware of them). 31 C.F.R. 103.22 (a) (1)

B. REPORTS OF CURRENCY TRANSACTIONS

1. Filing The Report 31 C.F.R. 103.26 (a)

Within 15 days following the date on which a transaction occurred, the bank must complete and file a Currency Transaction Report ("CTR") using Form 4789. A copy of the form is attached as Exhibit I. (Note the form was revised December, 1985 and use of the new form has been required since July, 1986).

- (a) The bank must verify and record the name, address and Social Security Number/Tax I.D. Number of the individual presenting the transaction and of the individual or organization for whose account the transaction is being made.
- (b) To verify the above information, the bank must use a passport or similar document for aliens or non-residents of the United States. Drivers licenses are acceptable for others. In each case, the bank must record on the CTR the method of identification used.

NOTE: Verification shall be made by examination of a document other than a bank signature card.

- (c) Improper completion and failure to complete Form 4789 are the most common violations of the regulation.

2. Transactions Not Covered by the Regulation: 31 C.F.R. 103.22 (b) (1)

- (a) Transfers of funds by bank check, bank draft or wire transfer which do not involve the physical transfer of currency from one person to another.

- (b) Transactions with the Federal Reserve or with Federal Home Loan Banks.
- (c) Transactions between domestic banks.

3. Exemptions 31 C.F.R. 103.22 (b) (2)

Exemptions may be authorized for the following transactions:

- (a) Deposits or withdrawals of currency from an existing account by an established depositor who is a United States resident and operates a "retail type of business" in the United States.
  - (1) A "retail type of business" is one "primarily engaged in providing goods to ultimate consumers and for which the business is paid in substantial portion by currency."
  - (2) Dealerships which sell automobiles, boats or airplanes are not exempt.
- (b) Deposits or withdrawals of currency from an existing account by an established depositor who is a United States resident and operates a sports arena, race track, amusement park, bar, restaurant, hotel, check cashing service licensed by state or local governments, vending machine company, theatre, regularly scheduled passenger carrier whose stock is publicly traded or any public utility company supervised by a state or federal regulatory agency.
- (c) Deposits or withdrawals, exchanges of currency, or other payments and transfers by local or state governments, or the United States or any of its agencies or instrumentalities.
- (d) Withdrawals for payroll purposes from an existing account by an established depositor who is a United States resident and operates a firm that regularly withdraws more than \$10,000 in order to pay its employees in currency.

4. Records For Exemptions 31 C.F.R. 103.22 (d)

Records must be maintained for each exemption granted and must comply with the following requirements:

- (a) Explain the reason for the exemption.
- (b) Maintain a central file of all exemptions. (31 C.F.R. 103.22(f)) (A sample of an exemption form is attached as Exhibit II).

- (c) The names and addresses of all banks accepted under the exemption for transactions between domestic banks must be included.
- (d) The exemption form must include the following information:
- (1) The name, address, business, taxpayer I.D. number and account number of the customer.
  - (2) Whether the exemption covers withdrawals, deposits or both and the dollar limit of the exemption. BANKS MAY EXEMPT ONLY THOSE AMOUNTS WHICH DO NOT EXCEED "AMOUNTS COMMENSURATE WITH THE CUSTOMARY CONDUCT OF THE LAWFUL, DOMESTIC BUSINESS OF THE CUSTOMER." 31 C.F.R. 103(c)
    - Note that this requirement means that the Authorizing Officer must exercise some judgment.
    - In many, if not most, cases, the exemption should not be available for withdrawals.
    - EXAMPLE: Movie theaters customarily deposit large amounts of currency, but they do not customarily make large withdrawals of currency. Therefore, the exemption might exempt deposits up to \$15,000 (assuming such amounts are customary in that line of business) but the exemption for withdrawals would be zero.
    - Even for deposit exemptions, some reasonable limitation must be set on the amount of currency deposits exempt from reporting requirements.
  - (3) Whether the exemption is limited to certain types of deposits or withdrawals (e.g. withdrawals for payroll purposes);
  - (4) A written statement signed by the customer describing the customary conduct of the lawful domestic business of the customer and detailing the reasons why such person is qualified for an exemption.
    - The signature shall include the title and position of the person signing.
    - Immediately above the signature line the following statement shall appear: "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."

- (e) The bank is responsible for independently verifying the activity of the account and determining the dollar limits for exempted deposits or withdrawals. This evaluation should include a review of the history of the frequency and amount of cash transactions.

5. Requests For Special Exemptions 12 C.F.R. 103.22 (e)

Note that the Bank may apply to the Treasury Department for exemptions to cover depositors not specifically exempted in the regulation.

C. RECENT AMENDMENTS

Effective October 27, 1986 the Omnibus Drug Enforcement, Education and Control Act of 1986 created new statutory provisions to curtail money laundering. The following highlights certain provisions of the Act:

- money laundering was made a federal criminal offense (18 U.S.C. 1956).
- "knowingly" engaging in a monetary transaction (i.e. deposit, withdrawal or transfer, etc.) in criminally derived property in excess of \$10,000 has been made a criminal offense (18 U.S.C. 1957).
- 12 USC 1353 of The Right to Financial Privacy Act was amended to allow reports to the federal government if a financial institution suspects a statute or regulation has been violated.
- civil and criminal penalties can be imposed on a person who causes or attempts to cause a financial institution not to file a report or to file an incorrect report or to structure a transaction to evade the reporting requirements of the Bank Secrecy Act.

Example: An individual who converts \$18,000 in currency to cashier's checks by buying two \$9,000 cashier's checks from two banks with the intent that the banks not be required to file currency transaction reports.

- customers will be required to sign and attest to statements exempting them from currency transaction reporting (See B. 4 above).

- a penalty of \$500 may be imposed for negligent violations of the recordkeeping and reporting requirements of the Bank Secrecy Act.
- the civil and criminal money penalties have been increased.
- 12 U.S.C. 1818 was amended to require each Federal banking agency to prescribe regulations requiring insured banks to establish Bank Secrecy Act Compliance programs. The regulations were published January 27, 1987 in the Federal Register beginning at p. 2858 and require a written compliance program to be approved by the board of directors, noted in the minutes and actually be in place by April 27, 1987. The program shall, at a minimum:
  - (a) provide for internal controls to assure compliance
  - (b) provide for independent testing of compliance by bank personnel or an outside party.
  - (c) designate an individual responsible for monitoring and coordinating day-to-day compliance
  - (d) provide for training

D. TRANSPORTATION OF CURRENCY OR "MONETARY INSTRUMENTS" -  
31 C.F.R. 103.23

The regulations also require each person who physically transports, mails or ships or causes to be physically transported, mailed or shipped (or attempts to transport or cause to be transported), currency or other monetary instruments in an aggregate amount exceeding \$10,000 on any occasion from the United States to any place outside the United States, or into the United States from any place outside the United States, to file with the Commissioner of Customs Customs Form 4790. A copy is attached as Exhibit III.

1. Any person who receives in the U. S. monetary instruments in an aggregate amount exceeding \$5,000 which have somehow been transported to such person from any place outside of the United States must also file Form 4790.
  - Although the regulation states that this category does not have to be reported if a report has been filed by someone else, it would be difficult as a practical matter to determine whether a report has been filed, and therefore a bank should simply file Form 4790 whenever receipt of such monetary instruments occurs.
  - Also, if someone has brought monetary instruments

into the country and then given them to the bank or deposited them in the bank, and the bank has knowledge that the monetary instruments are from any place outside the U. S., a Form 4790 should be filed.

2. A transfer of funds through normal banking procedures which does not involve the physical transportation of currency or monetary instruments is not required to be reported by this section. In addition, banks need not report currency or other monetary instruments mailed or shipped through the postal service or by common carrier.
3. "Monetary instruments" are defined as coin or currency of the U. S. or of any other country, travelers' checks, money orders, investment securities, and negotiable instruments (like checks or notes) that are in bearer form or in a form that allows ownership to pass upon delivery. For example, a check or travelers' check or money order that is signed but has a blank named payee is a monetary instrument. However if such checks or money orders are payable to the order of a particular person, and have not been endorsed or have a restrictive endorsement, such as "for deposit only," they are not a monetary instrument.

E. FOREIGN BANK ACCOUNTS 31 C.F.R. 103.24

Anyone having an interest in or signature authority for a bank, securities or other financial account in a foreign country must report this fact to the Treasury Department each year on a form prescribed by the Treasury.

F. TRANSACTIONS REQUIRING BOTH FORMS 4789 AND 4790

If the requirements for both kinds of reports are met, both reports should be filed.

G. FILING OF FORM 4790

Reports for transactions involving shipment into and out of the United States must be filed on or before the date of entry or departure, mailing or shipping. 31 C.F.R. 103.26 (b) In the case of persons receiving currency or monetary instruments, the reports must be filed within thirty days after receipt. 31 C.F.R. 103.26 (c)

H. PENALTIES

There are civil and criminal penalties for willful violation of any requirements of the regulation. The Justice Department of the United States has obtained several convictions of individual officers and banks under the provisions of this regulation.

Form **4789**  
(Rev. December 1985)

# Currency Transaction Report

OMB No. 1545-0183  
Expires: 10-31-88

Department of the Treasury  
Internal Revenue Service

▶ **File a separate report for each transaction.** ▶ **Please type or print.**  
▶ **For Paperwork Reduction Act Notice, see page 3.**  
*(Complete all applicable parts—See instructions)*

If amended report, see instructions and check here ▶

## Part I Identity of individual who conducted this transaction with the financial institution

1 If multiple individuals involved, see instructions and check here ▶

2 Last name \_\_\_\_\_ 3 First name \_\_\_\_\_ 4 Middle initial \_\_\_\_\_ 5 Social security number \_\_\_\_\_

6 Address (number and street) \_\_\_\_\_ 7 Occupation, profession, or business \_\_\_\_\_

8 City \_\_\_\_\_ 9 State \_\_\_\_\_ 10 ZIP code \_\_\_\_\_ 11 Country (if not U.S.) \_\_\_\_\_

12 Method used to verify identity: a Describe ▶ \_\_\_\_\_  
b Issued by ▶ \_\_\_\_\_ c Number ▶ \_\_\_\_\_

13 Reason items 2-12 are not completed: a  Armored car service (enter name) ▶ \_\_\_\_\_  
b  Mail deposit/shipment c  Night deposit or ATM transaction d  Multiple transactions (see instructions)

## Part II Individual or organization for whom this transaction was completed

14 If multiple individuals or organizations are involved, see instructions and check here ▶

15 Individual's last name \_\_\_\_\_ 16 First name \_\_\_\_\_ 17 Middle initial \_\_\_\_\_ 18 Social security number \_\_\_\_\_

19 a Name of organization \_\_\_\_\_ b Check if: (1)  broker/dealer in securities, or (2)  financial institution (see instructions) 20 Employer identification number \_\_\_\_\_

21 Address (number and street) \_\_\_\_\_ 22 Occupation, profession, or business \_\_\_\_\_

23 City \_\_\_\_\_ 24 State \_\_\_\_\_ 25 ZIP code \_\_\_\_\_ 26 Country (if not U.S.) \_\_\_\_\_

## Part III Customer's account number(s) affected by transaction

27 <sup>s</sup>  Savings ▶ \_\_\_\_\_ <sup>t</sup>  Securities ▶ \_\_\_\_\_ <sup>h</sup>  CD/Money market ▶ \_\_\_\_\_  
<sup>c</sup>  Checking ▶ \_\_\_\_\_ <sup>l</sup>  Loan ▶ \_\_\_\_\_ <sup>o</sup>  Other (specify) ▶ \_\_\_\_\_

## Part IV Type of transaction. Check applicable boxes to describe transactions

28  Currency exchange (currency for currency)

29 CASH IN: <sup>f</sup>  CD/Money market purchased <sup>h</sup>  For wire transfer <sup>A</sup>  Receipt from abroad <sup>K</sup>  Other cash in (specify) ▶ \_\_\_\_\_  
<sup>d</sup>  Deposit <sup>G</sup>  Security purchased <sup>P</sup>  Check purchased

30 CASH OUT: <sup>R</sup>  CD/Money market redeemed <sup>U</sup>  From wire transfer <sup>B</sup>  Shipment abroad <sup>Y</sup>  Other cash out (specify) ▶ \_\_\_\_\_  
<sup>C</sup>  Check cashed <sup>T</sup>  Security redeemed <sup>W</sup>  Withdrawal

31 Total amount of currency transaction (in U.S. dollars). ▶ \$ \_\_\_\_\_ 32 Amount in Item 31 in \$100 bills or higher \$ \_\_\_\_\_ 33 Date of transaction (month, day, and year) \_\_\_\_\_

34 If other than U.S. currency is involved, please furnish the following information: a Exchange made  for or  from U.S. currency  
b Currency name \_\_\_\_\_ c Country \_\_\_\_\_ d Total amount of each foreign currency (in U.S. dollars) . . . ▶ \$ \_\_\_\_\_

35 If a check or wire transfer was involved in this transaction, please furnish the following information (see instructions):  
a If more than one check or wire transfer is involved, see instructions and check here . . . ▶   
b Date of check or wire transfer \_\_\_\_\_ c Amount of check or wire transfer (in U.S. dollars) \$ \_\_\_\_\_ d Payee \_\_\_\_\_  
e Drawer of check \_\_\_\_\_ f Drawee bank and MICR number \_\_\_\_\_

## Part V Financial institution where currency transaction took place

36 Check applicable box to indicate type of financial institution a  Bank (enter code number from instructions here) ▶ \_\_\_\_\_  
b  Savings and loan association c  Credit union d  Security broker/dealer e  Other

37 Name of financial institution Liberty National Bank and Trust Company 38 Employer identification number 61 0259676

39 Address (number and street) \_\_\_\_\_ 40 Social security number \_\_\_\_\_

41 City \_\_\_\_\_ 42 State \_\_\_\_\_ 43 ZIP code \_\_\_\_\_ 44 MICR number 0830 0013 7

45 Signature (preparer) \_\_\_\_\_ 46 Title \_\_\_\_\_ 47 Date \_\_\_\_\_

48 Type or print preparer's name \_\_\_\_\_ 49 Approving official (signature) \_\_\_\_\_ 50 Date \_\_\_\_\_

Sign Here ▶

### Multiple Transactions

(Complete applicable parts below if box 1, 14, or 35a on page 1 is checked)

**Part I Continued—Complete if box 1 on page 1 is checked**

2 Last name	3 First name	4 Middle initial	5 Social security number
6 Address (number and street)		7 Occupation, profession, or business	
8 City	9 State	10 ZIP code	11 Country (if not U.S.)
12 Method used to verify identity: b Issued by ▶		a Describe ▶ ..... c Number ▶	

2 Last name	3 First name	4 Middle initial	5 Social security number
6 Address (number and street)		7 Occupation, profession, or business	
8 City	9 State	10 ZIP code	11 Country (if not U.S.)
12 Method used to verify identity: b Issued by ▶		a Describe ▶ ..... c Number ▶	

**Part II Continued—Complete if box 14 on page 1 is checked**

15 Individual's last name	16 First name	17 Middle initial	18 Social security number
19 a Name of organization		b Check if: (1) <input type="checkbox"/> broker/dealer in securities, or (2) <input type="checkbox"/> financial institution (see instructions)	20 Employer identification number
21 Address (number and street)		22 Occupation, profession, or business	
23 City	24 State	25 ZIP code	26 Country (if not U.S.)

15 Individual's last name	16 First name	17 Middle initial	18 Social security number
19 a Name of organization		b Check if: (1) <input type="checkbox"/> broker/dealer in securities, or (2) <input type="checkbox"/> financial institution (see instructions)	20 Employer identification number
21 Address (number and street)		22 Occupation, profession, or business	
23 City	24 State	25 ZIP code	26 Country (if not U.S.)

**Part IV Continued—Complete if box 35a on page 1 is checked**

35 b Date of check or wire transfer	c Amount of check or wire transfer (in U.S. dollars) \$	d Payee
e Drawer of check		f Drawee bank and MICR number

35 b Date of check or wire transfer	c Amount of check or wire transfer (in U.S. dollars) \$	d Payee
e Drawer of check		f Drawee bank and MICR number



EXEMPTION FOR REPORTING  
CURRENCY TRANSACTIONS OVER \$10,000

Account Number

Tax Identification Number

\_\_\_\_\_

\_\_\_\_\_

Name and Address

Type of Business

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

This exemption covers:

- Deposits
- Withdrawals
- Deposits & Withdrawals

- Deposits  Withdrawals for the following specific purpose

\_\_\_\_\_  
\_\_\_\_\_

Maximum Exempt  
Transaction  
Deposit

Maximum Exempt  
Transaction  
Withdrawal

\$ \_\_\_\_\_

\$ \_\_\_\_\_

Deposit-Reason for Exemption

Withdrawal-Reason for Exemption

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

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.

\_\_\_\_\_  
(customer signature)

\_\_\_\_\_  
(Title and Position)

\_\_\_\_\_  
Date

\_\_\_\_\_  
Exemption Requested By (Title)

Reviewed by:

\_\_\_\_\_  
Compliance Officer

\_\_\_\_\_  
Branch or Department

This form is to be filled with the United States Customs Service

Privacy Act Notification  
on reverse



DEPARTMENT OF THE TREASURY  
UNITED STATES CUSTOMS SERVICE

**REPORT OF INTERNATIONAL  
TRANSPORTATION OF CURRENCY  
OR MONETARY INSTRUMENTS**

Customs Use Only

Control No.

31 USC 5316; 31 CFR 103.23 and 103.25

Please Type or Print

**PART I - FOR INDIVIDUAL DEPARTING FROM OR ENTERING THE UNITED STATES**

1. NAME (Last or family, first and middle)		2. IDENTIFYING NO. (See instructions)		3. DATE OF BIRTH (Mo./Day/Yr.)	
4. PERMANENT ADDRESS IN UNITED STATES OR ABROAD					
5. OF WHAT COUNTRY ARE YOU A CITIZEN/SUBJECT?					
6. ADDRESS WHILE IN THE UNITED STATES					
7. PASSPORT NO. & COUNTRY		8. U.S. VISA DATE		9. PLACE UNITED STATES VISA WAS ISSUED	
10. IMMIGRATION ALIEN NO. (If any)					
11. CURRENCY OR MONETARY INSTRUMENT WAS: (Complete 11A or 11B)					
A. EXPORTED			B. IMPORTED		
Departed From: (City in U.S.)		Arrived At: (Foreign City/Country)		From: (Foreign City/Country)	
				At: (City in U.S.)	

**PART II - FOR PERSON SHIPPING, MAILING OR RECEIVING CURRENCY OR MONETARY INSTRUMENTS**

12. NAME (Last or family, first and middle)		13. IDENTIFYING NO. (See instructions)		14. DATE OF BIRTH (Mo./Da./Yr.)	
15. PERMANENT ADDRESS IN UNITED STATES OR ABROAD					
16. OF WHAT COUNTRY ARE YOU A CITIZEN/SUBJECT?					
17. ADDRESS WHILE IN THE UNITED STATES					
18. PASSPORT NO. & COUNTRY		19. U.S. VISA DATE		20. PLACE UNITED STATES VISA WAS ISSUED	
21. IMMIGRATION ALIEN NO. (If any)					
22. CURRENCY OR MONETARY INSTRUMENTS	23. CURRENCY OR MONETARY INSTRUMENTS	NAME AND ADDRESS		24. IF THE CURRENCY OR MONETARY INSTRUMENT WAS MAILED, SHIPPED, OR TRANSPORTED COMPLETE BLOCKS A AND B.	
DATE SHIPPED	<input type="checkbox"/> Shipped To <input type="checkbox"/> Received From			A. Method of Shipment (Auto, U.S. Mail, Public Carrier, etc.)	
DATE RECEIVED				B. Name of Transporter/Carrier	

**PART III - CURRENCY AND MONETARY INSTRUMENT INFORMATION (SEE INSTRUCTIONS ON REVERSE) (To be completed by everyone)**

25. TYPE AND AMOUNT OF CURRENCY/MONETARY INSTRUMENTS		Value in U.S. Dollars		26. IF OTHER THAN U.S. CURRENCY IS INVOLVED, PLEASE COMPLETE BLOCKS A AND B. (SEE SPECIAL INSTRUCTIONS)	
Coins ..... <input type="checkbox"/> A. ▶ \$				A. Currency Name	
Currency ..... <input type="checkbox"/> B. ▶				B. Country	
Other Instruments (Specify Type) ..... <input type="checkbox"/> C. ▶					
(Add lines A, B and C) ..... TOTAL AMOUNT ▶ \$					

**PART IV - GENERAL - TO BE COMPLETED BY ALL TRAVELERS, SHIPPERS AND RECIPIENTS**

27. WERE YOU ACTING AS AN AGENT, ATTORNEY OR IN CAPACITY FOR ANYONE IN THIS CURRENCY OR MONETARY INSTRUMENT ACTIVITY? (If "Yes" complete A, B and C)  Yes  No

PERSON IN WHOSE BEHALF YOU ARE ACTING ▶	A. Name	B. Address	C. Business activity occupation or profession
	Under penalties of perjury, I declare that I have examined this report, and to the best of my knowledge and belief it is true, correct and complete.		
28. NAME AND TITLE	29. SIGNATURE		30. DATE

(Replaces IRS Form 4790 which is obsolete)

## GENERAL INSTRUCTIONS

This report is required by Treasury Department regulations (31 Code of Federal Regulations 103).

**Who Must File.** — Each person who physically transports, mails, or ships, or causes to be physically transported, mailed, shipped or received currency or other monetary instruments in an aggregate amount exceeding \$10,000 on any one occasion from the United States to any place outside the United States, or into the United States from any place outside the United States.

**A TRANSFER OF FUNDS THROUGH NORMAL BANKING PROCEDURES WHICH DOES NOT INVOLVE THE PHYSICAL TRANSPORTATION OF CURRENCY OR MONETARY INSTRUMENTS IS NOT REQUIRED TO BE REPORTED.**

**Exceptions.** — The following persons are not required to file reports: (1) a Federal reserve bank, (2) a bank, a foreign bank, or a broker or dealer in securities in respect to currency or other monetary instruments mailed or shipped through the postal service or by common carrier, (3) a commercial bank or trust company organized under the laws of any State or of the United States with respect to overland shipments of currency or monetary instruments shipped to or received from an established customer maintaining a deposit relationship with the bank, in amounts which the bank may reasonably conclude do not exceed amounts commensurate with the customary conduct of the business, industry or profession of the customer concerned, (4) a person who is not a citizen or resident of the United States in respect to currency or other monetary instruments mailed or shipped from abroad to a bank or broker or dealer in securities through the postal service or by common carrier, (5) a common carrier of passengers in respect to currency or other monetary instruments in the possession of its passengers, (6) a common carrier of goods in respect to shipments of currency or monetary instruments not declared to be such by the shipper, (7) a travelers' check issuer or its agent in respect to the transportation of travelers' checks prior to their delivery to selling agents for eventual sale to the public, and (8) a person engaged as a business in the transportation of currency, monetary instruments and other commercial papers with respect to the transportation of currency or other monetary instruments overland between established offices of banks or brokers or dealers in securities and foreign persons.

### WHEN AND WHERE TO FILE:

**A. Recipients.** — Each person who receives currency or other monetary instruments shall file Form 4790, within 30 days after receipt, with the Customs officer in charge at an port of entry or departure or by mail with the Commissioner of Customs, Attention: Currency Transportation Reports, Washington, D.C. 20229.

**B. Shippers or Mails.** — If the currency or other monetary instrument does not accompany the person entering or departing the United States, Form 4790 may be filed by mail on or before the date of entry, departure, mailing, or shipping with the Commissioner of Customs, Attention: Currency Transportation Reports, Washington, D.C. 20229.

**C. Travelers.** — Travelers carrying currency or other monetary instruments with them shall file Form 4790 at the time of entry into the United States or the time of departure from the United States with the Customs officer in charge at any Customs port of entry or departure.

An additional report of a particular transportation, mailing, or shipping of currency or the monetary instruments, is not required if a complete and truthful report has already been filed. However, no person otherwise required to file a report shall be excused from liability for failure to do so if, in fact, a complete and truthful report has not been filed. Form may be obtained from any United States Customs Service office.

**PENALTIES.** — Civil and criminal penalties, including under certain circumstances a fine of not more than \$500,000 and imprisonment of not more than five years, are provided for failure to file a report, supply information, and for filing a false or fraudulent report. In addition, the currency or monetary instrument may be subject to seizure and forfeiture. See sections 103.47, 103.48 and 103.49 of the regulations.

### DEFINITIONS:

**Bank.** — Each agent, agency, branch or office within the United States of a foreign bank and each agency, branch or office within the United States of any person doing business in one or more of the capacities listed: (1) a commercial bank or trust company organized under the laws of any state or of the United States; (2) a private bank; (3) a savings and loan association or a building and loan association organized under the laws of any state or of the United States; (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 the laws of any state or of the United States; and (7) any other organization chartered under the banking laws of any state and subject to the supervision of the bank supervisory authorities of a state.

**Foreign Bank.** — A bank organized under foreign law, or an agency, branch or office located outside the United States of a bank. The term does not include an agent, agency, branch or office within the United States of a bank organized under foreign law.

**Broker or Dealer in Securities.** — A broker or dealer in securities, registered or required to be registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

**IDENTIFYING NUMBER.** — Individuals must enter their social security number, if any. However, aliens who do not have a social security number should enter passport or alien registration number. All others should enter their employer identification number.

**Investment Security.** — An instrument which: (1) is issued in bearer or registered form; (2) is of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; (3) is either one of a class or series or by its terms is divisible into a class or series of instruments; and (4) evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer.

**Monetary Instruments.** — Coin or currency of the United States or of any other country, travelers' checks, money orders, investment securities in bearer form or otherwise in such form that title thereto passes upon delivery, and negotiable instruments (except warehouse receipts or bills of lading) in bearer form or other in such form that title thereto passes upon delivery. The term includes bank checks, travelers' checks and money orders which are signed but on which the name of the payee has been omitted, but does not include bank checks, travelers' checks or money orders made payable to the order of a named person which have not been endorsed or which bear restrictive endorsements.

**Person.** — An individual, a corporation, a partnership, a trust or estate, a joint stock company, an association, a syndicate, joint venture, or other unincorporated organization or group, and all entities cognizable as legal personalities.

### SPECIAL INSTRUCTIONS:

You should complete each line which applies to you. Part II. — Line 22, Enter the exact date you shipped or received currency or the monetary instrument(s). Line 23, Check the applicable box and give the complete name and address of the shipper or recipient. Part III. — Line 26, If currency or monetary instruments of more than one country is involved attach a schedule showing each kind, country, and amount.

### PRIVACY ACT AND PAPERWORK REDUCTION ACT NOTICE

Pursuant to the requirements of Public Law 93-579, (Privacy Act of 1974), notice is hereby given that the authority to collect information on Form 4790 in accordance with 16 U.S.C. 552a(e)(3) is Public Law 91-508; 31 U.S.C. 5316; 5 U.S.C. 301; Reorganization Plan No. 1 of 1950; Treasury Department No. 165, revised, as amended; 31 CFR 103; and 44 U.S.C. 3501.

The principal purpose for collecting the information is to assure maintenance of reports or records where such reports or records have a high degree of usefulness in criminal, tax or regulatory investigations or proceedings. The information collected may be provided to those officers and employees of the Customs Service and any other constituent unit of the Department of the Treasury who have a need for the records in the performance of their duties. The records may be referred to any other department or agency of the Federal Government upon the request of the head of such department or agency.

Disclosure of this information is mandatory. Failure to provide all or any part of the requested information may subject the currency or monetary instruments to seizure and forfeiture, as well as subject the individual to civil and criminal liabilities.

Disclosure of the social security number is mandatory. The authority to collect this number is 31 CFR 103.25. The social security number will be used as a means to identify the individual who files the record.

The collection of this information is mandatory pursuant to 31 U.S.C. 5316.



AMENDMENTS TO ARTICLE NINE  
OF THE UNIFORM COMMERCIAL CODE  
and  
THE FOOD SECURITY ACT OF 1985

John T. McGarvey  
Morgan and Pottinger  
Louisville, Kentucky



KENTUCKY AMENDMENTS TO ARTICLE NINE  
OF THE UNIFORM COMMERCIAL CODE SENATE  
BILL 28 OF THE 1986 LEGISLATURE

SCOPE:

Although Senate Bill 28 has been and will continue to be referred to as the adoption of the 1972 amendments to the Uniform Commercial Code the scope of the Bill is much broader. In addition to the 1972 amendments, the 1966 and 1977 amendments promulgated by the American Law Institute and the National Conference of Commissioners on Uniform State Law were also adopted by the Bill. In the enactment of the 1972 amendments relating to Article 9 (KRS 355.9) the Bill additionally made substantial changes in the perfection of security interests in motor vehicles under Chapters 186 and 186A of Kentucky's statutes.

The 1966 amendments were essentially clean-up amendments scattered throughout the Code. The 1966 amendments have been adopted in their entirety with the exception of additional alternative sections provided for Article 2 Section 318 which relates to seller's warranties in relation to persons not in privity with the seller.

The 1977 amendments to Article 8 are almost as substantial as the changes in Article 9. The changes primarily relate to the use of uncertificated securities and will not be covered in this seminar.

The 1972 amendments constitute an overhaul but not a radical modification of the original Article 9 of the Uniform Commercial Code. Article 9 replaced the law of chattel mortgages in the various states and was originally the most imaginative and innovative articles of the Code. The fact that Article 9 started from the beginning rather than adapting various principles of existing law resulted in some degree of confusion concerning the meaning of its various provisions and the discovery that some subjects were left untreated. The 1972 amendments attempt to rectify both of these problems in Article 9 and additionally make changes in Articles 1, 2 and 5 as those articles relate to Article 9.

BACKGROUND OF SENATE BILL 28:

Kentucky was one of the first states in the nation to adopt the Uniform Commercial Code. The first enactment of the Code in Kentucky was in 1958. Kentucky adopted the Code at such an early stage that in 1962 and 1964 it adopted changes which had been made in the official text before the Code became generally accepted. With rare exception the Uniform Commercial Code in Kentucky has remained unchanged since 1964. There have been various attempts at enacting portions of the 1972 amendments all

of which have met failure. The primary changes in Article 9 since 1964 have been the adoption of various non-Uniform provisions primarily relating to the protection of the sellers of particular kinds of goods. (KRS 355.9-307)

In 1984 Kentucky remained one of six states which had not adopted the 1972 amendments. (Louisiana has never adopted the Code in its entirety.) Two of Kentucky's neighbors, Indiana and Tennessee, were among states which had not adopted the 1972 amendments but were in the process of enacting them. The Legislative Research Commission created the Special Study Commission of the Uniform Commercial Code. Senator David Karem of Louisville was named as Chairman and members included Representative Thomas M. Jones, Representative Ernesto Scorsone; attorneys John T. McGarvey, Francis Mellon, Jr., M. Brooks Senn, and Paul J. Vesper; and Mack J. Morgan, President of the Kentucky Retail Federation, Inc. The LRC assigned staff members Gregory Karemellas, Robert S. Sherman and Robert Fallon to the project. Professors Harold R. Weinberg of the University of Kentucky College of Law and David Leibson of the University of Louisville School of Law became ex officio members of the Commission and provided substantial drafting and scholarly assistance.

Various persons and groups who were thought to have an interest in the field of commercial law were placed on notice of the creation of the Commission and its various meetings. Representatives of eighteen groups provided input at one or more meetings of the Commission. The resulting Bill, particularly where it deviates from the language of the uniform statute, reflects input received from the individuals who testified before the Committee. A special subcommittee was set up to handle matters relating to the perfection of security interests in motor vehicles. Substantial input and testimony on motor vehicle liens was received from the Kentucky County Clerk's Association and the Kentucky Automobile Dealers Association.

Strong opposition from the County Clerks resulted in no attempt to set up a central filing system for security interests in Kentucky. Meetings with representatives of the County Clerk's Association during and since the legislature may result in a 1988 Bill to make additional changes in Part 4 of Article 9 relating to the filing and perfection of liens and other changes which may be mandated by the federal enactment of the Food Security Act of 1985.

#### THE AMENDMENTS TO ARTICLE 9:

1-201, 2-107, and 5-116. Changes were enacted in each of these articles and subsections to reflect the changes made in Article 9. These changes primarily relate to the characterization of minerals (including oil and gas), timber, and contract rights as they relate to commercial transactions. References to "contract rights" often found in security instruments in Kentucky, are being deleted throughout the Code. The



intent of the amendment is that all areas previously covered by the term "contract rights" be merged into the term "accounts."

9-103. Substantial changes were made in this section to help clear up questions of where the perfection of a security interest must take place. The original section was drawn before it was known how widely the Uniform Commercial Code would be accepted and concentrated on conflict of laws. The latter question is now primarily handled by Article 1, Section 105 and Article 9, Section 102. The new text of 9-103 provides that questions of perfection are now governed by law of the jurisdiction where the collateral is located when a conflicting claim comes into existence. The only exceptions to this rule relate to purchase money security interests, mobile goods, and collateral subject to a title statute. The law of the state in which a debtor's chief executive office is located will determine perfection on accounts.

9-104. This subsection defines the scope of Article 9 coverage. Security interests created by government debtors are now specifically excluded from coverage as are transfers of a single account in satisfaction of a pre-existing indebtedness. The exclusion of railway equipment trusts has been deleted thus adding that mode of financing to the scope of Article 9 as well as rights represented by a judgment taken on a right to payment which was collateral.

9-105. The definition section of Article 9 has been expanded through additions to prior definitions and the addition of several new definitions. New definitions include: Transmitting Utility, Deposit Account, Pursuant to Commitment, Encumbrance, and Mortgage. Additions have been made to the scope of existing definitions including warehouse type receipts to the term "Document" and minerals (including oil and gas) before extraction and standing timber to be cut to the term "Goods."

9-106. References to "contract right" have been removed from this definition section. Reference to "money" is deleted from the definition of general intangibles. The latter change avoids the possibility that a security interest in money may be perfected by filing.

9-114. An entirely new section is added to Article 9 recognizing the use of consignment sales as a financing vehicle. In order to protect his ownership of consigned goods a consignor must file a financing statement prior to the time the goods come to rest on the premises of the consignee, give written notification to the holders of conflicting inventory security interests, (much like a purchase money lien holder under 9-312), state in the notice that the transaction is a consignment and describe the goods involved by item or type, and make sure that the holders of other interests have received a notification within five years before the consignee originally receives possession of the consigned goods and at five year intervals thereafter.

9-203. Additions to this section add requirements to the formal requisites of a security agreement. The elements of agreement, value, and rights in collateral are combined with the requirement of a written agreement. A new section is added to make it clear that a security agreement need not refer to proceeds in order to cover proceeds.

9-204. Kentucky deviated from the uniform language due to its concern for agriculture and the protection of the farmer. Kentucky law provides that no security interest attaches to crops under an after acquired property clause which become crops more than one year after the security interest is executed (see 9-402).

9-301. There is a small but important change in the objective versus subjective test imposed by the Code. Paragraph 1(b) has been amended to eliminate the element of knowledge in the conditions under which a lien creditor may defeat an unperfected security interest. Knowledge of the security interest will no longer subordinate the lien creditor to the unfiled security interest. A new Subsection 4 deals with the question of the extent to which advances made under a perfected security interest after the rights of a lien creditor have attached to the collateral will come ahead of the position of the lien creditor. The new section must be read in conjunction with 9-307(3) and 9-312(7). The priority of the security interest for future advances over the judgment lien is absolute for forty-five days without regard to any knowledge of the secured party that the judgment lien exists.

9-302. The provision exempting purchase money security interests in farm equipment having a purchase price of less than \$500.00 has been eliminated. A new exemption takes its place at Paragraph 1(c) which exempts security interests created by assignments of beneficial interests in trusts and estates from the filing rules.

9-304. A change in Subsection 1 corrects an inadvertent omission from the former official text and makes it clear that a security interest in money cannot be perfected by filing. A provision has been added to Subsection 5 making it clear that the twenty-one day period referred to therein deals only with perfection but that there must be compliance with the notice provisions of 9-312(3) in order to achieve priority over earlier inventory financiers.

9-306. A new second sentence of Subsection 1 is intended to overrule various cases to the effect that proceeds of insurance on collateral are not proceeds of collateral. The ambiguity concerning insurance proceeds has been clarified in favor of an automatic right to proceeds. The requirement of claiming proceeds in a financing statement has been eliminated. A filed claim for the original collateral is treated as constituting a filing as to proceeds.

9-307. All of the various non-uniform provisions of the existing Kentucky law which provide protection to such entities as stockyards, tobacco warehouses, thoroughbred auctions, etc., were left unscathed. The only changes to this section are conforming changes necessary due to amendments in other sections of the Code. [See section on Federal Food Security Act at the end of this material.]

9-308. The primary changes are for clarity purposes. The section provides that the holder of a negotiable instrument who may not qualify as a holder-in-due-course may nevertheless qualify for the protections of this section.

9-312. This is the primary conflict resolution section of Article 9. The principal changes begin in Subsection 3 and attempt to answer unresolved questions under the former Code. Subsection 3 relates to the perfection of purchase money security interests often used in floor plan financing of wholesale and retail businesses. The amendments provide that notice to the holder of a conflicting security interest must be given within five years of the time the debtor receives possession of the goods where the PMSI is claimed.

Another issue answered by the amendments concerns the conflicting claims of the inventory financier and the creditor holding a security interest in the debtor's accounts. The new Code rules that a prior right to inventory does not confer a prior right to any proceeds except identifiable cash proceeds received on or before the delivery of the inventory and without the intervention of an account.

A new Subsection 5 of 9-312 ranks conflicting security interests by their priority in time dating back to the respective times when without interruption the security interests were either perfected or were the subject of appropriate filings.

9-312(6) has been replaced with new language to make it clear that (subject to some limitations) the time of filing or perfection as to original collateral is the time of filing or perfection as to proceeds.

9-313. The original enactment of this section left numerous questions in its application to construction mortgages and in the sections failure to clearly state that the filing of fixture security interests was to be in the real estate records where they could be found by a standard real estate records search. The 1972 amendments were drafted to meet these criticisms and to make a substantial shift in the law in favor of the construction mortgages. A fixture filing in Kentucky is to be made "in the office where a mortgage on real estate would be filed or recorded ..."

9-401. Subsection 1 has been rewritten to provide that when collateral is timber to be cut or is minerals or the like or

accounts, or when the financing statement is filed as a fixture filing and the collateral is goods which are or are to become fixtures that the proper place to file is in the office where a mortgage on the real estate would be filed or recorded.

The remainder of the amendments to 9-401 are designed to provide direction on where to file as to individuals and as to various types of business entities from which security interest might be obtained.

The Commission attempted to clear up the current controversy in Kentucky on where to file against a corporation. There is federal case law to the affect that a filing should be made in the county where a corporation's resident agent is located [see National Cash Register Co. v. K.W.C., Inc., 432 F. Supp. 82 (E.D.Ky. 1977)]. The federal decision is not binding on the state courts and prudent practitioners, in situations where the principal place of business and the registered agent are in separate counties, have usually filed in both counties. Central filing was politically unacceptable as to corporations and in order to provide clarity and certainty it will be a matter of Kentucky law that "a corporation organized under KRS 271(A), 273 or 274 shall be deemed to be a resident of the county in which its registered office is located, as set forth in its most recent corporate filing by the Secretary of State which officially designates its current registered office."

9-402. The requirements that a financing statement be signed by a creditor and state whether or not it secured an indebtedness of \$200.00 or more have both been eliminated. These requirements frequently caused problems for Kentucky creditors and their counsel.

Non-standard language has been adopted concerning financing statements on crops. A financing statement on crops "shall not describe more than one production season." A presumption is built into the statute that if a production season is not described the financing statement shall be deemed to describe crops produced in the production season which ends within twelve months after the filing date of the financing statement. The non-standard language of 9-402 places a substantial burden on creditors engaged in agricultural financing and was enacted following strong input to the Commission from farmers and their representative groups.

Conforming changes have also been made in 9-402 to respond to complaints that the original version failed in several ways to tie fixture filings to the real estate search system.

It must be remembered that the debtor's signature is still required on a financing statement. Only the requirement as to the signature (not other identification information) of the creditor has been deleted.

9-403. Changes have been made in Subsection 2 to make every financing statement (except those described by Subsection 6) effective for a full five years. A new Subsection 6 provides that when a real estate mortgage is effective as a fixture filing (meets all the other requirements of 9-402) it remains effective as a fixture filing until the mortgage is released or terminated.

When a financing statement covers timber to be cut or minerals (including gas or oil), or is a fixture filing, it should be indexed under the names of both the debtor and any owner of the real estate on which the collateral is located. Subsection 7 should be closely examined in its entirety at the time of the recording of any financing statement covering fixtures or other property related to the real estate.

9-404. Additions to Subsection 1 of the statute require the filing of termination statements in the case of consumer goods even without a demand by the consumer. If a termination statement is not filed within 15 days after a secured transaction is terminated the creditor shall be liable to the debtor for \$25.00 and any actual loss proved by the debtor. Actual loss could conceivably be interpreted to mean damage to credit reputation and attorney's fees.

The scope of the change is not as great as it first appears because filing is not required for purchase money security interest in consumer goods, except in the case of motor vehicles, and perfection of security interests in most motor vehicles is governed by certificate of title laws and not by the provisions of Article 9.

9-407. This section requires a filing officer (County Clerk or Secretary of State) to issue his certificate as to whether or not a financing statement is on file in his or her office as to a certain debtor and particular collateral. This was an optional provision in the original Code which has now been adopted in Kentucky. A specific exemption is provided to the filing officer and employees exempting them from any personal liability which may arise due to information furnished on the certificate. The official form for requesting a filing officer report is the UCC-11.

9-408. At the time of the enactment of the original UCC leasing was a little known means of acquiring rights in personal property. As leasing has become more important the creditor has been faced with the problem of filing a financing statement for protection but running the risk of having the lease transaction deemed a disguised installment sale and covered entirely by Article 9. 9-408 allows protective filing but specifically provides that the filing shall of itself not be a factor in determining whether or not the lease is intended as security. The same provisions apply to protective filings for consignments. If for any reason it is determined that the consignment or lease transaction is a disguised secured transaction the security

interest is deemed to be protected by a filing under this section. Filing as to true leases is not required but since the question of whether a lease is a true lease may be a close one filing is permitted.

9-501 and 9-502. The changes are purely technical and conforming changes to the other amendments to the Code.

9-504. Under the current Code a repossessing creditor must not only provide a notice of sale to the debtor but to every other person who had duly filed a financing statement indexed in the name of the debtor and who still claimed a security interest in the collateral and additionally to any other person known by the secured party to have an interest in the collateral. Under the 1972 amendments a notice of sale must only be sent to the debtor and such persons as have notified the secured party in writing of their claim of an interest in the collateral prior to the notification of sale sent to the debtor. The model form of the 1972 amendments allows any debtor to waive a notice of sale after default. Non-standard language was adopted by Kentucky which allows a waiver of notice of sale except in the case of consumer goods.

9-505. The remedy of strict foreclosure has been made much more valuable to the creditor. Changes in this section have shortened the notice period to the debtor from thirty to twenty-one days and begin the notice period on the date the notice is sent as opposed to the date notice is received. New language in the section also recognizes a written post-default waiver by a debtor of rights to notice under this section. The creditor is also relieved of notifying other claimants to the collateral unless the creditor has been put on written notice of a claim of an interest in the collateral.

#### TRANSITION:

All of the new amendments become effective July 1, 1987. Any financing statement or continuation statement filed prior to July 1, 1987, and which has not lapsed prior to that date shall remain effective for the full period as provided in the old Code but not less than five years. A security interest in new collateral acquired by a debtor after July 1, 1987, will only be effective if the financing statement, and its continuation statements, are filed in the office deemed appropriate under the new Code.

Any financing statement or continuation filed prior to July 1, 1987, may be continued by a continuation statement as permitted by the new Code except that if the new Code requires a filing in an office where there is no previous financing statement a new financing statement must be filed in that office. This provision will more than likely relate to timber, minerals, fixtures, etc. If the record of a mortgage of real estate would have been effective as a fixture filing if the new Code had been effective

on the date of the recording of the mortgage the mortgage shall be deemed effective as a fixture filing under Subsection 6 of 9-402 as of July 1, 1987. If a security interest was perfected prior to July 1, 1987, without filing or recording, and the new Code requires filing a recording, the perfection and priority rights of the security interest continues for three years after July 1, 1987. This three year provision also applies to security interests perfected under a law other than Article 9 which require no further filing.

MOTOR VEHICLE LIENS:

The Kentucky title law (KRS Chapter 186A) established the Certificate of Title as the sole means of determining the priority of liens on motor vehicles. Perfection on the title was not in lieu of perfection under the Code but in addition to the filing of a financing statement. The original enactment of the title law even referred to the financing statement. Kentucky creditors were thus faced with a dual perfection system. Priority was determined by the order of recording on the title but perfection also required a UCC filing.

The new version of KRS 355.9-302 specifically provides that perfection on a motor vehicle must be by notation on the title and the filing of a financing statement will not be effective. A single but important exception is the perfection of a lien on motor vehicles held as "inventory."

Other than perfection of the lien, Article 9 will still apply to all aspects of secured transactions involving motor vehicles.

The County Clerk's Association requested that the new statute provide them with a document to be filed in their office so that the local filing officer would have proof of why a lien had been placed on a motor vehicle. Because perfection was no longer necessary under Article 9 it was decided that a financing statement would be inappropriate. The Department of Transportation is to promulgate a new form to be used when recording a lien on a motor vehicle which will be denominated as a Motor Vehicle Lien Statement.

A secured party seeking a lien on a motor vehicle must tender the Motor Vehicle Lien Statement, an application for first title, or existing title, and the appropriate fees in order to have a lien recorded. The lien should be recorded in the county of the residence of the debtor, or for non-residents, in the county of principal operation of the vehicle.

Where a security interest is taken in vehicles already titled it should be presented within fifteen (15) days of the execution of the security agreement or the secured party will be required to pay a \$2.00 penalty.

FOOD SECURITY ACT OF 1985:

This law became effective on December 24, 1986, and is entitled "Protection for Purchasers of Farm Products." The federal statute pre-empts the Uniform Commercial Code and all other state law relating to the enforcement of security interests against the purchasers of farm products. Article 9, Section 307 of the UCC has always protected buyers in the ordinary course of business of goods from person who ordinarily sell the type of goods purchased by the buyer. The UCC created a "farm products" exception to this rule. In essence the federal law extends 9-307 type protection to all purchasers of farm products.

The effect of the Federal Legislation in Kentucky is not as dire as it is in some states in that Kentucky has attempted through various amendments to 9-307 to protect warehouses, stockyards, horse auctions, etc. The Act, titled "Protection for Purchasers of Farm Products," became effective December 24, 1986. It sets up two systems for creditors to attempt to enforce security interests in farm products. The creditor must notify the buyer of the farm product, commission merchant, or selling agent of the existence of the security interest prior to the date of sale or the state where the farm products are grown or produced must have set up a central filing system for liens against farm products.

There is no form of central filing in Kentucky (except Secretary of State filings for liens against corporations which have no principal place of business in Kentucky). The discussion of any form of central filing in the most recent legislation was cut-off by the County Clerks. The Clerk's Association has now indicated that they are willing to discuss legislation for the 1988 legislature which might establish a central file in Frankfort so long as the filing was made through the local filing system.

In the interim Kentucky creditors must comply with the pre-notification provisions of the Federal Act if they are going to preserve their perfected security interest in farm products. Compliance requires that written notice of the security interest be received by the buyer, commission merchant, or selling agent within one year prior to the date of sale. If the buyer or seller is put on notice of the lien but fails to make proper payment arrangements the security interest is not effected and the secured party may proceed against the buyer, commission merchant or selling agent.

The federal law provides that receipt shall be determined as a matter of state law. KRS 355.1-201(26) provides "a person 'receives' a notice or notification when (a) it comes to his attention; or (b) it is duly delivered at the place of business through which the contract was made or at any other place held out by him as the place for receipt of such communications." If a buyer, commission merchant, or agent rejects a certified mail



notice the envelope should provide proof of receipt at the place of business.

The notice itself must contain: (1) the name and address of the secured party; (2) the name and address of the person indebted to the secured party; (3) the social security number of the debtor or, in the case of a debtor doing business other than as an individual, the Taxpayer Identification Number of such debtor; (4) a description of the farm product subject to the security interest created by the debtor including the amount of such products, where applicable, crop year, county, and a reasonable description of the property. If the secured party wishes to impose any particular payment terms or obligation on the entity notified they must be so stated in the notice.

A metes and bounds description of real estate should not be necessary. Any description which reasonably identifies the real estate should suffice. See Bank of Danville v. Farmers National Bank of Danville, Ky., 602 S.W.2d 160 (1980). A material change in the description of collateral requires resending the notice within three (3) months of the change. The federal statute forces creditors to guess as to what constitutes a "material change." Documents between the lender and agricultural borrower should be modified to require the borrower to provide the lender with the necessary information for the sending of the required notice and to update the information as there are changes in the collateral.

One remedy for the creditor is to use the provision of the Federal Act which requires a farmer to furnish a list of buyers, commission merchants and selling agents through which he may dispose of his farm products. If the products are not sold to or through a person on the list the farmer is subject to a fine of \$5,000.00 or 15% (whichever is greater) of the proceeds of sale. The farmer may go outside of the list originally provided to the creditor if the creditor is notified of the new place of sale seven days prior to the sale or the creditor is paid within ten days after the sale.

The ability of the farmer to go outside of the list originally provided the creditor on only seven (7) days notice is an operational problem for lenders. A procedure should be set up within all agricultural lenders to quickly respond to such a notice received from a borrower in order that a notice is received by the new seller within the seven (7) day period. One obvious question which is unanswered in the statute is when the seven (7) day period commences.

It must be remembered that compliance with the Federal Food Security Act is in addition to the perfection of the lender's lien under Article 9. Compliance with the Act does no more than prevent a notified seller from invoking the Act to relieve the seller of secondary liability. A lender which has complied with the Federal Food Security Act but has not perfected under Article

9 does not have a perfected lien sufficient to notify a seller  
much less prevail against a trustee in Bankruptcy.

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FARM BANKRUPTCY

By

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William R. Mapother



FARM BANKRUPTCY

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# "FARM BANKRUPTCY"

1987

## I. Introduction

- A. "The Family Farmer Bankruptcy Act of 1986" became available to farm Ds filing after November 26, 1986.
- B. Chp 12 is to make farm reorganizations more achievable, so as to encourage the continuation of small farms.
- C. Until this change, family farmers in need of financial rehabilitation could proceed under either Chp 11 or Chp 13.
  - 1. Most family farmers had too much debt to qualify under Chp 13 and were thus limited to relief under Chp 11.
  - 2. Family farmers have found Chp 11 needlessly complicated, inordinately expensive, and unworkable.
- D. This is the third major change to bankruptcy law in the past eight years:
  - 1. Bankruptcy Reform Act of 1978.
  - 2. Bankruptcy Amendments and Federal Judgeships Act of 1984.
  - 3. The Family Farm Bankruptcy Act of 1986.
- E. Most of Chp 12 has been lifted from Chp 13, and the rest has come from Chp 11.

## II. Chp 12 - Overview

- A. Advantages to D of Chp 12 over Chp 11.
  - 1. Less adequate protection (such as interest and depreciation) need be given secured Cs during preconfirmation period. (Fortunately, this period will be less than 6 months.)

2. It will be far easier to get a plan confirmed.
  - a. D need not acquire C consent, no C voting rights. §1126.
  - b. D need not comply with absolute-priority requirement. §1129(b)(2)(B).
3. There is no creditors' committee to oversee the D's operation. §1102-§1103. (But a Chp 12 Tee is automatically appointed to handle receipts and distributions.)
4. D can "downsize" by selling encumbered collateral even if C objects.
5. D has the exclusive right to file a plan. §1221.
6. There is a codebtor stay, but only as to consumer debts.
7. No disclosure statement is required, which means:
  - a. Less work for D's attorney, and
  - b. All the more reason to take discovery to get all the facts. See Mapother, Strategic Use of Discovery in Bankruptcy (Including 260 Questions to ask a Chapter 11 or 12 Debtor).

B. Disadvantages to Ds of Chp 12 over Chp 11.

1. Appointment of Tee.
  - a. Farmers do not like outsiders snooping.
  - b. Farmers are often poor managers with few records.
2. Having to pay a commission to Chp 12 Tee increases D's debts.
3. D must file a plan within 90 days of the petition, and there is no deadline in Chp 11.
4. Tax benefits in Chp 11 are lessened in Chp 12.

C. Advantages to Ds of Chp 12 over Chp 13.

1. D is given 90 days, rather than 15 days in Chp 13.
2. There is no requirement that D commence payments within 30 days after plan is filed. §1326.
  - a. There is no deadline at all in Chp 12.
  - b. It will be important for Cs' counsel to push for deadlines by local rule or in the confirmation orders. §1226 contemplates payments will commence within the preconfirmation period. Cs should insist, because those who do not ask often do not receive.
  - c. Only payment requirement is that D have sufficiently stable annual income to fund plan. §109(f) and §101(17).
3. The restrictive \$450,000 debt ceiling is removed.
4. Secured Cs receive less adequate protection during preconfirmation period.

D. Disadvantages to Ds of Chp 12 over Chp 13.

1. Cs do not lose, as in Chp 13, their right to seek nondischargeability of their claims based upon fraud.
2. Many courts have a local rule requiring monthly reports.



III. Eligibility - "only a family farmer with regular annual income may be a debtor under Chp 12 of this title." §109(f) and §101(17).

- A. "Regular annual income" means income that is sufficiently stable and regular to enable such family farmer to make payments under a Chp 12 plan. §101(18).

This definition contrasts with that in Chp 13 of "an individual with regular income," without reference to "annual." This should make it clear that Chp 12 is available to crop farmers as well as dairy farmers.

- B. "Family farmer" is defined in §101(17) as:

1. An individual engaged in a farming operation whose aggregate debts do not exceed \$1.5 million, and
2. Not less than 80% of whose aggregate, noncontingent, liquidated debts arise out of a farming operation owned or operated by the individual.
  - a. A debt for the principal residence is excluded unless such debt arises out of a farming operation.
  - b. Presumably, this would mean that if farm land and house were purchased and financed as a unitary tract, the "principal residence" debt would be included in the 80% computation for Chp 12.
3. And: Such individual receives from such farming operation more than 50% of his gross income for the taxable year preceding the taxable year in which the case was filed.

- C. The definition of "family farmer" also includes a corporation or partnership in which:

1. More than 50% of the outstanding stock or equity is held by one family, and
2. More than 80% of the value of its assets consists of assets related to the farming operation, and
3. Its aggregate debts do not exceed \$1.5 million and not less than 80% of its aggregate debts . . . arise out of the farming operation.

- D. "Farmer" (§101(19)) and "farming operation" (§101(20)) are narrowly defined to exclude agribusiness corporations, hobby farmers and tax shelters.

- E. Questioning eligibility will be a critical strategy for Cs. See Mapother,

1. Chapter 12 Strategies for Agricultural Creditors.
2. Chapter 12 Legal Forms for Agricultural Creditors.

IV. Basic framework of Chp 12 - Officers, Administration, and the Estate.

A. Operation of the farm with Tee supervision - §1202-1204.

1. Although a Tee will be appointed, a Chp 12 D will be allowed to operate the farm much as a Chp 11 DIP. §1202 and §1203.
  - a. Chp 12 D has all rights and powers of Tee and performs all duties of Tee, except investigative duties specified in §1106(a)(3),(4).
    - (1) D must file list of Cs, schedule of assets and liabilities, and statement of financial affairs.
    - (2) D must cooperate with Chp 12 Tee.
    - (3) D must surrender such property as is required by confirmed plan.
  - b. Tee serves as disbursing agent unless otherwise provided in plan. Tee fulfills other administrative and investigative duties. §1203.
    - (1) Investigate financial affairs of D. §704(4).
    - (2) Furnish such information concerning the estate and its administration as is requested by a C. §704(7).
    - (3) Investigate acts, conduct, assets, liabilities, financial condition and operation of D's business. §1106(a)(3),(4).
2. Removal of D. If fraud or gross mismanagement is shown, a C or Tee may move to have Tee placed in sole control of the estate property.
  - a. Factors would include commingling of assets, failure to keep adequate records, numerous asset transfers, continuing loss and inability to obtain necessary future financing. See Hammel & Sons, Inc., 20 BR 830 (S.D. Oh. 1982).
  - b. Although a Tee may be placed in charge of operating D's farm, Tee will not have power to file a plan.
  - c. Tee can file a Motion to Dismiss or Convert to Chp 11 or 7. §1208(c),(d).

B. Property of the estate - §541 and 1207.

1. Definition of property of the estate is so broad that pre-petition repossession by C can be set aside, and C can be compelled to return the property before it is sold by C.
  - a. D can force C to return repossessed collateral unless C can show grounds for relief from stay. U.S. v. Whiting Pools, 103 S.Ct. 2309 (1983), held that §542 permits D to force return of collateral. ("Although Congress might have safeguarded the interests of secured creditors outright by excluding from the estate any property subject to a secured interest, it chose instead to . . . provide secured creditors with 'adequate protection' for their interests.")  
If D's property is repossessed by a C prior to commencement of case, it remains property of the estate and subject to turnover under §542 in a Chp 13 case. The same will apply in Chp 12.

- b. Tee spends little effort on discovery of prepetition transfers, partly because recovery is likely to be only for the benefit of the D who made the transfer. D usually prosecutes turnover in rehabilitation cases.
- c. C faced with turnover motion by D, should respond with motion for relief. Better yet, C should take initiative and file motion for relief upon learning of Chp 12. Same grounds to resist turnover as prosecuting motion for relief.  
Tip: Evaluate position in terms of chances of prevailing on Motion for Relief. If success is questionable, use this opportunity to negotiate settlement with D. This is an excellent chance to establish repayment schedule, validity of lien, and "drop-dead" stipulation.

2. Exemptions - just as Ds in Chp 13 cases are entitled to claim exemptions, Ds in Chp 12 will also be entitled.

- a. The justification is the need to determine liquidation value of the estate for confirmation purposes.
- b. Exemption of property from the estate does not affect the validity of C's security interest.

C. Grounds for dismissal §1208(c).

1. In addition to the ability to seek the appointment of a Tee, Cs have the right to move for the dismissal of the case for:
  - a. Unreasonable delay or gross mismanagement,
  - b. Failure to timely file a plan, or make payments under the plan, or
  - c. "Continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation."

D. Adequate protection - §1205

1. Secured Cs are said to be entitled to "adequate protection" if their collateral is being used in a reorganization case.
2. Most Circuit Courts have said this means that secured Cs are entitled to depreciation and interest.
3. Chp 12 has severely limited the right of secured Cs to receive depreciation and interest, and this will be discussed later.
4. The issue arises in the temporary (preconfirmation) period between the filing and confirmation. Since this period is only 4-1/2 months in Chp 12 (as opposed to the open-ended period in Chp 11), having less adequate protection in Chp 12 should not be as damaging as in Chp 11.

V. The Plan - §1221-1222

- A. The plan must be filed within 90 days after the filing of the petition. The Court may grant an extension if such an extension would be "substantially justified."
- B. The court is required to promptly hold a hearing on confirmation, and "except for cause, the hearing shall be concluded not later than 45 days after the filing of the plan."
1. The Legislative History suggests that "cause" be limited to a backlog of cases.
  2. Congress expected "this exception to be used sparingly in order to facilitate the proper operation of Chapter 12 - which proper operation depends on prompt action."
- C. Only D can file plan. §1221. C plans are not permitted as they are in Chp 11.
- D. The plan will generally be 3 years, but court "for cause" can approve a longer period up to 5 years.
- E. Mandatory requirements of any plan - §1222(a).
1. D must submit all or part of future income.
  2. The plan must provide for full payment of all claims entitled to priority under §507, such as administrative expenses allowed under §503(b), the most common of which are postpetition expenses of "preserving the estate," such as administrative rent and debts for goods or services purchased on credit by D.
  3. If the plan classifies claims, it must provide the same treatment for each claim within a class.
- F. Permissive requirements of a Chp 12 plan.
1. D may designate classes of unsecured claims, but D may not discriminate unfairly against any class so designated.
    - a. Administrative convenience - classification of unsecured claims based solely on amount is allowed, if court finds such classification reasonable and necessary for administrative convenience.
    - b. Priority claims - are entitled to payment in full and are properly classified separately from other unsecured claims.
    - c. Debts upon which there is a codebtor. A Chp 12 D is not prohibited from discriminating among unsecured Cs on the basis of the existence of a codebtor. It is not "unfair discrimination" to pay 100% of cosigned debts and a lesser percentage to other unsecured Cs.

- d. Objecting Cs - §1225(b)(1) is intended to benefit objecting C so that such different treatment should not be found to unfairly discriminate against others who do not object.
2. D may modify rights of unsecured claims.
3. Plan may provide for the curing or waiving of any default.
  - a. Curing of default ("reinstatement") should have no importance in Chp 12, because all secured Cs are subject to cram-down. (Right to cure is important in Chp 13 because of cram-down limitations on real estate lender under §1322(b)(2).)
  - b. Where default is waived, there will be a "modified" payment schedule.
4. D may pay unsecured claims concurrently with secured claims. Cs routinely accept that secured claims are paid first, with unsecured claims deferred. Where plan does not so propose payment, unsecured C may wish to oppose plan, because:
  - a. D will resolve problem which caused Chp 12 and then convert to Chp 7.
  - b. D may convert previously non-exempt property into exempt property and then convert to Chp 7. See Lindberg, 735 F.2d 1087 (8th Cir. 1984), where D filed a Chp 13 and owned a farm which was nonexempt because he did not live on it. During the Chp 13, D moved to farm. Court allowed D to convert to Chp 7 and claim farm as exempt.
5. D may cure default within reasonable time on secured claims where the final payment is due after completion of Chp 12 plan.

While this provision is important in Chp 13 because of the special residential real estate lender protection and three-to-five-year plan limitation on "cram-down", it will have little significance in Chp 12.
6. D may assume or reject executory contract. Most common form of executory contract is a true lease. D or Tee has option to assume or reject, and "ipso facto" clause (i.e., "this lease terminates if lessee files Bk") in executory contract is not valid.
  - a. In Chp 12, there is no deadline to assume or reject, other than that it must be done prior to confirmation, so promptly file motion to compel assumption or rejection. Mauro, 681 F.2d 102 (2d Cir. 1982). See Form 6 in Mapother, Chapter 12 Legal Forms for Agricultural Creditors.
  - b. Strategy for lessor's attorney is to file, as quickly as possible, a "combination" motion seeking:
    - (1) A deadline for D to assume or reject lease under §365(d)(2);
    - (2) Prompt curing of default under §365(b)(1)(A);
    - (3) Adequate protection under §363(e);
    - (4) A request that D abandon property and vacate farm, or release collateral under §554.

- c. D is required to assume or reject unexpired lease on nonresidential real property within 60 days, and, until assumed or rejected, all rent must be promptly paid. §364(d)(3).
- 7. D may provide for payment of a claim from property of the estate or property of D.
- 8. D may provide for sale of encumbered property.
  - a. §1206 allows D to sell collateral preconfirmation after "notice and a hearing," but without C's consent. (C's lien will attach to sale proceeds.)
  - b. §1206 only applies to "farmland or farm equipment."
- 9. D may provide for payment of secured claims over a period longer than the length of the plan.
  - a. Unlike Chp 13, D need not provide to cure default within a "reasonable time" or maintain future payments at regular contract rate to utilize this provision.
  - b. This is a big change from Chp 13 and has profound implications for secured Cs. It will be discussed under "cram-down."
  - c. The general rule is that a Chp 12 plan can run three to five years.
  - d. Despite this rule as to duration of Chp 12 plan, a D may modify secured obligations and provide for payment on such secured obligations during a period in excess of five years.
- 10. D may provide for vesting of property of the estate in D or in any other entity.
- 11. D may include any other appropriate provision not inconsistent with Chp 12.
  - a. This gives D certain flexibility.
  - b. It also can serve the secured C who requests:
    - (1) A drop-dead provision as to this C's collateral and payments, or
    - (2) A provision that if D sold C's collateral after confirmation for more than the crammed-down figure, that C would get excess.

## VI. Confirmation of the Plan.

- A. Confirmation requirements. Section 1225 provides that the court shall confirm D's plan if it meets 5 tests (and 2 other minor requirements):
  - 1. The liquidation test.
    - a. The plan must provide that the amount distributed to each unsecured C is not less than that C would receive as a dividend if D were liquidated in Chp 7.
    - b. This will be discussed in B below.
  - 2. The good-faith test.
    - a. The plan must be proposed in "good faith."
    - b. This has been the most litigated issue in Chp 13, and will be discussed in C below.
  - 3. The cram-down test.
    - a. Each secured C must at least be paid the value of its collateral.
    - b. This will be discussed in D below.

4. The disposable-income test.
  - a. D must at least pay Tee for 3 years all of D's "projected disposable income."
  - b. This is the famous test that was added into Chp 13 by Congress in 1984 and will be discussed in E below.
5. The feasibility test.
  - a. The D must be able to make all payments under the plan and to comply with the plan. This is a relative of the §1208 rehabilitation test, and both feasibility and rehabilitation are profitability concepts, all of which was discussed earlier.
6. The plan complies with the provisions of Chp 12 and other applicable Code provisions. The most relevant such provisions are contained in:
  - a. Sections 362 - 364 relating to adequate protection, and
  - b. Section 1222(a), which recites that the plan shall:
    - (1) Provide for the submission to the supervision and control of the Chapter 12 Trustee of whatever portion of future income is necessary for the execution of the plan;
    - (2) Provide for full payment of §507 priority claims;
    - (3) If the plan classifies claims and interests, provide the same treatment for each claim or interest within a particular class.
7. All required fees or charges have been paid.

B. The liquidation test.

1. The plan must provide that "the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7."
2. This is a mathematical test that means that the amount to be paid on each unsecured claim must not be less than the amount which would be paid if the D's nonexempt assets were liquidated and distributed to unsecured Cs. Since unsecured Cs receive little in most Chapter 7 cases, such a C can be given the same treatment in Chp 12.
3. This test requires totaling the value of the D's assets and subtracting the amount of secured claims and exemptions to determine what would be left for distribution to general unsecured Cs in a Chp 7. The D's Chp 12 plan must propose to pay unsecured Cs at least that amount.
4. The Sixth Circuit has held that confirmation of Chp 13 plan, under which all allowed unsecured claim would be paid in full, but without interest, was properly denied, where D's equity in house was more than sufficient to cover unsecured debts upon immediate liquidation of the estate. In re Hardy, 755 F.2d 75 (6th Cir. 1985).

C. The good faith test.

1. This is the acid test that has generated tons of litigation in Chapter 13. Seven Circuit Courts have addressed the issue, and all of them have said that the Bk Court must inquire on a case-by-case basis into whether the plan abuses the provisions, purpose or spirit of Chp 13.

- a. The leading explanation of the rule is in In re Estus, 695 F.2d 311 (8th Cir. 1982), in which the court said:

. . . in addition to the percentage of repayment to unsecured creditors, some of the factors that a court may find meaningful in making its determination of good faith are:

- (1) the amount of the proposed payments and the amount of the debtor's surplus;
- (2) The debtor's employment history, ability to earn and likelihood of future increases in income;
- (3) the probable or expected duration of the plan;
- (4) the accuracy of the plan's statements of the debts, expenses and percentage of repayment of unsecured debt and whether any inaccuracies are an attempt to mislead the court;
- (5) the extent of preferential treatment between classes of creditors;
- (6) the extent to which secured claims are modified;
- (7) the type of debt sought to be discharged and whether any such debt is nondischargeable in Chapter 7;
- (8) the existence of special circumstances such as inordinate medical expenses;
- (9) the frequency with which the debtor has sought relief under the Bankruptcy Reform Act;
- (10) the motivation and sincerity of the debtor in seeking Chapter 13 relief; and
- (11) the burden which the plan's administration would place upon the trustee.

- b. Congress intended to provide Bk courts with the discretion to examine and question D's motives. Bad faith need not be based upon an actual finding of fraud, requiring proof of malice, scienter or an intent to defraud. In re Waldron, 785 F.2d 936 (11th Cir. 1986).

2. Cs want a mathematical formula to be followed by all concerned, rather than a case-by-case approach. The latter means time and expense for Cs in protecting their rights in every case. In some districts being at the mercy of Tee and Judge is not so bad. In others, it is dreadful.

D. The cram-down test.

1. The plan must provide as to each secured claim that:



- a. The plan provides that the secured C retain its lien and be paid the value of its collateral "as of the effective date of the plan," or
- b. The D surrenders the collateral to the secured C.
- 2. This requirement means that if the secured C does not accept the plan, then the D must return the collateral or cram his plan down the secured C's throat by agreeing to pay in the plan to the secured C an amount equal to the value of the collateral held by the secured C.
- 3. For example: C has balance of \$150,000 secured by collateral worth \$100,00 on a 20-year loan.
  - a. C's claim will be bifurcated into two claims:
    - (1) A secured claim of \$100,000.
    - (2) An unsecured claim of \$50,000.
  - b. Secured claim will be paid in the amount of \$100,000 plus interest in deferred cash payments over a period not to exceed 20 years.
  - c. Unsecured portion of the claim (\$50,000) will be lumped in with all other unsecured Cs and paid in accordance with the plan over the term of the plan.

E. Disposable Income Test.

- 1. If the Tee or an unsecured C objects to the plan, the court may not approve any plan calling for less than 100% repayment unless the plan provides:
  - a. That all of the D's "projected disposable income be paid to the trustee," and
  - b. That it be paid for a three-year period beginning with the first payment due.
 

"Disposable income" is defined as that "which is not reasonably necessary to be expended -

    - (a) For the maintenance or support of the D or a dependent of the D; or
    - (b) For the payment of expenditures necessary for the continuation, preservation, and operation of the D's business."
- 2. In short, D must pay 100% of his debts or commit 100% of his disposable income over a three-year period. But this requirement only applies if Tee or an unsecured C objects.
- 3. One of the most difficult tasks for Cs and courts in implementing the disposable income test is to find what expenses are necessary for the maintenance and support of the D or his dependents. An unsecured C should attack any budget providing for unnecessary luxury expenses where such expenditures are more than nominal.
- 4. For example, D with family of 4 listed expenses including \$500 per month college tuition, \$500 per month secondary school education, \$515 per month food, \$989 housing expenses. Expenses were found to be not "reasonably necessary." Court explained that this test means that amount of money sufficient to pay the D's basic living expenses not related to D's former status in society or life style to which D has been accustomed. In re Jones, 55 BR 462 (Minn. 1985).

## VII. What if a Plan is Confirmed?

- A. Effect of confirmation. Once a plan is confirmed, the terms of the plan govern the rights of each C and the obligations of D.
1. Confirmation eliminates issues involving adequate protection, confirmation standards, etc.
  2. A confirmed plan becomes binding upon the D and each C in the same manner as if they had contracted for that result. If the D completes the payments specified under the plan, the portions of the debt which then remain unpaid will be discharged (except support and long-term debts reinstated under the plan).
  3. Confirmation is a court order and must be strictly complied with by all parties.
  4. Confirmation reverts all property of the estate in the D. In the absence of default, after confirmation a secured C is barred from seeking relief from stay.
- B. Lien survival
1. §1227 provides that property vesting in D is free and clear of claims or interests of the C, but this is different from liens. Liens survive. Secured Cs must retain liens, and this should be expressed in Order of Confirmation. §1225(a)(5)(B)(i).
  2. If secured C fails to file a secured claim or is tardy in doing so, the C may lose its debt but not the underlying lien. See In re Tarnow, 749 F.2d 464 (7th Cir. 1984), and In re Bradshaw, 14 BCD 1346 (M.D. N.C. 1986).
- C. Postconfirmation modification.
1. At any time after confirmation of plan, but before completion of payments, plan may be modified upon request of D, Tee, or unsecured C to:
    - a. Increase or reduce amount of payment.
    - b. Extend or reduce time for repayment.
    - c. Alter amount of distribution to Cs.
  2. The plan as modified may not provide for payments for more than five years after that of first payment.
- D. Dismissal of a confirmed plan.
1. The court may dismiss a confirmed plan for the following reasons:
    - a. Unreasonable delay or gross mismanagement.
    - b. Failure to commence making timely payments required by the plan.
    - c. Material default by D as to a term of the plan.
    - d. Continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation.
  2. The court may dismiss the case if D has committed fraud in connection with it.

PUBLIC LAW 99-554 [H.R. 5316]; October 27, 1986

**BANKRUPTCY JUDGES, UNITED STATES TRUSTEES, AND  
FAMILY FARMERS BANKRUPTCY ACT OF 1986**

*For Legislative History of Act see Report for P.L. 99-554 in  
Legislative History Section, post.*

An Act to amend title 28 of the United States Code to provide for the appointment of additional bankruptcy judges, to provide for the appointment of United States trustees to serve in bankruptcy cases in judicial districts throughout the United States, to make certain changes with respect to the role of United States trustees in such cases, and for other purposes.

*Be it enacted by the Senate and House of Representatives of the  
United States of America in Congress assembled, That this Act may  
be cited as the "Bankruptcy Judges, United States Trustees, and  
Family Farmer Bankruptcy Act of 1986".*

**TITLE I—AMENDMENTS TO TITLE 28 OF  
THE UNITED STATES CODE**

THE UNITED STATES DEPARTMENT OF JUSTICE

**UNITED STATES DEPARTMENT OF JUSTICE  
FEDERAL BUREAU OF INVESTIGATION**

Washington, D. C. 20535

TO : DIRECTOR, FBI (100-441100)

FROM : SAC, NEW YORK (100-100000)

SUBJECT: [REDACTED]

RE: [REDACTED]

**TO : DIRECTOR, FBI (100-441100)**  
**FROM : SAC, NEW YORK (100-100000)**

## Subtitle B—Debtors Who Are Family Farmers

### SEC. 251. DEFINITIONS.

Section 101 of title 11, United States Code, as amended by section 201 of this Act, is amended—

(1) in paragraph (17) by inserting “(except when such term appears in the term ‘family farmer’)” after “means”,

(2) by redesignating paragraphs (17) through (49) as paragraphs (19) through (51), respectively, and

(3) by inserting after paragraph (16) the following new paragraphs:

“(17) ‘family farmer’ means—

“(A) individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed \$1,500,000 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such individual or such individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual’s or such individual and spouse’s gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed; or

“(B) corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family, and such family or such relatives conduct the farming operation, and

“(i) more than 80 percent of the value of its assets consists of assets related to the farming operation;

“(ii) its aggregate debts do not exceed \$1,500,000 and not less than 80 percent of its aggregate noncontingent, liquidated debts (excluding a debt for one dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a farming operation), on the date the case is filed, arise out of the farming operation owned or operated by such corporation or such partnership; and

“(iii) if such corporation issues stock, such stock is not publicly traded;

“(18) ‘family farmer with regular annual income’ means family farmer whose annual income is sufficiently stable and regular to enable such family farmer to make payments under a plan under chapter 12 of this title;”.

### SEC. 252. APPLICABILITY OF CHAPTERS.

Section 103 of title 11, United States Code, is amended—

(1) in subsection (a) by striking out “or 13” and inserting in lieu thereof “12, or 13”,

(2) by adding at the end thereof the following:

“(i) Chapter 12 of this title applies only in a case under such chapter.”.

**SEC. 253. WHO MAY BE A DEBTOR.**

Section 109 of title 11, United States Code, is amended—

(1) in subsection (f)—

(A) by inserting "or family farmer" after "individual",  
and

(B) by redesignating such subsection as subsection (g), and  
(2) by inserting after subsection (e) the following:

"(f) Only a family farmer with regular annual income may be a debtor under chapter 12 of this title."

**SEC. 254. INVOLUNTARY CASES.**

Section 303(a) of title 11, United States Code, is amended by inserting ", family farmer," after "farmer".

**SEC. 255. FAMILY FARMERS.**

Title 11 of the United States Code is amended by inserting after chapter 11 the following new chapter:

**"CHAPTER 12—ADJUSTMENT OF DEBTS OF A  
FAMILY FARMER WITH REGULAR ANNUAL  
INCOME**

**"SUBCHAPTER I—OFFICERS, ADMINISTRATION, AND THE ESTATE**

"Sec.

- "1201. Stay of action against codebtor.
- "1202. Trustees.
- "1203. Rights and powers of debtor.
- "1204. Removal of debtor as debtor in possession.
- "1205. Adequate protection.
- "1206. Sales free of interests.
- "1207. Property of the estate.
- "1208. Conversion or dismissal.

**"SUBCHAPTER II—THE PLAN**

- "1221. Filing of plan.
- "1222. Contents of plan.
- "1223. Modification of plan before confirmation.
- "1224. Confirmation hearing.
- "1225. Confirmation of plan.
- "1226. Payments.
- "1227. Effect of confirmation.
- "1228. Discharge.
- "1229. Modification of plan after confirmation.
- "1230. Revocation of an order of confirmation.
- "1231. Special tax provisions.

**"SUBCHAPTER I—OFFICERS, ADMINISTRATION, AND THE  
ESTATE**

**"§ 1201. Stay of action against codebtor**

"(a) Except as provided in subsections (b) and (c) of this section, after the order for relief under this chapter, a creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt, unless—

"(1) such individual became liable on or secured such debt in the ordinary course of such individual's business; or

"(2) the case is closed, dismissed, or converted to a case under chapter 7 of this title.

“(b) A creditor may present a negotiable instrument, and may give notice of dishonor of such an instrument.

“(c) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided by subsection (a) of this section with respect to a creditor, to the extent that—

“(1) as between the debtor and the individual protected under subsection (a) of this section, such individual received the consideration for the claim held by such creditor;

“(2) the plan filed by the debtor proposes not to pay such claim; or

“(3) such creditor’s interest would be irreparably harmed by continuation of such stay.

“(d) Twenty days after the filing of a request under subsection (c)(2) of this section for relief from the stay provided by subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the debtor or any individual that is liable on such debt with the debtor files and serves upon such party in interest a written objection to the taking of the proposed action.

“§ 1202. Trustee

“(a) If the United States trustee has appointed an individual under section 586(b) of title 28 to serve as standing trustee in cases under this chapter and if such individual qualifies as a trustee under section 322 of this title, then such individual shall serve as trustee in any case filed under this chapter. Otherwise, the United States trustee shall appoint one disinterested person to serve as trustee in the case or the United States trustee may serve as trustee in the case if necessary.

“(b) The trustee shall—

“(1) perform the duties specified in sections 704(2), 704(3), 704(5), 704(6), 704(7), and 704(9) of this title;

“(2) perform the duties specified in section 1106(a)(3) and 1106(a)(4) of this title if the court, for cause and on request of a party in interest, the trustee, or the United States trustee, so orders;

“(3) appear and be heard at any hearing that concerns—

“(A) the value of property subject to a lien;

“(B) confirmation of a plan;

“(C) modification of the plan after confirmation; or

“(D) the sale of property of the estate;

“(4) ensure that the debtor commences making timely payments required by a confirmed plan; and

“(5) if the debtor ceases to be a debtor in possession, perform the duties specified in sections 704(8), 1106(a)(1), 1106(a)(2), 1106(a)(6), 1106(a)(7), and 1203.

“(c) If the number of cases under this chapter commenced in a particular judicial district so warrants, the court may appoint one or more individuals to serve as standing trustee for such district in cases under this chapter.

“(d)(1) A court that has appointed an individual under subsection (a) of this section to serve as standing trustee in cases under this chapter shall set for such individual—

“(A) a maximum annual compensation not to exceed the lowest annual rate of basic pay in effect for grade GS-16 of the General Schedule prescribed under section 5332 of title 5; and

“(B) a percentage fee not to exceed the sum of—

“(i) not to exceed ten percent of the payments made under the plan of such debtor, with respect to payments in an aggregate amount not to exceed \$450,000; and

“(ii) three percent of payments made under the plan of such debtor, with respect to payments made after the aggregate amount of payments made under the plan exceeds \$450,000;

based on such maximum annual compensation and the actual, necessary expenses incurred by such individual as standing trustee.

“(2) Such individual shall collect such percentage fee from all payments under plans in the cases under this chapter for which such individual serves as standing trustee. Such individual shall pay annually to the Treasury—

“(A) any amount by which the actual compensation received by such individual exceeds five percent of all such payments made under plans in cases under this chapter for which such individual serves as standing trustee; and

“(B) any amount by which the percentage fee fixed under paragraph (1)(B) of this subsection for all such cases exceeds—

“(i) such individual's actual compensation for such cases, as adjusted under subparagraph (A) of this paragraph; plus

“(ii) the actual, necessary expenses incurred by such individual as standing trustee in such cases.

“§ 1203. Rights and powers of debtor

“Subject to such limitations as the court may prescribe, a debtor in possession shall have all the rights, other than the right to compensation under section 330, and powers, and shall perform all the functions and duties, except the duties specified in paragraphs (2) and (4) of section 1106(a), of a trustee serving in a case under chapter 11, including operating the debtor's farm.

“§ 1204. Removal of debtor as debtor in possession

“(a) On request of a party in interest, and after notice and a hearing, the court shall order that the debtor shall not be a debtor in possession for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the commencement of the case.

“(b) On request of a party in interest, and after notice and a hearing, the court may reinstate the debtor in possession.

“§ 1205. Adequate protection

“(a) Section 361 does not apply in a case under this chapter.

“(b) In a case under this chapter, when adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

“(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of property securing a claim or of an entity's ownership interest in property;



"(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of property securing a claim or of an entity's ownership interest in property;

"(3) paying to such entity 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; or

"(4) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will adequately protect the value of property securing a claim or of such entity's ownership interest in property.

**"§ 1206. Sales free of interests**

"After notice and a hearing, in addition to the authorization contained in section 363(f), the trustee in a case under this chapter may sell property under section 363 (b) and (c) free and clear of any interest in such property of an entity other than the estate if the property is farmland or farm equipment, except that the proceeds of such sale shall be subject to such interest.

**"§ 1207. Property of the estate**

"(a) Property of the estate includes, in addition to the property specified in section 541 of this title—

"(1) all property of the kind specified in such section that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7 of this title, whichever occurs first; and

"(2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7 of this title, whichever occurs first.

"(b) Except as provided in section 1204, a confirmed plan, or an order confirming a plan, the debtor shall remain in possession of all property of the estate.

**"§ 1208. Conversion or dismissal**

"(a) The debtor may convert a case under this chapter to a case under chapter 7 of this title at any time. Any waiver of the right to convert under this subsection is unenforceable.

"(b) On request of the debtor at any time, if the case has not been converted under section 706 or 1112 of this title, the court shall dismiss a case under this chapter. Any waiver of the right to dismiss under this subsection is unenforceable.

"(c) On request of a party in interest, and after notice and a hearing, the court may dismiss a case under this chapter for cause, including—

"(1) unreasonable delay, or gross mismanagement, by the debtor that is prejudicial to creditors;

"(2) nonpayment of any fees and charges required under chapter 123 of title 28;

"(3) failure to file a plan timely under section 1221 of this title;

"(4) failure to commence making timely payments required by a confirmed plan;

"(5) denial of confirmation of a plan under section 1225 of this title and denial of a request made for additional time for filing another plan or a modification of a plan;

"(6) material default by the debtor with respect to a term of a confirmed plan;

"(7) revocation of the order of confirmation under section 1230 of this title, and denial of confirmation of a modified plan under section 1229 of this title;

"(8) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; or

"(9) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation.

"(d) On request of a party in interest, and after notice and a hearing, the court may dismiss a case under this chapter or convert a case under this chapter to a case under chapter 7 of this title upon a showing that the debtor has committed fraud in connection with the case.

"(e) Notwithstanding any other provision of this section, a case may not be converted to a case under another chapter of this title unless the debtor may be a debtor under such chapter.

#### "SUBCHAPTER II—THE PLAN

##### "§ 1221. Filing of plan

"The debtor shall file a plan not later than 90 days after the order for relief under this chapter, except that the court may extend such period if an extension is substantially justified.

##### "§ 1222. Contents of plan

"(a) The plan shall—

"(1) provide for the submission of all or such portion of future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan;

"(2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507 of this title, unless the holder of a particular claim agrees to a different treatment of such claim; and

"(3) if the plan classifies claims and interests, provide the same treatment for each claim or interest within a particular class unless the holder of a particular claim or interest agrees to less favorable treatment.

"(b) Subject to subsections (a) and (c) of this section, the plan may—

"(1) designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated; however, such plan may treat claims for a consumer debt of the debtor if an individual is liable on such consumer debt with the debtor differently than other unsecured claims;

"(2) modify the rights of holders of secured claims, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

"(3) provide for the curing or waiving of any default;

"(4) provide for payments on any unsecured claim to be made concurrently with payments on any secured claim or any other unsecured claim;

"(5) provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;

"(6) subject to section 365 of this title, provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not previously rejected under such section;

"(7) provide for the payment of all or part of a claim against the debtor from property of the estate or property of the debtor;

"(8) provide for the sale of all or any part of the property of the estate or the distribution of all or any part of the property of the estate among those having an interest in such property;

"(9) provide for payment of allowed secured claims consistent with section 1225(a)(5) of this title, over a period exceeding the period permitted under section 1222(c);

"(10) provide for the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity; and

"(11) include any other appropriate provision not inconsistent with this title.

"(c) Except as provided in subsections (b)(5) and (b)(9), the plan may not provide for payments over a period that is longer than three years unless the court for cause approves a longer period, but the court may not approve a period that is longer than five years.

#### "§ 1223. Modification of plan before confirmation

"(a) The debtor may modify the plan at any time before confirmation, but may not modify the plan so that the plan as modified fails to meet the requirements of section 1222 of this title.

"(b) After the debtor files a modification under this section, the plan as modified becomes the plan.

"(c) Any holder of a secured claim that has accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless the modification provides for a change in the rights of such holder from what such rights were under the plan before modification, and such holder changes such holder's previous acceptance or rejection.

#### "§ 1224. Confirmation hearing

"After expedited notice, the court shall hold a hearing on confirmation of the plan. A party in interest, the trustee, or the United States trustee may object to the confirmation of the plan. Except for cause, the hearing shall be concluded not later than 45 days after the filing of the plan.

#### "§ 1225. Confirmation of plan

"(a) Except as provided in subsection (b), the court shall confirm a plan if—

"(1) the plan complies with the provisions of this chapter and with the other applicable provisions of this title;

"(2) any fee, charge, or amount required under chapter 123 of title 28, or by the plan, to be paid before confirmation, has been paid;

"(3) the plan has been proposed in good faith and not by any means forbidden by law;

"(4) the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date;

"(5) with respect to each allowed secured claim provided for by the plan—

"(A) the holder of such claim has accepted the plan;

"(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

"(ii) the value, as of the effective date of the plan, of property to be distributed by the trustee or the debtor under the plan on account of such claim is not less than the allowed amount of such claim; or

"(C) the debtor surrenders the property securing such claim to such holder; and

"(6) the debtor will be able to make all payments under the plan and to comply with the plan.

"(b)(1) If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan—

"(A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or

"(B) the plan provides that all of the debtor's projected disposable income to be received in the three-year period, or such longer period as the court may approve under section 1222(c), beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

"(2) For purposes of this subsection, 'disposable income' means income which is received by the debtor and which is not reasonably necessary to be expended—

"(A) for the maintenance or support of the debtor or a dependent of the debtor; or

"(B) for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business.

"(c) After confirmation of a plan, the court may order any entity from whom the debtor receives income to pay all or any part of such income to the trustee.

#### "§ 1226. Payments

"(a) Payments and funds received by the trustee shall be retained by the trustee until confirmation or denial of confirmation of a plan. If a plan is confirmed, the trustee shall distribute any such payment in accordance with the plan. If a plan is not confirmed, the trustee shall return any such payments to the debtor, after deducting—

"(1) any unpaid claim allowed under section 503(b) of this title; and

"(2) if a standing trustee is serving in the case, the percentage fee fixed for such standing trustee.

"(b) Before or at the time of each payment to creditors under the plan, there shall be paid—

"(1) any unpaid claim of the kind specified in section 507(a)(1) of this title; and

"(2) if a standing trustee appointed under section 1202(d) of this title is serving in the case, the percentage fee fixed for such standing trustee under section 1202(e) of this title.

"(c) Except as otherwise provided in the plan or in the order confirming the plan, the trustee shall make payments to creditors under the plan.

**"§ 1227. Effect of confirmation**

"(a) Except as provided in section 1228(a) of this title, the provisions of a confirmed plan bind the debtor, each creditor, each equity security holder, and each general partner in the debtor, whether or not the claim of such creditor, such equity security holder, or such general partner in the debtor is provided for by the plan, and whether or not such creditor, such equity security holder, or such general partner in the debtor has objected to, has accepted, or has rejected the plan.

"(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

"(c) Except as provided in section 1228(a) of this title and except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

**"§ 1228. Discharge**

"(a) As soon as practicable after completion by the debtor of all payments under the plan, other than payments to holders of allowed claims provided for under section 1222(b)(5) or 1222(b)(10) of this title, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided for by the plan allowed under section 503 of this title or disallowed under section 502 of this title, except any debt—

"(1) provided for under section 1222(b)(5) or 1222(b)(10) of this title; or

"(2) of the kind specified in section 523(a) of this title.

"(b) At any time after the confirmation of the plan and after notice and a hearing, the court may grant a discharge to a debtor that has not completed payments under the plan only if—

"(1) the debtor's failure to complete such payments is due to circumstances for which the debtor should not justly be held accountable;

"(2) the value, as of the effective date of the plan, of property actually distributed under the plan on account of each allowed unsecured claim is not less than the amount that would have been paid on such claim if the estate of the debtor had been liquidated under chapter 7 of this title on such date; and

"(3) modification of the plan under section 1229 of this title is not practicable.

"(c) A discharge granted under subsection (b) of this section discharges the debtor from all unsecured debts provided for by the plan or disallowed under section 502 of this title, except any debt—

"(1) provided for under section 1222(b)(5) or 1222(b)(10) of this title; or

"(2) of a kind specified in section 523(a) of this title.

"(d) On request of a party in interest before one year after a discharge under this section is granted, and after notice and a hearing, the court may revoke such discharge only if—

"(1) such discharge was obtained by the debtor through fraud; and

"(2) the requesting party did not know of such fraud until after such discharge was granted.

"(e) After the debtor is granted a discharge, the court shall terminate the services of any trustee serving in the case.

**§ 1229. Modification of plan after confirmation**

"(a) At any time after confirmation of the plan but before the completion of payments under such plan, the plan may be modified, on request of the debtor, the trustee, or the holder of an allowed unsecured claim, to—

"(1) increase or reduce the amount of payments on claims of a particular class provided for by the plan;

"(2) extend or reduce the time for such payments; or

"(3) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim other than under the plan.

"(b)(1) Sections 1222(a), 1222(b), and 1223(c) of this title and the requirements of section 1225(a) of this title apply to any modification under subsection (a) of this section.

"(2) The plan as modified becomes the plan unless, after notice and a hearing, such modification is disapproved.

"(c) A plan modified under this section may not provide for payments over a period that expires after three years after the time that the first payment under the original confirmed plan was due, unless the court, for cause, approves a longer period, but the court may not approve a period that expires after five years after such time.

**§ 1230. Revocation of an order of confirmation**

"(a) On request of a party in interest at any time within 180 days after the date of the entry of an order of confirmation under section 1225 of this title, and after notice and a hearing, the court may revoke such order if such order was procured by fraud.

"(b) If the court revokes an order of confirmation under subsection (a) of this section, the court shall dispose of the case under section 1207 of this title, unless, within the time fixed by the court, the debtor proposes and the court confirms a modification of the plan under section 1229 of this title.

**§ 1231. Special tax provisions**

"(a) For the purpose of any State or local law imposing a tax on or measured by income, the taxable period of a debtor that is an individual shall terminate on the date of the order for relief under this chapter, unless the case was converted under section 706 of this title.

"(b) The trustee shall make a State or local tax return of income for the estate of an individual debtor in a case under this chapter for

each taxable period after the order for relief under this chapter during which the case is pending.

"(c) The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1225 of this title, may not be taxed under any law imposing a stamp tax or similar tax.

"(d) The court may authorize the proponent of a plan to request a determination, limited to questions of law, by a State or local governmental unit charged with responsibility for collection or determination of a tax on or measured by income, of the tax effects, under section 346 of this title and under the law imposing such tax, of the plan. In the event of an actual controversy, the court may declare such effects after the earlier of—

- "(1) the date on which such governmental unit responds to the request under this subsection; or
- "(2) 270 days after such request."

**SEC. 256. CONVERSION FROM CHAPTER 11 TO CHAPTER 12.**

Section 1112(d) of title 11, United States Code, is amended—

- (1) by inserting "12 or" before "13",
- (2) in paragraph (1) by striking out "and" at the end thereof,
- (3) in paragraph (2) by striking out the period at the end thereof and inserting "; and", and
- (4) by inserting after paragraph (2) the following:

"(3) if the debtor requests conversion to chapter 12 of this title, such conversion is equitable."

**SEC. 257. CONFORMING AMENDMENTS.**

(a) Title 11 of the United States Code is amended in the table of chapters by inserting after the item relating to chapter 11 the following new item:

"12. Adjustment of Debts of Family Farmers with Regular Annual Income.. 1201".

(b) Section 108 of title 11, United States Code, is amended—  
(1) in subsection (b) by inserting "1201 or" before "1301", and  
(2) in subsection (c)—

(A) by striking out "section 1301" and inserting in lieu thereof "section 1201 or 1301", and

(B) by inserting "1201," after "722,".

(c) Sections 321(a), 329(b)(1)(B), and 1106(a)(5) of title 11, United States Code, are each amended by striking out "or 13" each place it appears and inserting in lieu thereof ", 12, or 13".

(d) Sections 322(a) and 546(a)(1) of title 11, United States Code, are each amended by striking out "or 1302" each place it appears and inserting in lieu thereof "1302, or 1202".

(e) Section 327 of title 11, United States Code, is amended—  
(1) in subsection (b) by inserting ", 1202," after "section 721,"

and

(2) in subsection (c) by inserting ", 12," after "section 7".

(f) Section 330(c) of title 11, United States Code, is amended by inserting "12 or" before "13".

(g) Section 346 of title 11, United States Code, is amended—

(1) in subsection (b) by inserting ", 12," after "chapter 7",

(2) in subsection (g)(1)(C) by inserting "or 12" after "chapter 11", and

(3) in subsection (i)(1) by inserting ", 12," after "chapter 7".

(h) Section 347 of title 11, United States Code, is amended—

(1) in subsection (a)—

- (A) by inserting " 1226," after "section 726", and
- (B) by inserting " 12," after "chapter 7", and
- (2) in subsection (b)—
  - (A) by striking out "or 11" and inserting in lieu thereof " 11, or 12", and
  - (B) by striking out "or 1173" and inserting in lieu thereof "1173, or 1225".
- (i) Section 348 of title 11, United States Code, is amended—
  - (1) in subsection (b)—
    - (A) by striking out "and 1328(a)" and inserting in lieu thereof "1201(a), 1221, and 1228(a)", and
    - (B) by striking out "or 1307" and inserting in lieu thereof "1307, or 1208",
  - (2) in subsections (c) and (e) by striking out "or 1307" each place it appears and inserting in lieu thereof "1307, or 1208", and
  - (3) in subsection (d) by striking out "or 1307" and inserting in lieu thereof " 1307, or 1208".
- (j) Sections 362(c)(2)(C), 365(d)(2), and 502(g) of title 11, United States Code, are each amended by striking out "or 13" each place it appears and inserting in lieu thereof "12, or 13".
- (k) Section 363 of title 11, United States Code, is amended—
  - (1) in subsection (c)(1) by striking out "or 1304" and inserting in lieu thereof "1304, 1203, or 1204", and
  - (2) in subsection (l) by striking out "or 13" and inserting in lieu thereof " 12, or 13".
- (l) Section 364(a) of title 11, United States Code, is amended by striking out "or 1304" and inserting in lieu thereof "1304, 1203, or 1204".
- (m) Section 365(g) of title 11, United States Code, is amended—
  - (1) in paragraph (1) by striking out "or 13" and inserting in lieu thereof "12, or 13", and
  - (2) in paragraph (2)—
    - (A) by striking out "or 13" and inserting in lieu thereof "12, or 13", and
    - (B) by striking out "or 1307" each place it appears and inserting in lieu thereof " 1307, or 1208".
- (n) Section 523(a) of title 11, United States Code, is amended by striking out "or 1328(b)" and inserting in lieu thereof " 1228(a), 1228(b), or 1328(b)".
- (o) Section 524 of title 11, United States Code, is amended—
  - (1) in subsections (a)(1), (c)(1), and (d) by striking out "or 1328" each place it appears and inserting in lieu thereof "1228, or 1328", and
  - (2) in subsection (a)(3) by striking out "or 1328(a)(1)" and inserting in lieu thereof " 1228(a)(1), or 1328(a)(1)".
- (p) Section 557(d)(3) of title 11, United States Code, is amended by inserting "1202," after "1104,".
- (q) Section 706 of title 11, United States Code, is amended—
  - (1) in subsection (a)—
    - (A) by striking out "or 1307" and inserting in lieu thereof " 1307, or 1208", and
    - (B) by striking out "or 13" and inserting in lieu thereof " 12, or 13", and
  - (2) in subsection (c) by inserting "12 or" before "13".
- (r) Section 726(b) of title 11, United States Code, is amended by inserting "1208," after "section 1112".



- (s) Section 727(a)(9) of title 11, United States Code, is amended by inserting "1228 or" before "1328".
- (t) Section 728(a) of title 11, United States Code, is amended by inserting "or 1208" after "section 1112".
- (u) Section 1306(a) of title 11, United States Code, is amended—
  - (1) in paragraph (1) by striking out "or 11" and inserting in lieu thereof ", 11, or 12", and
  - (2) in paragraph (2) by striking out "or 11" and inserting in lieu thereof ", 11, or 12".
- (v) Section 1307 of title 11, United States Code, is amended—
  - (1) in subsection (b) by striking out "or 1112" and inserting in lieu thereof ", 1112, or 1208",
  - (2) in subsection (d) by inserting "or 12" after "chapter 11", and
  - (3) in subsection (e) by striking out "or 11" and inserting in lieu thereof ", 11, or 12".

### **Subtitle C—Miscellaneous Amendments and Technical Corrections to Title 11**

#### **SEC. 251. SUPPORT OBLIGATIONS.**

- Section 523(a)(5) of title 11, United States Code, is amended—
- (1) by striking out "decree," and inserting in lieu thereof "decree", and
  - (2) by inserting ", determination made in accordance with State or territorial law by a governmental unit," after "record".

#### **SEC. 252. DISCHARGE.**

- Section 524(d) of title 11, United States Code is amended—
- (1) in the first sentence by striking out "shall" the first place it appears and inserting in lieu thereof "may",
  - (2) in the second sentence by inserting "any" after "At", and
  - (3) in the third sentence by inserting "the court shall hold a hearing at which the debtor shall appear in person and" after "then".

#### **SEC. 253. TECHNICAL CORRECTIONS.**

- (a)(1) Section 101(43)(A)(xv) of title 11, United States Code, as amended by section 251, is amended by striking out "security" and inserting in lieu thereof "security".
- (2) Section 101(51) of title 11, United States Code, as amended by section 251, is amended by striking out the semicolon at the end thereof and inserting in lieu thereof a period.
- (b)(1) Section 303(b) of title 11, United States Code, is amended by striking out "subject on" and inserting in lieu thereof "subject of".
- (2) Section 303(h)(1) of title 11, United States Code, is amended by striking out "that".
- (c) Section 346(j)(7) of title 11, United States Code, is amended by striking out "owned" and inserting in lieu thereof "owed".
- (d) Section 362(b) of title 11, United States Code, is amended—
  - (1) in paragraph (6) by striking out "financial institution," each place it appears and inserting in lieu thereof ", financial institutions",
  - (2) striking "or" after the semicolon in the first paragraph (9),

- (3) striking out "(9)" in the second paragraph (9), and "(10)" in paragraph (10) and inserting in lieu thereof "(10)" and "(11)", respectively, and
- (4) in paragraph (10), as so redesignated, by striking out the period at the end thereof and inserting in lieu thereof "; or".
- (e)(1) Section 365(c) of title 11, United States Code, is amended by—
- (1) striking "or and assignee of such contract or lease" in subparagraph (1)(A), and
  - (2) in paragraph (3) by—
    - (A) inserting "is" after "lease", and
    - (B) inserting "and" after "property".
- (2) Paragraph (1) of section 365(h) of title 11, United States Code, is amended by inserting "or timeshare plan" after "lease" the fourth place it appears.
- (3) Section 365(m) of title 11, United States Code, is amended by striking out "362(b)(9)" and inserting in lieu thereof "362(b)(10)".
- (f)(1) Section 502(b)(6)(A)(ii) of title 11, United States Code, is amended by striking out "repossessed" and inserting in lieu thereof "repossessed".
- (2) Section 502(i) of title 11, United States Code, is amended by striking out "507(a)(6)" and inserting in lieu thereof "507(a)(7)".
- (g) Section 503(b) of title 11, United States Code, is amended—
- (1) in subparagraph (1)(B) by striking out "507(a)(6)" and inserting in lieu thereof "507(a)(7)".
  - (2) in paragraph (5) by inserting "and" after the semicolon, and
  - (3) in paragraph (6) by striking out "; and" and inserting in lieu thereof a period.
- (h) Section 521(4) of title 11, United States Code, is amended by inserting ", whether or not immunity is granted under section 344 of this title" after "estate" the second place it appears.
- (i)(1) Section 522(h)(1) of title 11, United States Code, is amended by striking out "title" and inserting in lieu thereof "title".
- (2) Section 522(i)(2) of title 11, United States Code, is amended by striking out "his" and inserting in lieu thereof "this".
- (j)(1) Section 523(a) of title 11, United States Code, is amended—
- (A) in subparagraph (1)(A) by striking out "507(a)(6)" and inserting in lieu thereof "507(a)(7)", and
  - (B) by redesignating the second paragraph (9) as paragraph (10).
- (2) Section 523(b) of title 11, United States Code, is amended by striking out "Services" and inserting in lieu thereof "Service".
- (k) Section 524(d)(2) of title 11, United States Code, is amended by striking out "subsection" the second place it appears and inserting in lieu thereof "section".
- (l) Section 546(e) of title 11, United States Code, is amended by inserting a comma after "stockbroker".
- (m) Section 547(b)(4)(B) of title 11, United States Code, is amended by inserting "and" after the semicolon.
- (n) Section 548(d)(2)(B) of title 11, United States Code, is amended by striking out "financial institution," and inserting in lieu thereof "financial institution".
- (o) Section 549(b) of title 11, United States Code, is amended—
- (1) by striking out "that occurs" and inserting in lieu thereof "made".

(2) by striking out "is valid against the trustee to the extent of" and inserting in lieu thereof "to the extent", and

(3) by inserting "is" before "given".

(p) Section 554(c) of title 11, United States Code, is amended by striking out "521(a)(1)" and inserting in lieu thereof "521(1)".

(q) The items relating to sections 557, 558, and 559 in the table of sections for subchapter III of chapter 5 of title 11, United States Code, are amended to read as follows:

"557. Expedited determination of interests in, and abandonment or other disposition of grain assets.

"558. Defenses of the estate.

"559. Contractual right to liquidate a repurchase agreement."

(r) Section 724(b)(2) of title 11, United States Code, is amended by—

(1) striking out "or", and

(2) inserting ", or 507(a)(6)" after "507(a)(5)".

(s) Section 726(b) of title 11, United States Code, is amended by striking out "or (6)" and inserting in lieu thereof "(6) or (7)".

(t) Section 743 of title 11, United States Code, is amended by striking out "(d)".

(u) Section 1121(d) of title 11, United States Code, is amended by striking out "subsection" and inserting in lieu thereof "subsections (b) and".

(v) Section 1129(a) of title 11, United States Code, is amended—

(1) in paragraph (7) by striking out "of" the first time it appears,

(2) in subparagraph (9)(B) by striking out "or 507(a)(5)" the first time it appears and inserting in lieu thereof "507(a)(5) or 507(a)(6)", and

(3) in paragraph (9)(C) by striking out "(6)" and inserting in lieu thereof "(7)".

(w) Section 1302(e)(1) of title 11, United States Code, is amended by striking out "fix" and inserting in lieu thereof "set for such individual".

(x) Section 1324 of title 11, United States Code, is amended in the second sentence by striking out "the" the first place it appears.

(y) Section 1325(b)(2)(A) of title 11, United States Code, is amended by striking out "or" after the semicolon and inserting in lieu thereof "and".

(z) Section 1326(a)(2) of title 11, United States Code, is amended by striking out "payments" and inserting in lieu thereof "payment".

(aa) Official Bankruptcy Form No. 1, referred to in Rule 1002 of the Bankruptcy Rules, is amended—

(1) in paragraph (6) by striking out "7 or 13" and inserting in lieu thereof "7, 11, 12, or 13", and

(2) by striking out "7 or 13" and inserting in lieu thereof "7, 11, 12, or 13" in the statement to be made by the attorney in "Exhibit 'B'".

### TITLE III—TRANSITION AND ADMINISTRATIVE PROVISIONS

#### SEC. 301. INCUMBENT UNITED STATES TRUSTEES.

(a) AREA FOR WHICH APPOINTED.—Notwithstanding any paragraph of section 581(a) of title 28, United States Code, as in effect

before the effective date of this Act, a United States trustee serving in such office on the effective date of this Act shall serve the remaining term of such office as United States trustee for the region specified in a paragraph of such section, as amended by this Act, that includes the site at which the primary official station of the United States trustee is located immediately before the effective date of this Act.

(b) **TERM OF OFFICE.**—Notwithstanding section 581(b) of title 28, United States Code, as in effect before the effective date of this Act, the term of office of any United States trustee serving in such office on the date of the enactment of this Act shall expire—

(1) 2 years after the expiration date of such term of office under such section, as so in effect, or

(2) 4 years after the date of the enactment of this Act, whichever occurs first.

**SEC. 302. EFFECTIVE DATES; APPLICATION OF AMENDMENTS.**

(a) **GENERAL EFFECTIVE DATE.**—Except as provided in subsections (b), (c), (d), (e), and (f), this Act and the amendments made by this Act shall take effect 30 days after the date of the enactment of this Act.

(b) **AMENDMENTS RELATING TO BANKRUPTCY JUDGES AND INCUMBENT UNITED STATES TRUSTEES.**—Subtitle A of title I, and sections 301 and 307(a), shall take effect on the date of the enactment of this Act.

(c) **AMENDMENTS RELATING TO FAMILY FARMERS.**—(1) The amendments made by subtitle B of title II shall not apply with respect to cases commenced under title 11 of the United States Code before the effective date of this Act.

(2) Section 1202 of title 11 of the United States Code (as added by the amendment made by section 255 of this Act) shall take effect on the effective date of this Act and before the amendment made by section 227 of this Act.

(3) Until the amendments made by subtitle A of title II of this Act become effective in a district and apply to a case, for purposes of such case—

(A)(i) any reference in section 326(b) of title 11 of the United States Code to chapter 13 of title 11 of the United States Code shall be deemed to be a reference to chapter 12 or chapter 13 of title 11 of the United States Code,

(ii) any reference in such section 326(b) to section 1302(d) of title 11 of the United States Code shall be deemed to be a reference to section 1302(d) of title 11 of the United States Code or section 586(b) of title 28 of the United States Code, and

(iii) any reference in such section 326(b) to section 1302(a) of title 11 of the United States Code shall be deemed to be a reference to section 1202(a) or section 1302(a) of title 11 of the United States Code, and

(B)(i) the first two references in section 1202(a) of title 11 of the United States Code (as added by the amendment made by section 255 of this Act) to the United States trustee shall be deemed to be a reference to the court, and

(ii) any reference in such section 1202(a) to section 586(b) of title 28 of the United States Code shall be deemed to be a reference to section 1202(c) of title 11 of the United States Code (as so added).

(d) **APPLICATION OF AMENDMENTS TO JUDICIAL DISTRICTS.**—

**(1) CERTAIN REGIONS NOT CURRENTLY SERVED BY UNITED STATES TRUSTEES.**—(A) The amendments made by subtitle A of title II of this Act, and section 1930(a)(6) of title 28 of the United States Code (as added by section 117(4) of this Act), shall not—

- (i) become effective in or with respect to a judicial district specified in subparagraph (B) until, or
- (ii) apply to cases while pending in such district before, the expiration of the 270-day period beginning on the effective date of this Act or of the 30-day period beginning on the date the Attorney General certifies under section 303 of this Act the region specified in a paragraph of section 581(a) of title 28, United States Code, as amended by section 111(a) of this Act, that includes such district, whichever occurs first.

(B) Subparagraph (A) applies to the following:

- (i) The judicial district established for the Commonwealth of Puerto Rico.
- (ii) The District of Connecticut.
- (iii) The judicial districts established for the State of New York (other than the Southern District of New York).
- (iv) The District of Vermont.
- (v) The judicial districts established for the State of Pennsylvania.
- (vi) The judicial district established for the Virgin Islands of the United States.
- (vii) The District of Maryland.
- (viii) The judicial districts established for the State of North Carolina.
- (ix) The District of South Carolina.
- (x) The judicial districts established for the State of West Virginia.
- (xi) The Western District of Virginia.
- (xii) The Eastern District of Texas.
- (xiii) The judicial districts established for the State of Wisconsin.
- (xiv) The judicial districts established for the State of Iowa.
- (xv) The judicial districts established for the State of New Mexico.
- (xvi) The judicial districts established for the State of Oklahoma.
- (xvii) The District of Utah.
- (xviii) The District of Wyoming (including those portions of Yellowstone National Park situated in the States of Montana and Idaho).
- (xix) The judicial districts established for the State of Alabama.
- (xx) The judicial districts established for the State of Florida.
- (xxi) The judicial districts established for the State of Georgia.

**(2) CERTAIN REMAINING JUDICIAL DISTRICTS NOT CURRENTLY SERVED BY UNITED STATES TRUSTEES.**—(A) The amendments made by subtitle A of title II of this Act, and section 1930(a)(6) of title 28 of the United States Code (as added by section 117(4) of this Act), shall not—

- (i) become effective in or with respect to a judicial district specified in subparagraph (B) until, or

(ii) apply to cases while pending in such district before, the expiration of the 2-year period beginning on the effective date of this Act or of the 30-day period beginning on the date the Attorney General certifies under section 303 of this Act the region specified in a paragraph of section 581(a) of title 28, United States Code, as amended by section 111(a) of this Act, that includes such district, whichever occurs first.

(B) Subparagraph (A) applies to the following:

(i) The judicial districts established for the State of Louisiana.

(ii) The judicial districts established for the State of Mississippi.

(iii) The Southern District of Texas and the Western District of Texas.

(iv) The judicial districts established for the State of Kentucky.

(v) The judicial districts established for the State of Tennessee.

(vi) The judicial districts established for the State of Michigan.

(vii) The judicial districts established for the State of Ohio.

(viii) The judicial districts established for the State of Illinois (other than the Northern District of Illinois).

(ix) The judicial districts established for the State of Indiana.

(x) The judicial districts established for the State of Arkansas.

(xi) The judicial districts established for the State of Nebraska.

(xii) The judicial districts established for the State of Missouri.

(xiii) The District of Arizona.

(xiv) The District of Hawaii.

(xv) The judicial district established for Guam.

(xvi) The judicial district established for the Commonwealth of the Northern Mariana Islands.

(xvii) The judicial districts established for the State of California (other than the Central District of California).

(xviii) The District of Nevada.

(xix) The District of Alaska.

(xx) The District of Idaho.

(xxi) The District of Montana.

(xxii) The District of Oregon.

(xxiii) The judicial districts established for the State of Washington.

(3) JUDICIAL DISTRICTS FOR THE STATES OF ALABAMA AND NORTH CAROLINA.—(A) Notwithstanding paragraphs (1) and (2), and any other provision of law, the amendments made by subtitle A of title II of this Act, and section 1930(a)(6) of title 28 of the United States Code (as added by section 117(4) of this Act), shall not—

(i) become effective in or with respect to a judicial district specified in subparagraph (E) until, or

(ii) apply to cases while pending in such district before, such district elects to be included in a bankruptcy region established in section 581(a) of title 28, United States Code, as

amended by section 111(a) of this Act, or October 1, 1992, whichever occurs first.

(B) Any election under subparagraph (A) shall be made upon a majority vote of the chief judge of such district and each bankruptcy judge in such judicial district in favor of such election.

(C) Notice that an election has been made under subparagraph (A) shall be given, not later than 10 days after such election, to the Attorney General and the appropriate Federal Circuit Court of Appeals for such district.

(D) Any election made under subparagraph (A) shall become effective on the date the amendments made by subtitle A of title II of this Act become effective in the region that includes such district or 30 days after the Attorney General receives the notice required under subparagraph (C), whichever occurs later.

(E) Subparagraph (A) applies to the following:

(i) The judicial districts established for the State of Alabama.

(ii) The judicial districts established for the State of North Carolina.

(F)(i) Subject to clause (ii), with respect to cases under chapters 7, 11, 12, and 13 of title 11, United States Code—

(I) commenced before the effective date of this Act, and

(II) pending in a judicial district in the State of Alabama or the State of North Carolina before any election made under subparagraph (A) by such district becomes effective or October 1, 1992, whichever occurs first,

the amendments made by section 113 and subtitle A of title II of this Act, and section 1930(a)(6) of title 28 of the United States Code (as added by section 117(4) of this Act), shall not apply until October 1, 1993, or the expiration of the 1-year period beginning on the date such election becomes effective, whichever occurs first.

(ii) For purposes of clause (i), the amendments made by section 113 and subtitle A of title II of this Act, and section 1930(a)(6) of title 28 of the United States Code (as added by section 117(4) of this Act), shall not apply with respect to a case under chapter 7, 11, 12, or 13 of title 11, United States Code, if—

(I) the trustee in the case files the final report and account of administration of the estate, required under section 704 of such title, or

(II) a plan is confirmed under section 1129, 1225, or 1325 of such title,

before October 1, 1993, or the expiration of the 1-year period beginning on the date such election becomes effective, whichever occurs first.

(G) Notwithstanding section 589a of title 28, United States Code, as added by section 115 of this Act, funds collected as a result of the amendments made by section 117 of this Act in a judicial district in the State of Alabama or the State of North Carolina under section 1930(a) of title 28, United States Code, before the date the amendments made by subtitle A of title II of this Act take effect in such district shall be deposited in the general receipts of the Treasury.

(H) The repeal made by section 231 of this Act shall not apply in or with respect to the Northern District of Alabama until

March 1, 1987, or the effective date of any election made under subparagraph (A) by such district, whichever occurs first.

(I) In any judicial district in the State of Alabama or the State of North Carolina that has not made the election described in subparagraph (A), any person who is appointed under regulations issued by the Judicial Conference of the United States to administer estates in cases under title 11 of the United States Code may—

(i) establish, maintain, and supervise a panel of private trustees that are eligible and available to serve as trustees in cases under title 11, United States Code, and

(ii) supervise the administration of cases and trustees in cases under chapters 7, 11, 12, and 13 of title 11, United States Code,

until the amendments made by subtitle A of title II take effect in such district.

**(e) APPLICATION OF UNITED STATES TRUSTEE SYSTEM AND QUARTERLY FEES TO CERTAIN CASES.—**

(1) **IN GENERAL.**—Subject to paragraph (2), with respect to cases under chapters 7, 11, 12, and 13 of title 11, United States Code—

(A) commenced before the effective date of this Act, and

(B) pending in a judicial district referred to in section 581(a) of title 28, United States Code, as amended by section 111(a) of this Act, for which a United States trustee is not authorized before the effective date of this Act to be appointed,

the amendments made by section 113 and subtitle A of title II of this Act, and section 1930(a)(6) of title 28 of the United States Code (as added by section 117(4) of this Act), shall not apply until the expiration of the 3-year period beginning on the effective date of this Act, or of the 1-year period beginning on the date the Attorney General certifies under section 303 of this Act the region specified in a paragraph of such section 581(a), as so amended, that includes such district, whichever occurs first.

(2) **AMENDMENTS INAPPLICABLE.**—For purposes of paragraph (1), the amendments made by section 113 and subtitle A of title II of this Act, and section 1930(a)(6) of title 28 of the United States Code (as added by section 117(4) of this Act), shall not apply with respect to a case under chapter 7, 11, 12, or 13 of title 11, United States Code, if—

(A) the trustee in the case files the final report and account of administration of the estate, required under section 704 of such title, or

(B) a plan is confirmed under section 1129, 1225, or 1325 of such title,

before the expiration of the 3-year period, or the expiration of the 1-year period, specified in paragraph (1), whichever occurs first.

(3) **RULE OF CONSTRUCTION REGARDING FEES FOR CASES.**—This Act and the amendments made by section 117(4) of this Act shall not be construed to require the payment of a fee under paragraph (6) of section 1930(a) of title 28, United States Code, in a case under title 11 of the United States Code for any conduct or period occurring before such paragraph becomes effective in the district in which such case is pending.



**(f) REPEAL OF CHAPTER 12 OF TITLE 11.**—Chapter 12 of title 11 of the United States Code is repealed on October 1, 1993. All cases commenced or pending under chapter 12 of title 11, United States Code, and all matters and proceedings in or relating to such cases, shall be conducted and determined under such chapter as if such chapter had not been repealed. The substantive rights of parties in connection with such cases, matters, and proceedings shall continue to be governed under the laws applicable to such cases, matters, and proceedings as if such chapter had not been repealed.

**SEC. 303. CERTIFICATION OF JUDICIAL DISTRICTS; NOTICE AND PUBLICATION OF CERTIFICATION.**

**(a) CERTIFICATION BY ATTORNEY GENERAL.**—The Attorney General may certify in writing a region specified in a paragraph of section 581(a) of title 28, United States Code (other than paragraph (16)), as amended by section 111(a) of this Act, to the appropriate court of appeals of the United States, for the purpose of informing such court that certain amendments made by this Act will become effective in accordance with section 302 of this Act.

**(b) NOTICE AND PUBLICATION OF CERTIFICATION.**—Whenever the Attorney General transmits a certification under subsection (a), the Attorney General shall simultaneously—

(1) transmit a copy of such certification to the Speaker of the House of Representatives and to the President pro tempore of the Senate, and

(2) publish such certification in the Federal Register.

**SEC. 304. ADMINISTRATIVE PROVISIONS.**

**(a) COOPERATIVE ARRANGEMENTS.**—The Attorney General and the Director of the Administrative Office of the United States Courts may enter into agreements under which United States trustees may—

(1) use—

(A) the services, equipment, personnel, records, reports, and data compilations, in any form, of the courts of the United States, and

(B) the facilities of such courts, and

(2) cooperate in the use by the courts of the United States of—

(A) the services, equipment, personnel, records, reports, and data compilations, in any form, of United States trustees, and

(B) the facilities of such trustees,

to prevent duplication during the 2-year period beginning on the effective date of this Act.

**(b) INFORMATION AND DOCUMENTS RELATING TO BANKRUPTCY CASES AND UNITED STATES TRUSTEES.**—The Director of the Administrative Office of the United States Courts shall make available to United States trustees, at the request of the Attorney General and on a continuing basis, all records, reports, and data compilations relating to—

(1) cases and proceedings under title 11 of the United States Code, and

(2) the duties of United States trustees under titles 11 and 28 of the United States Code.

**SEC. 305. APPLICATION OF CERTAIN BANKRUPTCY RULES.**

(a) **RULES RELATING TO THE UNITED STATES TRUSTEE SYSTEM.**—If a United States trustee is not authorized, before the effective date of this Act, to be appointed for a judicial district referred to in section 581(a) of title 28, United States Code, as amended by section 111(a) of this Act, then part X of the Bankruptcy Rules shall not apply to cases in such district until the amendments made by subtitle A of title II of this Act become effective under section 302 of this Act in such district.

(b) **RULES RELATING TO CHAPTER 12 OF TITLE 11.**—The rules prescribed under section 2075 of title 28, United States Code, and in effect on the date of the enactment of this Act shall apply to cases filed under chapter 12 of title 11, United States Code, to the extent practicable and not inconsistent with the amendments made by title II of this Act.

**SEC. 306. SALARY OF INCUMBENT UNITED STATES TRUSTEES.**

For service as a United States trustee in the period beginning on the effective date of this Act and ending on the expiration under section 301 of this Act of their respective terms of office, the salary payable to United States trustees serving in such offices on the effective date of this Act shall be fixed in accordance with section 587 of title 28, United States Code, as amended by section 114(a) of this Act.

**SEC. 307. PRESERVATION OF UNITED STATES TRUSTEE SYSTEM DURING PENDENCY OF LEGISLATION; REPEALER.**

(a) **TEMPORARY DELAY OF REPEAL OF UNITED STATES TRUSTEE SYSTEM.**—Effective immediately before November 10, 1986, section 408(c) of the Act of November 6, 1978 (Public Law 95-598; 92 Stat. 2687), is amended by striking out "November 10, 1986" and inserting in lieu thereof "30 days after the effective date of the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986".

(b) **CONFORMING AMENDMENT.**—Section 408 of the Act of November 6, 1978 (Public Law 95-598; 92 Stat. 2687), is repealed.

**SEC. 308. CONSIDERATION OF CURRENT PRIVATE TRUSTEES FOR APPOINTMENT BY UNITED STATES TRUSTEES.**

(a) **TRUSTEES IN BANKRUPTCY CASES UNDER CHAPTER 7.**—It is the sense of the Congress that individuals who are serving before the effective date of this Act, as trustees in cases under chapter 7 of title 11, United States Code, should be considered by United States trustees for appointment under section 586(a)(1) of title 28, United States Code, to the panels of private trustees that are established as a result of the amendments made by this Act.

(b) **STANDING TRUSTEES IN BANKRUPTCY CASES UNDER CHAPTER 13.**—It is the sense of the Congress that individuals who are serving before the effective date of this Act, as standing trustees in cases under chapter 13 of title 11, United States Code, should be considered by the United States trustees for appointment under section 586(b) of title 28, United States Code, as standing trustees who are appointed as a result of the amendments made by this Act.

**SEC. 309. APPOINTMENT OF UNITED STATES TRUSTEES BY THE ATTORNEY GENERAL.**

It is the sense of the Congress that individuals otherwise qualified who are serving, before the effective date of this Act, as estate administrators under title 11 of the United States Code should be considered by the Attorney General for appointment under sections 581 and 582 of title 28, United States Code, to new positions of United States trustee and assistant United States trustee resulting from the amendments made by this Act.

**SEC. 310. ELECTRONIC CASE MANAGEMENT DEMONSTRATION PROJECT.**

(a) **ESTABLISHMENT OF PROJECT.**—Not later than 1 year after the effective date of this Act, the Director of the Executive Office for United States Trustees, in consultation with the Director of the Administrative Office of the United States Courts, shall establish an electronic case management demonstration project to be carried out in 3 Federal judicial districts that have a sufficiently large and varied bankruptcy caseload so as to provide a meaningful evaluation of the cost and effectiveness of such system. A contract for such project shall be awarded—

(1) on the basis of competitive bids submitted by qualified nongovernmental entities that are able to design an automated joint information system for use by the United States courts and by United States trustees, and

(2) in accordance with the Federal Property and Administrative Services Act of 1949, the Office of Federal Procurement Policy Act, and title 31 of the United States Code.

(b) **STUDY BY GENERAL ACCOUNTING OFFICE.**—Not later than 1 year after the electronic case management system begins to operate in all of the judicial districts participating in the demonstration project carried out under subsection (a), the General Accounting Office shall conduct a study to compare the cost and effectiveness of such system with the cost and effectiveness of case management systems used in Federal judicial districts that are not participating in such project.

(c) **TERM OF PROJECT.**—The demonstration project required by subsection (a) shall be carried out until—

(1) the expiration of the 2-year period beginning on the date the electronic case management system begins to operate in all of the judicial districts participating in such project, or

(2) legislation is enacted to extend, expand, modify, or terminate the operation of such project,

whichever occurs first.

(d) **USE BY CLERKS OF THE COURTS.**—The electronic case management system demonstrated under the project required by subsection (a) shall provide the clerk of court in each district in which such system is operated, with a means of—

(1) maintaining a complete electronic case file of all relevant information contained in petitions and schedules (and any amendments thereto) relating to debtors in cases under title 11 of the United States Code, including—

(A) a complete list of creditors in each such case, as listed by the debtor,

(B) a complete list of assets scheduled by the debtor, the value of such asset, and any action taken by the trustee or debtor in possession with regard to such asset during the pendency of such case,

- (C) a complete list of debts and, with respect to each debt—
- (i) any priority of such debt under title 11 of the United States Code,
  - (ii) whether such debt is secured or unsecured, and
  - (iii) whether such debt is contingent or noncontingent, and
- (D) the debtor's statements of current expenses and income, and
- (2) maintaining all calendars and dockets and producing all notices required to be sent in cases under title 11 of the United States Code.
- (e) **USE BY UNITED STATES TRUSTEES.**—The electronic case management system demonstrated under the project required by subsection (a) shall provide, at a minimum, the United States trustee in each district in which such system is operated with—
- (1) complete electronic case files which contain, in addition to the information listed in subsection (d), records of case openings, case closings, hearings, and the filing of all motions, trustee appointments, pleadings, and responses, as well as a record of the responses by the United States trustee to those motions, trustee appointments, and pleadings,
  - (2) a means to generate standardized forms for motions, appointments, pleadings, and responses,
  - (3) a means to generate standard management reports and letters on an exception basis,
  - (4) a means to maintain accounting records, reports, and information required to be maintained by debtors in possession and trustees in cases under title 11 of the United States Code,
  - (5) a means to calculate and record distribution to creditors, final applications and orders for distribution, and final case closing reports, and
  - (6) a means to monitor the payment of filing and other required fees.
- (f) **AVAILABILITY TO CERTAIN GOVERNMENTAL ENTITIES.**—Unlimited access to information maintained in the electronic case management system demonstrated under the project required by subsection (a) shall be provided at no charge to the following:
- (1) The Congress.
  - (2) The Executive Office for the United States Trustees.
  - (3) The Administrative Office of the United States Courts.
  - (4) The clerks of the courts in judicial districts in which such system is operated and persons who review case information, in accordance with section 107(a) of title 11, United States Code, in the offices of the clerks.
  - (5) The judges on the bankruptcy and district courts in districts in which such system is operated.
  - (6) Trustees in cases pending in districts in which such system is operated.
- (g) **FEES FOR OTHER USERS.**—(1) The entity which is awarded a contract to provide the electronic case management system demonstrated under this project may, under guidelines established by the Director of the Executive Office for the United States Trustees in the provisions of such contract, collect reasonable fees from assets of the estate of the debtor in bankruptcy for providing notices and services to the court and trustees under the demonstration project.

(2) Access to information maintained in electronic case files pursuant to the demonstration project may be provided to persons other than those specified in subsection (f), but such access shall be limited to viewing such information only. A reasonable charge for such access may be collected by the entity which is awarded a contract under this section, in accordance with the guidelines established by the Director of the Executive Office for the United States Trustees in such contract. A reasonable portion of any charge so collected may be required by the Director to be remitted to the Executive Office for United States Trustees and deposited in the United States Trustee System Fund established in section 589a of title 28, United States Code.

(h) SECURITY.—Access provided under subsection (f) to an entity or an individual shall be subject to such security limitations as may be imposed by the Congress or the head of the affected entity.

**SEC. 311. CASES PENDING UNDER THE BANKRUPTCY ACT.**

At the end of one calendar year following the date the amendments made by subtitle A of title II of this Act take effect in a district in which any case is still pending under the Bankruptcy Act, the district court shall withdraw the reference of any such case and, after notice and a hearing, determine the status of the case. Such case shall be remanded to the bankruptcy judge with such instructions as are necessary for the prompt closing of the case and with a requirement that a progress report on the case be provided by the bankruptcy judge after such interval as the district court deems appropriate.

Approved October 27, 1986.

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LENDER LIABILITY  
PART I

"Sue the Lender"  
Videotape

Bankers Training and Consulting Company  
St. Louis, MO

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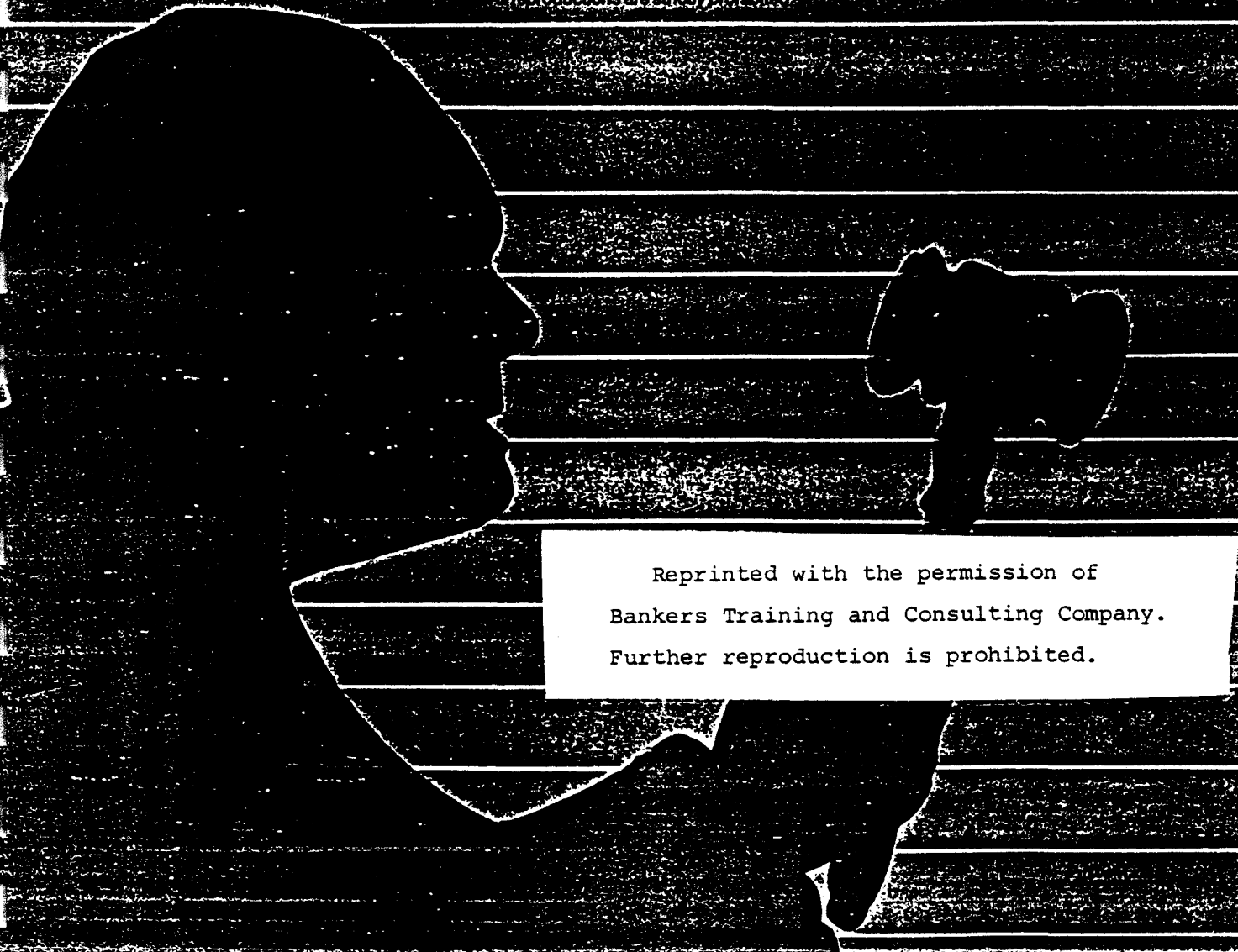


# SUE THE LENDER!

Presented by  
**BancVideo**

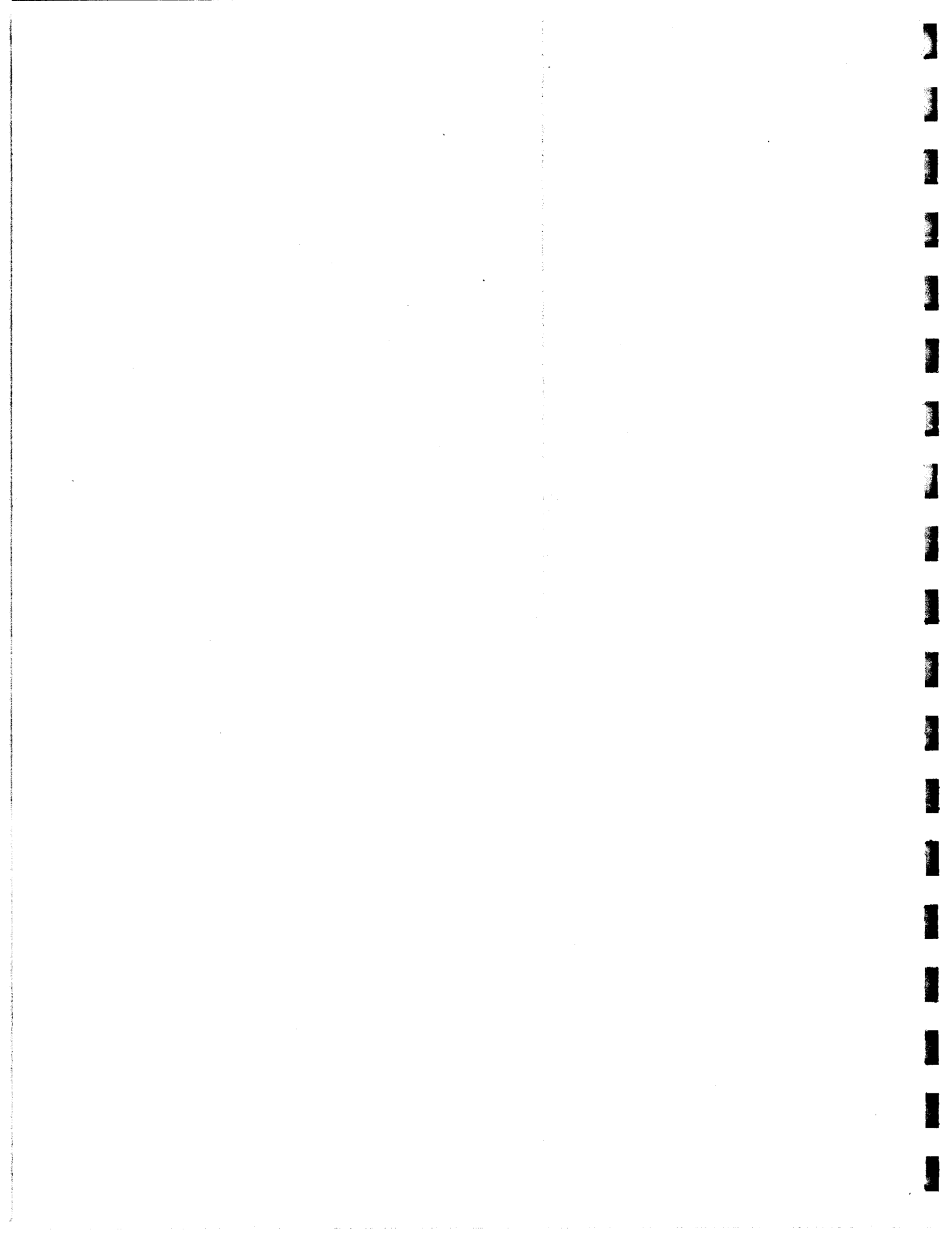
*Designed to Accompany Video-Cassette*

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Section J



## **Viewing Guide for "Sue the Lender!"**

The video tape "*Sue the Lender!*" is designed for both self-instruction and group viewing. Here are some suggestions to help you get the most out of this video program.

### **Self-Instruction**

We encourage self-instruction viewers to stop the tape when exhibit numbers appear and refer to the appropriate section of this handbook. It summarizes the material and contains additional material and advice. There is also space to write notes for future reference.

Many aspects of "Lender Liability" are new, and we encourage you to have a senior loan officer or legal counsel available for "debriefing" and discussion.

### **Group Viewing**

"*Sue the Lender!*" is also an excellent group discussion aid. The lively, entertaining format will teach your loan personnel with minimal advance preparation.

Although the program is designed primarily for commercial loan officers, we encourage you to have other loan personnel attend the viewings...consumer lenders, credit analysts and note tellers. When everybody is sensitive to the pitfalls of lender liability, they can help each other detect potential problems before it is too late.

We also encourage you to have a senior loan officer or legal counsel present when the tape is shown.

- Discuss how the program advice relates to your organization's loan policy and lending practices.
- How do the cases discussed during the show compare to some of your war stories?
- Use role playing to practice responding to credit inquiries on your organization's deteriorating accounts.

## —NOTICE—

The field of lender liability is changing rapidly. Although we have made every effort to present accurate and up-to-date information, this handbook and accompanying video tape are not substitutes for sound legal counsel.

### **What is "Lender Liability"?**

Certain actions by lenders may make them liable for the damages that result, both to borrowers and to third parties like suppliers and investors. Some of the pitfalls have emerged recently while others have existed for a long time.

### **Why is lender liability important?**

There has been a rapid and disturbing rise in the number of lawsuits alleging lender liability. It has become one of the "hottest" areas of the law.

The costs of lender liability can be staggering.

- Multi-million dollar judgements...
- Voided security agreements...
- Subordination of claims to other creditors...
- Bad publicity in the community...
- Lost customer loyalty...
- Wasted management time...
- Decreased employee morale...
- Large legal expenses...

Lenders do win the majority of lawsuits alleging lender liability...but win or lose, the cost to all creditors is high.

### **What this program covers**

*"Sue the Lender"* focuses on three of the most common, and important, areas of lender liability

- 1 Controlling and interfering in a borrower's affairs
- 2 Not dealing with a borrower in "good faith"
- 3 Misrepresentation and Fraud

It reviews many of the cases involving lender liability and includes numerous suggestions to help you minimize trouble.

### **What this program does not cover**

There are other areas of lender liability not covered in this program, including:

- Fraudulent conveyances
- Equitable subordination
- Violations of federal security laws
- The racketeer influenced and corrupt organization act (RICO)

We encourage you to seek qualified counsel on all these issues.

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Bankers Training and Consulting Company, 1695 South Brentwood Blvd., Suite 206, St. Louis, MO 63144.  
(314) 968-0220

## **CONTROL AND INTERFERENCE**

**Exhibit 1**

### **What is the Problem?**

When a credit starts to deteriorate, the lender has a natural desire to get involved with the debtor to protect its loan.

However, in the process of working with the debtor to solve its problems, lenders occasionally exercise excessive control over management, or interfere unreasonably in the operations. When this happens, the lender may become liable for any resulting damages, including financial losses suffered by the debtor, missed opportunities, and punitive damages. A lender in control of a debtor may also become liable for the debtor's other obligations.

### **It can add up to a lot of money.**

The legal concepts of control and interference are sometimes difficult to grasp because every lending relationship contains some degree of "control" and "interference". Both security agreements and loan agreements restrict the debtor in a number of ways. Therefore, loan officers need to understand which controls and restrictions are safe and which ones may constitute "control and interference" in a legal sense.

### **What actions and restrictions constitute Control and Interference?**

Unfortunately, no court or commentator has yet put forth a workable definition of what constitutes "control" and "interference". Every case is different, and many courts interpret the issues differently. It is too early to tell how the creditor control doctrine will evolve until the appellate courts sort out the legal issues and competing interests.

Ask yourself these questions:

- Are the restrictions I impose necessary to protect my loan?
- Are these restrictions applied in a consistent, reasonable manner?
- Are they reasonable commercial practices in my industry and in my community?

If the answer is "no", you may have crossed the line into "Control and Interference".

A finding of 'Control and Interference' will depend on the cumulative impact of the facts in each case, the circumstances surrounding the facts and the over all relationship between the lender and the debtor. **Just because your loan documents give you the right to impose certain controls and restrictions does not protect you from becoming liable for "Control and Interference".**

### **Trouble spots**

Every case is different, but there are still some general trouble spots to beware of.

**1. Restrictive Covenants:** Every loan agreement contains some restrictions on the borrower, and the courts agree that the mere existence of restrictions does not constitute control or interference in the legal sense. It has been widely accepted that most of the "normal" loan covenants are an integral part of the lender-debtor relationship. For example, having the right to veto a debtor's large financial transactions, such as mergers and large capital expenditures, is usually safe.

Also, the courts recognize the lender's need to get more involved in a deteriorating company, including imposition of additional restrictions.

However, making management decisions or exercising a veto over normal day to day activities (such as hiring and firing employees, purchasing and marketing) is strong evidence of control. Any daily involvement in the debtor's business is evidence of control and interference.

**2. Controlling the composition of the debtor's board of directors:** Loan agreements sometimes give the lender the right to veto changes on the board of directors. By itself, this is not proof of control...but if the lender uses that veto power to get its own people elected to the board, people who are there to serve its interests rather than the shareholders, this is very strong evidence of control and interference. Also, as we will see shortly, it is very dangerous for a lender to use its veto power over the board to coerce the borrower to do other things that it wants done.

Occasionally loan agreements give the lender the right to fill specific board seats. Avoid that situation whenever possible. And remember that being a director is one of the tests of being an insider under the bankruptcy code.

**3. Improper use of economic coercion** to effect management changes or to control operations is often used to substantiate allegations of control and interference.

Although mere dependence by the debtor on the creditor is not proof of control, threatening to call a loan to control a debtor or get him to do your bidding will definitely be used against you in court.

Also, if the lender uses economic coercion to induce the debtor to do things that are clearly intended only for the lender's benefit, such as selling off assets to the competition to pay down bank debt, it will be used as evidence of control.

**Lesson:** Having the right to call a loan does not give you the right to threaten to call a loan in order to control your borrower's course of action.

**4. Control over finances:** Restricting major financial transactions, such as mergers, acquisitions, and capital expenditures, is usually safe. The courts recognize that such transactions can undermine the quality of a loan and that it is reasonable for a lender to restrict them.

However, the lender should not get into a position where he/she controls all cash disbursements. If you approve every payment, either directly or through an agent, it is strong evidence of control. It is also very dangerous for a loan officer to assure other creditors that they will be paid...it may make you responsible to do so.

**5. Counseling:** When a loan begins to deteriorate, debtors often seek their lender's advice. In most circumstances, it is safe for the lender to give such counsel. If the borrower follows your advice, it does not constitute control and interference...even if your advice is "bad" and damages result, you won't normally be held liable for the results.

However, trouble arises when the lender uses the threat of default to get the debtor to follow its advice, or when the advice is clearly intended solely for the lender's benefit.

**6. Control over management appointments:** Many loan agreements give lenders the right to veto changes in management (usually called a "management change clause"). This is especially important in smaller companies which are heavily dependent on one or two people.

With or without a management change clause, it is normally safe for the lender to express dissatisfaction with existing management and suggest possible replacements. But don't select those replacements, whether or not you have a management change clause.

And be reasonable in the way you apply the management change clause:

- Don't keep saying "no" until they select the person you prefer;
- Be especially careful saying "no" if the debtor isn't in default, or is only in "minor" default;
- Don't use the management change clause to coerce the debtor to do other things you want done (see Farah case below for illustration);

**Lesson:** If the lender selects management, or interferes unreasonably in its selection, it may become liable for the damages that result.

**7. Hiring consultants:** When a company hits upon hard times, a lender will often suggest the use of a consultant to help fill the gaps in existing management and/or turn the firm around.

Suggesting that a debtor hire a consultant does not by itself constitute control. A lender can, and should, give suggestions on possible candidates and relate his/her knowledge and experience about each. However, if you make the selection, or pressure the debtor to accept your choice, you are vulnerable to charges of control and interference.

On the other hand, lenders do have the right to hire their own consultant to visit the debtor's premises, meet with management, and **monitor** its activities. Just be sure the consultant doesn't get involved in day to day management...controlling the checkbook, firing and hiring people, countermanding management decisions and so on.

**8. Inducing the debtor to renege on an obligation,** or to breach an existing contract, is very dangerous. This can arise with employment contracts or when a lender knowingly obtains a pledge of collateral that violates a negative pledge to another creditor.

**9. Having voting power of debtor's stock** may be tantamount to control.

**10. Taking possession of the debtor's facilities** will almost certainly be deemed "control".

**11. Requiring your borrower to provide information:** To date, the courts have not questioned the lender's right to require detailed reports, financial statements, and other pertinent information.

**Remarks:** \_\_\_\_\_  
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**An example to illustrate control and interference**

One of the most widely publicized cases of lender liability involved the Farah Manufacturing Company. Even though it had some unique characteristics that limit its application elsewhere, the case illustrates many of the pitfalls posed by workout loans.

Farah Manufacturing Company (FMC) made men's apparel. Originally family owned and run, FMC had grown to become a publicly held company with professional management. When the business got into financial difficulty, one of the founders, Mr. William Farah, tried to get elected Chief Executive Officer, but the lenders used a management change clause in the loan agreement to prevent his election.

Instead the lenders used the threat of default to induce FMC to hire consultants selected by them, one of whom was later elected CEO. As CEO, he took over day to day management of the firm, controlling disbursements, hiring and firing, limiting capital expenditures and selling off assets to pay down bank debt. The lenders also got 2 of their representatives elected to FMC's Board of Directors.

Despite these changes, FMC continued to decline and eventually Mr. Farah did become Chief Executive Officer. He turned FMC around, sued the lenders, and won a judgement of over \$18 million for the lender's "fraud, duress and interference".

Here are some lessons we can learn from the FMC case and others like it:

**Lesson #1: Don't coerce the borrower.** In the FMC case, the lenders used the threat of default to:

- 1) Prevent Mr. Farah's return to management,
- 2) Pack the board of directors, and
- 3) Install a hand chosen consultant.

This constituted duress and "unlawful interference with Farah's right to lawful management and proper corporate governance". They told FMC's board that they would "bankrupt" FMC and "padlock it the next day" if Mr. Farah was elected CEO. Even though the loan agreement gave the lenders the right to approve management changes, this did not give them the right to coerce the debtor to do other things they wanted to have done, such as hire a consultant or change the composition of the board.

To quote the court on this issue: "acceleration clauses are not be used offensively such as for commercial advantage of the creditor. They do not permit acceleration when the facts make its use unjust or oppressive".

(Please see Exhibit 12 for a discussion of how **fraud** also affected this case)

**Lesson #2: Avoid personality conflicts with the debtor.** Personality conflicts played an important role in the outcome of the Farah case. The plaintiffs showed that one of the loan officers who handled the account probably held a grudge against Mr. Farah for something that happened when he had once



worked for FMC. This raised the possibility that his actions were motivated by malice rather than the economics of the situation. Also, the counsel for one of the lenders engaged in theatrics during the loan negotiations, pounding the table and shouting that he would put the company into bankruptcy if necessary.

Any signs of malice, vindictiveness, or callousness by a lender or its counsel will definitely be used against it in court. Most juries perceive banks as the "big" guys and borrowers as the "underdogs". Unprofessional displays of emotion aggravate that perception.

**Lesson #3: Borrowers will go to great lengths to sue their lenders when they feel they have been wronged.** FMC spent over a million dollars and many months preparing for this trial. They used 8 full time data processing employees to process all the information for the trial and conducted extensive market research to develop a computer model of the "ideal" juror. They even built a replica of the actual court room where their witnesses could practice their testimony.

**Footnote:** Any personality conflicts or emotional outbursts by the lender fuel the debtor's desire for "revenge". All the more reason to have someone handling workouts who can assess the facts objectively.

**Lesson #4: When you are wrong, look for opportunities to settle with the borrower early.** A leading attorney for borrowers in "lender liability" lawsuits believes that 90% of the cases leading to big judgements could and should have been settled out of court for small amounts. For example, a lawsuit in Kansas City could have been settled for \$250,000 but the bank insisted on going to trial where they lost about \$3,000,000. In another lender liability case, the borrower offered to settle for \$100,000 but ended up winning \$10,000,000 in court. And the Farah case could have been settled for a restructured credit line before going to court.

**Lesson #5: Teach lenders how to maintain credit files.** In the Farah case, the court determined that the lender's threat to call the loan if Mr. Farah was elected Chief Executive Officer was fraudulent. How did they know? By the lender's own credit memos! Notes prepared by a junior loan officer reflected the feeling that if Farah were elected he should be strongly controlled and have life made miserable for him. In other words, they hadn't decided to call the loan. But the next day they informed FMC's board that they would call the loan if Mr. Farah was elected.

Be sensitive to how your credit memos might be construed later, or taken out of context.

Remarks: \_\_\_\_\_  
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**Other examples**

Here is a brief summary of other cases that help illustrate some of these problems:

1. A lender had an agreement to finance the construction of a housing project but refused to make further advances unless the debtor agreed to pay additional loan fees. They were found guilty of economic duress.

**Exhibit 2** 2. The article reprinted as Appendix A tells the story of a farmer who won a large judgement from a bank that controlled his marketing decisions.

- 3. When a company got into financial trouble, the bank required them to:
  - A. Cut the president's salary in half;
  - B. Hire a new accountant selected by the lender;
  - C. Get its approval on all checks;

The court found this proof of control and interference. Discovery of a 13 point program in the credit file to "salvage whatever is possible" from the debtor was important evidence against the bank.

**Lesson:** Don't get involved in day to day management decisions.

**Lesson:** Keep your credit memos professional and stick to the facts. Do not say things that might be construed later as control or interference.

4. A lender pressured a problem debtor to hire a consulting firm. The court found that the bank, through its hand picked consultant, "implemented or caused to be implemented strict and oppressive credit policies, sales procedures, and inventory policies", that they "acted without regard to wishes or approval of directors and stockholders" and that they were "negligent in management."

**Remarks:** \_\_\_\_\_  
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**Exhibit 3 Avoidance techniques**

1. Counsel your borrowers, but don't make the decisions for them or get involved in every day operating matters. It's their business ... they've got to run it and be responsible.

2. Be sensitive to the style you use when advising your debtors:

Good: "Mike, this business plan you drew up looks good. I see you've made some decisions to cut back on expenses that should help your cash flow considerably in the next year. I did have a question about your advertising budget ... do you think a 15% cutback is enough given your highest priority which is ..."

Bad: "Mike, you just can't go on like this. Now, I've written up some things that you've got to do to keep our support and get back on target. As you'll see, the advertising expenses will have to be cut way back and we certainly can't justify buying that new equipment at this time ..."

As long as communications don't break down, loan officers can usually convince a borrower of the wisdom of their advice without being autocratic.

3. When it comes to giving advice, admit what you don't know. Loan officers can't expect to know all the answers to all the problems, and should be willing to introduce debtors to other sources of expertise.

4. If you feel that management is the problem, by all means make your feelings known. But don't select new managers, and if you make recommendations, make more than one.

If you have a management change clause and you believe in good faith that a management change has undermined your loan, by all means refuse to make further advances until the situation is rectified. But don't use your veto power to dictate the new choice, or to win other concessions from the debtor.

5. In a workout situation, it is normally safe for the lender to hire a consultant or use one of its own employees to visit the premises, meet with company management, and gather information. But if they give advice or make management decisions, you may be held liable for the consequences. And remember that the jury will seldom believe that a \$2,000 a day consultant was installed to merely monitor the debtor's activities.

If you help your debtor find a consultant, don't coerce them to choose the one you prefer. And if they choose someone that you did recommend, spell out in writing what the consultant's responsibilities are.

6. Don't use the threat of calling a loan to coerce the debtor to do your bidding. If the loan is in default, either call it or don't...don't use it as a club to control the debtor for your own benefit.

7. Occasionally you may feel that the composition of the board of directors is a critical part of your credit. If so, by all means put a clause in your loan agreement giving you the right to call the loan if you disapprove of changes. But apply the clause reasonably and don't use it to get your own people on the board. And stay out of political power struggles.

8. Many experts advise lenders to take closely held stock as collateral only as a last resort.

9. Act professionally at all times. Don't get emotional when dealing with a debtor, no matter how frustrated you become or how many times they don't live up to their promises. If the account officer has personality problems with a borrower, switch the account to someone else immediately. There's a lot of ego involved when one of your own loans turns sour, and it's hard, if not impossible, to stay professional and unemotional. Any sign of malice or callousness by the lender will definitely be used against you in court.

10. Seek qualified advice before calling a loan, threatening to call it, or taking any enforcement action. This is especially true if the borrower is not in payment default. No matter how many events of default are written in your loan documents, many juries won't believe that the actions you take to protect your loan are justified if payments are current.

11. Train all loan personnel how to write memos and maintain a credit file. Be aware that everything you write will be scrutinized in court.

- Make sure the file supports the actions you took;
- Stick to the facts;
- Do not use emotional or vulgar language or make subjective comments about the borrower;
- Keep good notes of your conversations with borrowers, especially if you are dealing with a problem loan. If it comes down to your memory against their memory, a well maintained credit file will usually bolster your position.

And always keep in mind that when it comes to questions of control and interference, the jury responds very poorly to any signs of **arrogance** on the lender's part. Lenders already have 2 strikes against them in many juror's eyes... don't give them the third one!

12. Seek legal counsel and be especially cautious if you are making a loan where you have an equity interest in the outcome of the project. Mixing those two roles may put you in a position of control and interference. Lenders taking equity positions need to segment the two roles clearly.

13. Don't let the fear of "control and interference" paralyze you into inaction or laziness. Be sensitive to the pitfalls, but don't roll over dead at the first sign of trouble. There are times when strong enforcement action is still required to protect your loan.

**Remarks:** \_\_\_\_\_  
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**Exhibit 4**      **GOOD FAITH AND FAIR DEALING**

**What is the problem?**

The common law and Uniform Commercial Code impose upon every party to a contract an implied covenant of "good faith". What this means is that lenders, like everyone else, have an obligation to treat their borrowers fairly and reasonably, no matter what the loan documents may say.

Good faith and fair dealing are not well defined and this makes their application to loan transactions unpredictable. Although all parties have an obligation to act in good faith, it is especially important to lenders because the courts are just now interpreting many "standard" loan practices as violations of "good faith". Although some courts have been more aggressive than others in how they apply the good faith obligation to loan transactions, it is a growing problem everywhere.

For lenders, good faith issues usually revolve around three issues:

- I. Discretionary advance clauses
- II. Demand and acceleration clauses
- III. Actions taken during work out loan negotiations

**I. Discretionary advance clauses**

**What are they:** Many notes and loan agreements give the lender the right to stop advancing funds or change the advance formula under a line of credit. Discretionary advance clauses protect the lender in the event that the borrower's credit worthiness suddenly declines.

**What's the problem.** If the lender has established a pattern of advancing the funds, which the courts call "course of dealing", and then stop making advances, or cut back the advance formula, they may be held liable for the damages caused, no matter what the loan documents say.

**An example to illustrate the problem.**

The debtor was a wholesale food broker with a line of credit of about \$3.5 million. The bank regularly used the line of credit to cover overdrafts, although the loan documents clearly gave them the right to stop making advances anytime they chose to. The company became unprofitable and the lender cut off further advances, even though room remained on the line of credit. Checks bounced and the debtor suffered in two ways: Suppliers stopped dealing with them and a potential buyer for the company was scared away. The court found the bank in violation of its "Good Faith" obligation and awarded the debtor \$7.5 million in damages.

Two things in particular hurt the bank's case:

First, the loan officer told the potential buyer of the company that he was cutting off the line of credit even though he knew they "were very well secured";

Second, the bank's normal policy was to give notice before cutting off a line of credit;

**Lesson:** Your "course of dealing" can neutralize the rights given you in your loan documents.

**Lesson:** Give "reasonable" notice before you change the way you administer a loan, especially if your action is likely to cause considerable harm.

**Lesson:** In the case described above, the court noted the lender's general vindictiveness toward the debtor as further evidence of their lack of good faith. If personality conflicts arise, switch loan officers immediately.

**Lesson:** Never tell third parties that you are cutting off a loan "even though you are fully secured". And be sure your credit file and loan policy support your enforcement action.

**Remarks:** \_\_\_\_\_  
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**An interesting sidelight:** In the case described above, the debtor waived its right to a jury trial in the loan documents. However, the court disregarded this waiver because the debtor "could not, and did not knowingly, voluntarily and intentionally waive its constitutional right to trial by jury". There was evidence that the loan officer had told the debtor at closing that the bank only enforced such waivers in the event of fraud.

**Lesson:** Do not undermine your loan documents with verbal assurances.

**Lesson:** In some jurisdictions, waivers of jury trials are not enforceable. Lenders should consider instead the use of limited waivers, which waive jury trials only on particular issues. And don't make these waivers a "boiler plate" part of every loan. If you negotiate the waiver each time, giving up something in return, this should make them more enforceable.

**Another example**

There was a case in Nebraska in which the loan documents gave the lender sole discretion over whether to make further loan advances, going so far as to say "nothing shall be construed to obligate (lender) to make advances".

The loan commitment was to allow the debtor to enlarge his livestock herd. After about half the money was loaned, the lender decided that further advances would be imprudent. Unfortunately, the debtor had spent a lot of money improving the farm in anticipation of the larger herd, and now they could not get the necessary economies to scale. The farm lost money, defaulted on the loans, and sued the lender for damages.

The trial court ruled in favor of the lender but the appeal court overruled. They sent the debtor's claims back to the trial court to determine liability and damages, including punitive damages.

Interestingly, the court found that the lender's own internal operating procedures did not support the manner in which they cut off further advances. (The policy called for the decision to be made at a higher level than it was made.) This was important evidence in the final outcome.

**Lesson:** Even if your loan documents give you the right, be careful reneging on a commitment if you know it will cause hardship to the borrower. Give them adequate time to line up additional financing whenever possible.

**Lesson:** A lender's written loan policies and operating procedures will be scrutinized by the court to find evidence of "bad faith". Your loan policies, documents, and actions should mirror one another.

**Yet another example**

The newspaper article printed as Appendix B describes another case in which the lender was found to have violated its obligation of good faith.

**Remarks:** \_\_\_\_\_  
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## II. Demand and acceleration clauses

**What are they:** A demand clause gives the lender the right to demand full payment of a loan anytime it desires. An insecurity clause gives the lender the right to call the loan if it deems itself "insecure". Other acceleration clauses give the lender the right to call a loan upon the occurrence of other events of default.

**What's the problem:** A lender's course of dealing can neutralize the demand feature of the note, and acceleration clauses must be applied fairly and in good faith, no matter what the loan documents say.

Here is the language from the Uniform Commercial Code that applies to this issue:

"Option to accelerate at will. A term providing that one party...may accelerate payment...or require additional collateral 'at will' or 'when he deems himself insecure' or in words of similar import shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment...is impaired."

(P.S. Some courts are even applying an "objective" standard to the application of insecurity causes ... the lender may have to demonstrate quantitatively how the prospect of repayment has been impaired.)

Part of the problem with demand loans is that they often contain a number of specific events of default, things like payment default, cross default, negative covenants, reporting requirements and so on. If the lender uses the demand clause to accelerate the loan, the obvious question in court is:

"If the parties had really intended it to be a demand note, why did you include all those specific events of default?"

**Lesson:** Your "course of dealing" can neutralize the demand feature of a note.

The other problem with demand notes is that loan officers sometimes ignore events of default. They continually accept late payments, or ignore violations of the loan agreement, until a course of dealing is established which the borrower comes to rely on. Then one day the loan officer gets fed up and calls the loan. Even though the loan documents clearly gave them this right, it violates their good faith obligation because of their course of dealing.

### An example

In Chicago there was a company that constantly made late loan payments, which the bank accepted. When the credit deteriorated the two parties negotiated a revised repayment plan which called for a specific payment on November 15. When the payment didn't arrive, the bank accelerated the loan the following day. The borrower sent in the late payment, but the bank refused it. The borrower sued them, charging a violation of good faith, and won a sizeable judgement. The court decided that a one day delay on the payment was not a material breach and noted that the debtor had enough money in the bank to make the payment.

**Lesson:** Demand clauses are not foolproof. They must be applied "reasonably".

**Lesson:** Give reasonable notice before changing the rules of a loan relationship, regardless of what the loan documents say.

**Lesson:** If you neglect events of default, be especially careful to give reasonable notice before accelerating a loan.

**Another example**

In another recent case the court held that a bank's breach of good faith in accelerating a loan and setting off accounts can result in the imposition of punitive damages where malice, oppression or fraud is proven. In that situation, the loan officer told an out-of-work borrower that the bank would convert a balloon note to an installment loan. Since he was leaving on vacation, the officer said he would talk to his associates in the bank so the necessary paperwork could be drawn up. This he neglected to do, and his colleague refused to "term out" the loan due to the borrower's lack of income. When the borrower protested, he set off their account without notice and applied the funds to pay down the loan. Since the debtor was temporarily out of work, he was relying on the money in the offset account to live on. He sued in court and won a sizeable judgement.

**Lesson:** Write memos about pending transactions so other officers know what you have agreed to.

**Lesson:** Don't make oral agreements without some written follow-up to the debtor.

**Lesson:** If one loan officer makes an agreement with a customer, stick to it until you give reasonable notice and change it in writing.

**Another example**

The loan documents provided for payment of interest and principal on the first day of the month and for the payment of a late charge if not received within 10 days of due date. The late charge could be paid in cash or added to the principal balance (at the discretion of the borrower). The lender accepted late payments for about a year and then sent a letter stating that it would foreclose on the collateral if any more late payments were received. The following month, the payment was not received on time and five days later the lender commenced foreclosure. The court issued an injunction against the lender, finding that their use of the foreclosure remedy to coerce payment on the first day of the month was an illegal penalty analogous to an excessive late charge. They concluded with the following observation, which has relevance to all lenders considering enforcement actions:

*"One of the most important functions of the law is to maintain a proper balance between creditor and debtor. To this end, it attempts to match the creditor's remedy to the debtor's default. Major default justifies drastic remedies; minor defaults only warrant lesser remedies."*

**Lesson:** 30 days may not be sufficient "reasonable" notice that you intend to change your course of dealing.

**Lesson:** A lender's obligation of good faith can neutralize the rights granted in your loan documents.



**Lesson:** Avoid actions that appear to be coercive.

**Yet another example**

The collateral was a private aircraft and the documents forbid the debtor from leasing the plane. Nevertheless, he violated that agreement. Two years later the bank discovered the violation, accelerated the loan and a lawsuit ensued. The court said that the bank could only accelerate the loan if it believed in good faith that the default impaired the borrower's repayment ability. Since the violation occurred two years earlier, and payments were current, it was hard to believe that the violation impaired the loan.

This case represents a significant expansion of the "good faith" obligation in loan transactions. To date, most other courts have not been as "aggressive", but the ground has been broken and the decision bears careful watching.

**A final example**

In a recent case in California, the court ruled that the lender's approval of the farmer's 7 year business plan implies an obligation to make loans available during that entire period, even though the loan documents were short term in nature!

**Warning:** Seek legal counsel and be especially cautious when accelerating a loan that is current on payments. No matter how many other events of default they have violated, it is hard to convince a jury that your enforcement actions were "in good faith" when the loan is current.

**A final warning:** Collecting a commitment fee on a loan can also raise issues of "good faith". Acceptance of a loan fee implies an obligation to make the loan for a "reasonable" period of time, no matter what your loan documents say.

**In conclusion:** Courts don't like demand notes. Use them with caution, and only when they are appropriate to the transaction.

**Remarks:** \_\_\_\_\_  
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**III. Workout negotiations**

**Exhibit 7**

Just as lenders have an obligation to act in good faith when it comes to discretionary advance clauses and demand notes, they also have an obligation to act fairly and reasonably when engaged in workout negotiations.

To illustrate the problem let's look at a specific court case out of Alaska:

A retail store had several loans from their bank, secured primarily by inventory. Business wasn't good, and they were unable to make payments on time. The lender offered to extend the payments in return for additional collateral: a second deed of trust on the owners' homes. The owners made a counter-offer

which did not include their homes as collateral. Without prior notification, a representative from the bank showed up at the store with a policeman and a locksmith, told the employees and customers to leave, and padlocked the doors. The court found this action to be a violation of good faith, and awarded actual and punitive damages to the borrower.

The bank claimed that its action was necessary to protect its collateral, but the court noted that they had routinely accepted late payments in the past, and pointed to a memo in the credit file which indicated that extending the loan payments until after Christmas was advisable if they obtained additional collateral.

**Lesson:** In this case, the loan documents clearly gave the bank the right to seize the collateral:

*"If borrower shall fail to pay when due any amount payable on any of the loans made hereby or on any other indebtedness of borrower's secured hereby, or shall fail to observe or perform any of the provisions of this agreement, borrower shall be in default hereunder. When borrower is so in default, all of such loans and other indebtedness secured hereby shall become immediately due and payable at bank's option without notice to borrower, and bank may proceed to enforce payment of the same and to exercise any or all rights and remedies afforded to bank by the Uniform Commercial Code of Alaska or otherwise possessed by bank."*

**Lesson:** Oral statements and a lender's course of dealing can modify the written loan documents.

**Lesson:** Put deadlines in writing.

**Lesson:** The court noted the fact that the loan officer acted "arrogantly" when he entered the store to repossess the collateral. Act professionally at all times. If personality conflicts arise with the debtor, switch loan officers immediately.

**Lesson:** Do not use collateral to coerce the borrower. In this case, the bank apparently enforced its security interest not to protect its loan but rather to force the debtors to pledge their homes as additional collateral. There was no evidence that the store inventory was about to disappear...seizure was not necessary to protect the loan.

**Remarks:** \_\_\_\_\_  
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**Exhibit 8** Avoidance techniques

1. **Be reasonable and act fairly:** Good faith and fair dealing issues are largely common sense.
  - If you've established a course of dealing, give fair notice before changing it.

- If you've neglected events of default in the past, give reasonable written warning before enforcing them in the future. Make sure your deadline gives the borrower time to move its loans. If you can wait until the next maturity date, use that for your deadline and notify the debtor as soon as possible.
- Do what you say you will do.
- Never accelerate a loan without reasonable written notice, no matter how long they've been in default, unless a delay will **really** erode your position. Many experts advise that lenders should make at least one extension before taking enforcement action against a debtor.
- Be careful about calling a loan for slightly late payments unless a minor delay will **really** undermine your position, and the documents spell out that fact (a "time is of the essence clause").
- Unless your collateral is in danger, always make demand before repossessing it.
- If you call a loan and accept a partial payment, make another written demand with fair notice before calling the loan again...
- Make sure your borrower understands, and you understand, all the fine print in the loan documents. Getting their signature on the bottom line isn't enough. Take the time to go over each point, and have someone witness what you did, put a memo in the file describing the discussion, and/or send a followup letter to the customer.
- Remember that collateral is intended to secure repayment of the loan. Don't use it as a club to coerce the debtor to do other things you want them to do...
- Think twice before suing for a deficiency where the deficiency is small and the probability of collection is slight. Your legal action may force the debtor to seek counsel, and provoke a cross complaint...

Remember: Good faith does not mean the lender is trapped into a certain course of dealing once it is established. It just means you've got to give reasonable notice before you change the rules of the game.

**2. Seek legal counsel before taking any enforcement action against a debtor.** It costs money, but an ounce of prevention is worth a pound of cure...

- It will give you a chance to review the file and uncover weaknesses in your position while there is still time to rectify them.
- The case law on "good faith and fair dealing" is changing quickly, and qualified counsel is necessary.
- Following the advice of counsel is usually an absolute defense to certain "intentional torts", including the charge that you intentionally inflicted emotional distress.
- When litigation is likely, interview everyone who was involved in the transaction, including people who may no longer work for you. Uncover all the agreements and understandings, written or oral, that were made.

**3. Stress to all loan personnel the importance of maintaining good credit files.**

- A lender's own credit file is often the best ammunition the borrower's attorney has in lender liability cases.

- Make sure your credit file supports your enforcement action. For example, it's easier for a jury to find a violation of good faith if you accelerate a loan for late payments but there is no mention of your concern in the credit file, and the loan isn't on the problem list.
- Remember that the courts will scrutinize internal loan reviews, policies and manuals. They should fit your actual loan practices.
- Make thorough notes of all conversations, especially in a workout situation. Keep them professional, stick to the facts, and don't use subjective statements, slang, or vulgarity. Any sign of malice or vindictiveness in the memos is evidence of "bad faith".

#### **4. Act professionally at all times**

Any personality conflicts or emotional displays by the lender will become evidence that it didn't act fairly and in good faith. We have stressed this point throughout this handbook because it is often a problem in these lawsuits. A lot of ego is involved when people deal with their own mistakes ... and it can distort their fairness and objectivity.

Lenders do not agree whether to bring in a new officer to handle a workout loan, or whether to let the original loan officer work out his/her own problems. Whichever strategy you choose you should immediately appoint a new loan officer at the first sign of a personality conflict or breakdown in communication. We recommend that 2 people be assigned to each workout loan. Make sure each of them knows all the agreements made by the other.

**5. Never make oral agreements on the side**, and if you do, put them in writing and abide by them until you give adequate notice and change them in writing.

**6. Don't use loan documents that aren't a necessary part of the transaction.** They will muddle what your true intentions were. For example, use of a demand note for term loans can become troublesome if someone later relies on the demand clause to call the loan.

And don't write letters which contradict the provisions in the loan documents. There was a case in Missouri where the lender sent the guarantor a letter explaining that the bank would probably only act against his collateral after all other remedies were exhausted. The letter somehow never made it into the credit file and caused havoc for the bank later in court.

**7. If you have a team of lenders handling a workout loan, make sure the right hand knows what the left one is doing.** Some borrowers are adept at playing one officer off another, and if you give them conflicting signals, they may use it against you in court someday. Use of the "good guy/bad buy" negotiating tactic may also become evidence of "bad faith".

**8. Maintain lines of communication directly between the lender and the borrower during a workout loan.** Seek advice from counsel before sitting down, but try to avoid the syndrome of "your attorney talking to my attorney". Many experts believe that ongoing direct communication is the best protection against problems with good faith. Most borrowers know that the lender is not their enemy ... it's only when we stop talking that the big animosities build up.

Other avoidance techniques:

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## **MISREPRESENTATION ... AND FRAUD** **Exhibit 9**

### **What is the problem?**

Misrepresentation and fraud are legal ways of saying you told a lie, you didn't tell the whole truth, or you gave misleading information. Perhaps it goes without saying, but honesty is not just the best business policy...it is also a requirement of the law. Engaging in misrepresentation and fraud will ruin your reputation in the community and make you liable for the damages caused by your deception. Suppliers, investors and the debtor himself are some of the parties that may be damaged by lender misrepresentation and fraud.

The problem arises often when answering credit inquiries.

### **I. Credit inquiries**

Third parties often contact lenders for credit information.

- Suppliers may call before extending trade credit.
- Buyers may call before placing a large order.
- Banks and finance companies will usually call you before making a loan to your customer.
- Parties considering an investment in your debtor may call you for information before making a decision.

Books have been written on the proper way to answer credit inquiries. We recommend in particular "*Information on Deteriorating Accounts*" published by Robert Morris Associates. The bottom line is: third parties have a right to rely on the accuracy and completeness of the information lenders give them, so we have an obligation not to give out false, misleading or incomplete information. If you withhold key information, or make misleading statements, you can be held liable for any damages that result.

There has been an increasing number of court cases involving exchange of commercial credit information, and problems tend to be big ones.

Misrepresentation with credit inquiries usually arises on deteriorating accounts. The borrower has problems and the lender may be trying to get out of the credit. Another organization calls to get information...if you tell the truth about the debtor, you might scare the other creditor away and accelerate the problem. On the other hand, if you give an incomplete or misleading answer, you will be held responsible for any harm this causes the inquirer. In the short run, we may be tempted to withhold some of the bad news to get someone else to share or take over our exposure.

There are two types of misrepresentation: fraudulent and negligent.

**A. Fraudulent misrepresentation** arises when the lender knowingly gives out false or misleading information. If the inquirer acts on your misrepresentation and is harmed, you may become liable for the damages.

Occasionally fraudulent misrepresentation entails an outright lie.

**Example #1:** A factoring company gave out false and glowing reports regarding one of their customers in order to induce another creditor to take over the loans. The court awarded over \$1 million in damages.

**Lesson:** Honesty is the best policy.

**Example #2:** An oil promoter gave his lender's name as a credit reference to a potential investor, who called the bank and was told that he was a competent oil driller and operator, that he was financially sound, and that he was one of the bank's most successful customers. In fact, however, the oil company was operating in a negative working capital position, had negative cash flow from operations, and was generating cash from the sale of leases. The investor relied on the bank's response, invested heavily in the oil company, and lost a lot of money. They sued the bank and the jury awarded him over \$10,000,000 in damages. (As of this writing, the trial judge overturned the award but the plaintiffs have appealed his decision).

**Lessons:** Tell the whole truth.

Often, however, fraudulent misrepresentation is more subtle ... involving statements that are not outright lies but rather intended to mislead ...

**Example #1:** A lender answered a credit inquiry by giving the normal information about the account balances and loans. When asked about the debtor's credit worthiness, the lender responded by saying lightly that "they are occasionally short of working capital, but what small company isn't." In fact, however, the debtor was in default on two loans and the bank was trying to push them out the door. The inquirer, in this case a customer, relied on the lender's positive assessment and sent in a deposit toward the purchase of a customized piece of equipment. The bank used the money to pay down its loans. Later, the second progress payment went to the attorney to file bankruptcy! The customer successfully sued the lender for damages.

**Lesson:** Third parties have a right to rely on the accuracy and completeness of credit inquiries. You can't just tell the good stuff and gloss over the problems with misleading statements like "they are occasionally short of working capital, but what small company isn't". If you respond to a credit inquiry, be accurate and complete.

**Other examples** of potentially fraudulent statements:

"They've been late occasionally in the past, but we were never worried about it"

"Like all companies, they do get into cash binds every now and then, but the credit is basically sound"

"The main reason we've asked them to move their loans elsewhere is a personality conflict"

"We don't really have a problem with that company...we just want to reduce our exposure in that industry"

**Remarks:** \_\_\_\_\_  
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**B. Negligent Misrepresentation** arises when a lender unknowingly gives out false or misleading information. Carelessness is usually the cause ... not intentional deception. Negligent misrepresentation is not as dangerous as the fraudulent kind, but still makes the lender liable for the damages it causes.

**Example #1.** A supplier called the lender to do a credit check on a meat company. The loan officer said he thought it would be safe to extend between 6 and 8 thousand dollars in credit and that the bank was "going along with them and hoping that they would do a good business and be a credit to the community". However, the meat company did not have an account at the bank...only the parent company did, and the bank was found guilty of negligent misrepresentation.

**Lesson:** In finding the bank guilty of negligence and misrepresentation, the court said:

*"...where a bank officer through its officer undertakes to give advice, even gratuitously, that officer is bound to use the skill and expertise which he has or which he could be presumed to have"*

**Lesson:** Loan officers aren't paid to give advice...so don't give it.

**Example #2:**

Imagine the following conversation:

Lender: "Hello"

Inquirer: "I'm running a credit check on XYZ company and they gave me your name as a reference"

Lender: "Oh, yeah, I've been handling that account for about 2 years ... now let's see, I think their loans total about mid-five figures right now ... account balances, the last time I looked, were in the low five figure range, although the owners do keep pretty good personal balances with us also. They've always handled their accounts as agreed ... great people really. Mr. Johnson founded the company and has an excellent reputation around town. He's a first rate engineer ... always on the forefront in innovation. Character is first class ..."

**Lesson:** Determine the purpose of a credit inquiry before responding to it. Either call them back to verify their identity or have a policy of responding only to written requests.

**Lesson:** Don't respond to credit inquiries without checking the facts first. Answering credit inquiries off the cuff is dangerous ("I think"... "The last time I looked"). Giving "out of date" information can make you liable for negligent

misrepresentation...even if the information is only a month or two old.

**Lesson:** If you decide to answer a credit inquiry, stick to the facts: account balances, loan balances, type of collateral and payment history. If you address things like the debtor's character and competence and they later go bankrupt, whoever relied on your advice is likely to take you to court. They may or may not win, but when lenders go before juries...anything is possible.

#### **Another example of misrepresentation**

A supplier called the bank to check the credit of a furniture store. The bank responded with a form letter which said that the company had a \$6 figure line of credit, 2 deposit accounts in a certain range, that they had handled their loans satisfactorily, and had "demonstrated sound business judgement". However, at the time of the inquiry the actual accounts were significantly less than the letter indicated, and they were having trouble keeping current on their loans. The supplier shipped \$10,000 worth of merchandise and the store went bankrupt a few months later. They successfully sued the bank for damages.

**Lesson:** Make sure the loan officer who handles an account reviews the response to credit inquiries before they are sent out.

**Lesson:** The courts will hold lenders responsible to exercise reasonable care and diligence to see that the information provided is accurate and up to date.

**Lesson:** If you provide opinions about the borrower, ("They have exercised sound business judgement") make sure these are clearly designated as opinions and separated from the facts.

### **Exhibit 10 Avoidance techniques—credit inquiries**

1. If you choose to respond to a credit inquiry, you must be accurate and complete. Not telling a lie is not the same as telling the truth.
2. Verify the source of the inquiry and determine the purpose for the call.
3. If the purpose of an inquiry involves potential litigation against the borrower, seek legal counsel before replying.
4. Verify your facts before giving out information.
5. Don't address subjective issues like character and competence. And don't make predictions about the future.
6. If you respond to credit inquiries on the phone, put a memo in file regarding what was said.
7. Be sure that credit inquiries are routed to the right loan officer, especially when dealing with a problem loan.
8. Spend some time training your loan personnel how to answer credit inquiries. Role playing is especially effective. On-the-job training is too risky.
9. Be especially careful if you are called by parties who are considering an investment in your borrower's business. (See the information on Federal Security Laws below.) With the rapid increase in limited partnership "deals", this has become an increasing problem for lenders.



- Do not give investment advice, and tell that explicitly to potential investors who call you. ("Mr. Jones, this bank has a strict policy of not advising people on investments").

10. There are even some precedents that say a lender may be obligated to keep a third party updated on any changes on the debtor's condition of the debtor **after** a credit inquiry. This is true, for example, if you discover that you had earlier given out false or misleading information. Seek legal counsel when faced with such situations.

**Remarks:** \_\_\_\_\_  
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**A word about Federal Securities Acts**

**Exhibit 11**

The Securities and Exchange Commission has promulgated rule IOB-5 which provides in part: "It shall be unlawful for any person...to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading...in connection with the purchase or sale of any security"

A review of the Federal Securities Acts is beyond the scope of this program. Be aware, however, that lenders occasionally run afoul of these laws because many credit inquiries are "in connection with the purchase or sale of securities". That is one reason we stressed the importance of determining the purpose of every credit inquiry. If there is any connection with a security, no matter how remote, you have a special duty to be accurate and complete.

For example, a bank was liable under Federal Securities Laws (and state fraud statutes) for not disclosing to a business broker the fact that a borrower was behind on its loans and had doctored its books.

In addition, a lender in control of a debtor may become liable for the debtor's violations of Federal Security Laws, especially if the lender had knowledge of the violations or was recklessly oblivious to them.

And be extremely careful if you have any material inside information about the borrower... in those situations, consult legal counsel.

**Discussion:** \_\_\_\_\_  
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**Misrepresentation and fraud by the lender to the borrower**

So far we have talked about the problems that arise when lenders misrepresent things in credit inquiries. We turn now to some of the problems that arise when lenders misrepresent facts to their borrowers.

**Exhibit 12**

**Example 1: Threatening to call the loan**

*"Tom, if you hire your brother in law as president, we're going to have to call the loan"*

*"Mike, if you go through with that large capital expenditure we've got no choice but to call our loans"*

*"Joe, if you don't cut back on your marketing and other overhead, you leave us no choice but to get out of this credit"*

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Situations like that occur in every lender's career: the borrower violates a covenant in the loan agreement or contemplates an action that will do the same thing, and we are tempted to "get them into line" by threatening to call the loan.

The problem with threatening to call a loan is that too often a lender hasn't **really** decided to do it. It's a bluff designed to gain their cooperation or affect their decision. Such "bluffs" have been construed by some courts as fraud, **even if your loan documents give you the right to carry out the "threat"**.

Fraud was a key issue in the Farah case discussed earlier. The lender told Mr. Farah that they would call the loan if he got elected as CEO, when in fact their own credit memos showed that they had not yet made that decision. Mr. Farah believed their threat, stayed out of management, and the lenders were held responsible for the damages caused by their deception.

**Lesson:** Don't threaten to call a loan unless you really mean it. And don't put things in the credit memos that might later be used as evidence of fraud or misrepresentation.

For example, the following statement in a credit memo might become important evidence of fraud:

*"...as always Mr. Roberts was stubborn about his decision and did not want to consider our suggestions. I had to put the heat on by making him believe that we might call the loan if he..."*

Other examples of statements that might be construed as fraudulent:

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**Example 2: Misrepresenting your loan policy**

Many loan officers have said, or been tempted to say, something like:

*"Joe, I wish I could be more flexible, but our loan policy requires that you..."*

On the surface, it sounds innocuous enough. But there have been some cases which indicate that such statements, if not true, open up the lender to charges of fraud and misrepresentation.

For example, a lender in Nebraska used the "loan policy" to justify certain

things they wanted the debtor to do. The debtor didn't like it, sued them and subpoenaed the bank's written loan policies. The most recent version was over 10 years old, and contradicted what the lender said were their policies. This helped prove misrepresentation.

**Lesson:** Know your loan policy, and make sure it corresponds to your current practices. Don't use it as the "scapegoat" for getting the borrower to do what you want them to do.

**Discussion:** \_\_\_\_\_  
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**Example 3: Misrepresenting your capabilities as a lender**

**Exhibit 13**

To illustrate this problem, lets eavesdrop on the tail end of a not-so-imaginary sales call:

**Lender:** *"Mr. Miller, I'm glad that I've convinced you to move your loans to our organization. Our newly formed asset based lending division is one of the finest in the region, and will be able to meet all your financing needs in the years to come."*

Sound like a typical sales call? Well, that segment refers to a recent decision out of Florida in which a debtor won a \$12 million judgement against a bank.

The bank had represented itself as an expert in the field of asset based lending, when in fact they had recently formed the division with only one professional, who it turns out, had been terminated from his previous job. They induced a small company to move its loans from another organization. The company got into problems which apparently the loan officer aggravated by allowing them to draw too much money against their inventory and receivables. When he discovered his error, he tried to cut the debt back quickly to the "proper amount", which helped ruin the company.

Some lawyers call this the "lenders malpractice case". In effect, the lesson is that lenders, like doctors, have an obligation to handle their customers with the ability and expertise that they purport to have. If they are negligent or incompetent, they will be held liable for the damages. Although it is too soon to tell how this case will stand up on appeal, or how widely it will be applied, it is a disturbing case that deserves close watching by every financial institution.

**Another sidelight:** One of the things that undermined the bank's position was a memo in the credit file which said:

*"We must force them (the borrower) down during a time when it will cause them the most problems".*

**Lesson:** Be sensitive to how your comments could be construed later by a jury.

## Appendix A

### DENNIS VS. BANCOHIO

# A fight for control of decision making

**T**he night before the trial, Keith and Janie Dennis decided to tell their three sons — Brian, 10, Brent, 8, and Brad, 6 — the basics.

Janie took Brian aside to talk to him first, asking if he knew what would be happening.

"Oh yeah, you've been having trouble with the bank. You're having a hearing this week."

"Is there anything else you want to tell me about it?" was Janie's natural response.

What the 10-year-old simplified in a few words was the beginning of a complex case whose verdict and its implications would attract national attention. (See adjoining story.) For in *Dennis vs. BancOhio National Bank* in Perry County Common Pleas Court, the jury found in favor of the Dennises, and on Feb. 20 awarded them \$1,039,032.02.

To those who haven't built up \$1½ million in debt, that might seem the jackpot of a lifetime. To others it is an undeserving award made to a young tiger who grew too big too fast, spent too much and sued to get out of paying his debts. Some applaud the judgment as a victory for one of the many victims of the farm economy.

The Dennises would have some problems with all those views.

First, their battle is far from over. BancOhio has filed motions asking the judge to overturn the judgment or grant a new trial. If the motions are denied the bank might appeal.

Second, if the Dennises do receive the \$1 million judgment, it will be used to pay farm debts and legal fees.

Also, Dennis doesn't see himself as a radical or "victim of the farm economy." Rather he says he's a businessman who wants to make his own decisions and pay for his own mistakes.

"We never denied we owed them the money," Dennis says. The judge's instructions to the jury show the Dennises did not dispute the creditors' claims. The court granted the bank a judgment of \$717,964.79 plus interest from Feb. 4, 1985, for a term loan. (The Dennises had paid back operating and hedge lines.) The court also awarded the Dennises' mortgage holders, Farmers Home and Lawrence and Betty Wolfinger, a total of \$793,137.91 plus interest.

When the Dennises filed suit Dec. 23, 1983, they were not in default. They were in a "work out" situation with their term loan due Dec. 31.

The Dennises filed the suit to regain control of their farm business, Dennis says. "I wasn't going to go another year with them (bank officials) running the business and running the debt up. It's my business and I'm going to make the decisions." The Dennises believe the bank overstepped its right to "reasonably restrict" the use of its loan funds.

That translated into the following charges by the plaintiffs, outlined in the judge's instructions to the jury. BancOhio denies all these claims:

- The bank was negligent in structuring the Dennises' 1982 operating loan. By rolling over 1981 losses into 1982's line of credit, instead of in a term loan, the bank started the snowball rolling toward escalating debt, the Dennises claim.

- The bank used economic duress to force the Dennises to make marketing decisions that decreased returns.

- The debtor-creditor relationship became a fiduciary one, which the bank violated.

A fiduciary relationship exists when a person places trust and

confidence in the integrity and loyalty of another. An example would be the bond between a doctor and patient. The Dennises' attorney, J. Stephen Teetor, says his clients relied on the bank's superior knowledge of finance. If the ties were fiduciary, the bank would have been required to act in the best interests of the borrower.

The Dennises claim the bank did not act in their interest when it set the 1982 line of credit and controlled their marketing decisions.

- The bank misrepresented provisions of a 1983 term note. The Dennises claim they were told the \$620,000 note was for 10 years at a 10% fixed rate. The note was actually a 1-year note amortized over 10 years.

BancOhio's vice president of corporate agribusiness, Tom Peoples, and counsel James Moats of the firm Kincaid, Palmer and Randall, cannot comment on the case. The bank's arguments presented here are from court documents.

The Dennises, on the other hand, feel free to talk now that the trial is over. When they filed the suit, they didn't even tell their parents until about a month later. Then they gave none of the details. "It was just us against the bank, and we didn't want to involve anyone else," Janie Dennis says.

### The beginnings

The Dennises first borrowed money from BancOhio in 1980. Dennis explains he was looking for a lender who could provide a bigger operating line.

In 1981 the Dennises signed an agreement with the bank for a \$340,000 operating line. The money was used to plant about 1,600 acres of corn, 609 acres owned and the balance rented from landlords in Perry, Fairfield

and Licking counties.

Dennis, 34, started his farming business in 1969 on about 200 acres. He and Janie, married in 1972, bought and moved to their current farm near Rushville in 1976.

Yields on the acreage usually averaged between 120 and 130 bushels per acre. Although it started that way as Dennis fertilized and readied his fields, 1981 was not an average year.

It rained.

Six hundred muddy acres, lying ready for seed, went unplanted. The 1,000 acres that were planted averaged 112 bushels per acre.

The loss of the crop, plus a \$12,000 loss from a poor marketing decision, added up to a \$300,000 shortfall.

In May 1982 the Dennises signed a credit agreement for \$440,000 on a revolving credit line. After paying off 1981 losses, only about \$140,000 remained for 1982 operating.

BancOhio's trial brief says: "Despite the fact that the monies extended by the Bank under the 1982 revolving credit line were to be used to pay for 1982 operating expenses, it was discovered that the Dennises actually had not paid some of their operating expenses for 1981 and that they had used some 1982 operating monies to pay these prior debts. This was done without the approval of the bank."

Dennis says the bank knew \$300,000 would be used to cover 1981 losses. The Dennises also claim the bank did not structure the loan properly. According to depositions of BancOhio's employees, the bank's policy manual recommends such losses should be termed out. (A deposition is a sworn statement taken before the trial.)

## Appendix A

### DENNIS VS. BANCOHIO

April 6, 1988 / THE OHIO FARMER

#### To market or not

Following 1981's losses, Dennis decided he wanted help with the finances and marketing savvy needed to run 1,600 acres. So in March 1982 he hired an ag consultant, Jim Martin of Allied Management Services in Reynoldsburg.

Martin recommended in April 1982 that Dennis sell corn futures at \$3.10. The bank, according to Dennis, said "no," it was below his break even. The market climbed to \$3.15, then dropped to \$1.90. "So we weren't able to make the hedge. That was the first marketing decision they (bank officials) made," he said.

Several more points of conflict on marketing followed during the next 2 years:

- In January 1983 the Dennises say the bank ordered them to sell their corn. An internal bank memo prepared by account manager Dave Kelley and dated Jan. 10, 1983, states: "Customer has been ordered to liquidate all grain and grain positions and apply such funds to L.O.C. (line of credit)."

- At a meeting between Kelley, Peoples, Martin and the Dennises at their farm Jan. 24, the bankers again told Dennis to sell their corn. As Dennis recalls, Martin responded: "He's making money. Why does he have to sell the corn? The price is rising."

- In March 1983 Dennis claims the bank would not allow him to lift a hedge at \$2.85.

- When the bank froze the Dennises' line of credit Dec. 6, 1983, bank officials again ordered the Dennises to sell their grain, 13,000 bushels not in PIK, Dennis says. This time he complied, using the money to pay end-of-the-year bills.

He says this was the only time he didn't take the money to the bank.

In the defendant's trial brief, the bank denies the Dennises were ordered to sell their corn crop. "Since the Dennises, in both cases, did not have the corn priced, they were simply wanting to sit tight and speculate that the price of corn was going to go up. As long as they did this, the Bank was unable to complete its consideration of the loan requests. Since the Bank would not finalize the Dennises' loan requests for the next year, the Dennises apparently felt 'forced' to sell their grain."

#### In trust

Besides the question of force and orders is that of advice and counsel.

"It is the contention of the Bank that even if there was advice and counselling offered to the Dennises that that does not create a fiduciary duty owed by the Bank to the Dennises," the bank says in its trial brief. It claims the relationship was that of any debtor to creditor.

The Dennises claim BancOhio assumed a fiduciary relationship with them by advising them in financial and marketing matters. "The Bank went so far as to order that plaintiffs fire their independent marketing consultant, telling plaintiffs that they were 'a no-frills operation,' that they could not afford this expense, and that the Bank would provide this marketing and consulting service at no cost to Dennis," according to the plaintiffs' trial brief.

An internal bank memo dated Feb. 22, 1983, from Peoples and Kelley to the Special Markets and Products Division Credit Committee says: "Mr. Dennis appears to be a good farmer but has had difficul-

ties in financial management of the operation ... (Hiring the consultant) has proved to be an asset to Mr. Dennis; however, due to the expense involved with the consulting firm, it was decided to eliminate farming income to pay debts, their notes were accelerated and foreclosures were filed.

#### The price

The Dennises knew the risks. They knew filing the suit would mean at least a year without operating money, and therefore no crop. They knew no crop would mean no income to pay off debt, so debts would be accelerated and the service. It is our opinion that this service will no longer be needed, as we will be able to monitor the credit through our department as well as through the Logan office per our instruction."

The Dennises believe if they had been able to follow their consultant's advice and make their own decisions, they could have met all expenses, continued operating and reduced their debts.

Instead, Dennis says the bank cost them about \$400,000 in lost marketing opportunities. After the Dennises filed suit and had no foreclosures filed.

They knew a court case would be expensive, with no guarantee of winning. They knew the suit would take time — years — to settle. They knew even if they won the suit, they could still lose all they had worked for the past 15 years.

They sued anyway, because Dennis also knew he couldn't continue farming while feeling he had no control over his business.

Says Teetor: "It had to be an agonizing decision for the two of

them to make." The Dennises did look at other alternatives. But, "There was never any doubt in their mind that this was the right thing to do."

Besides the Dennises' unswerving sense of purpose, Dennis's "incredible memory" was a plus, according to Teetor. As bank documents became available, Teetor discovered Dennis's recollection of 3 years of bank meetings and transactions was flawless.

Another asset was Dennis's credibility. "He's a very honest, straightforward type guy." In deposition before the trial and in 12 hours on the stand during the trial, his story never changed.

Despite the uncertainties and stress, "We tried really hard to keep life as normal as possible," Janie says. That job fell mostly to her, as Dennis focused on the suit. Custom work and trucking kept food on the table.

When things got tough, Janie reminded herself she and Dennis were teaching their boys to stand up for what they believe is right. "We felt we were right and had to stand up for our rights," Janie says.

The fight isn't over. The Dennises are now trying to secure operating money to plant some acreage this year.

If things go as planned, Brian — "10 going on 111," according to his mother — will not need to ask why Dad isn't planting this year.

Carolyn Eselgroth and  
Sharon Minot  
The Ohio Farmer



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## Appendix B

Serving All Of Yolo County Since 1857

A newspaper of general circulation for the County of Yolo and the City of Woodland. Publishes daily except Sunday by the Ed E. Leake Publishing Co. Woodland, Calif. 95695. Second class postage paid at the Woodland Post Office.

# Yolo's longest trial Jury awards \$1.5 million to rancher

By Susan Stern

After more than four months, the longest trial in Yolo County history ended Wednesday when a jury awarded just over \$1.5 million to a Sacramento cattleman who sued the Woodland Production Credit Association (WPCA) for destroying his business.

The 11-woman, one-man jury deliberated three days before deciding that the WPCA both intentionally and negligently interfered with Nicoli G. Nicholas' cattle breeding business when they foreclosed on their 1973 loan, selling his cattle to repay the debt.

While WPCA attorney William Gallagher greeted the verdict with a terse "no comment," Nicholas turned the Yolo County courtroom into what looked like a wedding reception line.

As the jurors trooped out with an audible sigh of relief, Nicholas stood in the courtroom aisle shaking each one's hand. Moments later, he assembled them all for a parting

shot—a group photograph on the Superior Court steps.

Though winning attorney Joe Genshlea had said his client's herd would have been worth \$2.3 million today had the WPCA not liquidated it in 1977, he called the \$1,515,000 award "a definite win."

For the WPCA, the trial, which ran five weeks longer than expected, was a double loss, which it will probably not accept without appeal.

First, the jury refused to order Nicholas to pay the WPCA his \$427,725 outstanding debt the credit association sued to recover.

Second, the jurors accepted Nicholas' contention that the credit association deliberately undermined his business, creating the appearance of a bad loan where none existed.

The credit association, Nicholas claimed, was under pressure from its parent organization, the Federal Intermediate Credit Bank (FICB), to clear its books of numerous bad

loans.

Though the cyclic downturn in the cattle market shortly after the WPCA initiated the loan rendered Nicholas unable to make his initial payments, he claimed he would have easily pulled into the black had the credit association stood by him while the market recovered.

But instead, he said, the WPCA panicked, and dumped his and most other livestock loans in a misguided attempt to please the FICB.

Nicholas claimed the WPCA took steps to make his financial situation look worse than it was. When they solicited his business in 1973, he said they appraised his cattle at their highest value. But when they sought to dump the loan four years later, they grossly undervalued his stock.

When Nicholas' plan to buy Glenn County grazing land fell through, he said he rented land there and in Contra Costa County. The WPCA soon voided those leases, forcing Nicholas to consolidate his herd on a piece of Sutter County property belonging to his family's estate.

But adding insult to injury, Nicholas claimed the WPCA then turned around and added the lease costs to his debt, making his finances look even worse on paper.

Finally, Nicholas said, consolidation was followed by foreclosure, when the WPCA sold off his cattle at "hamburger prices" to clear their books of a bad loan they themselves created.

The WPCA had argued that Nicholas forced them to foreclose through his own mismanagement. Had he been allowed to continue borrowing, Gallagher said, he would have been almost \$4 million in debt by 1981.

"He would have owed us so much money the value of his herd wouldn't have made any difference," Gallagher told the jury.

Even if Nicholas had succeeded in increasing his herd to 3,200 head by 1981, Gallagher

said, the rural credit organization would still have been stuck with a \$1.6 to \$2.2 million net deficit.

Though the WPCA loaned Nicholas \$1 million in 1975, and \$45,500 in 1976, adding to their original 1973 commitment of \$691,000, Gallagher said Nicholas was never promised more than a one year loan. He said the WPCA traditionally extended one year loans if a business was profitable, though in Nicholas' case he said the money continued to flow in an attempt to help Nicholas recover from a venture which had soured almost from the beginning.

The slump in the cattle market decreased the value of Nicholas' cattle, Gallagher acknowledged. But he claimed the Sacramento rancher also lost money through his own mismanagement and made purchases which weren't allowed in the loan agreement.

The jury, however, found the WPCA made—and broke—their agreement to provide Nicholas a seven-year capital investment loan to almost double his 1,800 head herd.

Because this agreement was broken, the jury awarded Nicholas \$750,000. They added another \$250,000 in damages for WPCA's "intentional" interference with Nicholas' business plus \$500,000 for punishment. As the icing on the cake, they ordered the credit association to pay Nicholas \$15,000 for "negligence."

Before the trial, Gallagher had said the WPCA's 400 farmer-members from Yolo, Solano and Sacramento counties would have to pay the price of a legal loss with higher interest rates on their own loans. But since WPCA, which filed numerous motions for a mistrial, is expected to appeal the verdict, there is no telling when the award will be paid.

In any case, after 74 days of trial, the Yolo County Superior Court jury is through with the dispute. Today, they return to the lives

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## Appendix C

## DEMOCRAT

# \$46 million award in apple case

By BOB KLOSE

A Superior Court jury Friday ordered the largest damage award in Sonoma County history, \$46.6 million to two Sebastopol apple families who jurors decided were defrauded by the Bank of America.

After eight days of deliberation, the panel of seven women and five men concluded the bank manipulated its loan policies to drive the apple companies of the families of George M. Jewell and Daniel O'Connell to financial ruin and bankruptcy.

The jury ordered the bank to pay \$31.7 million to George M. and Laura Jewell; \$5.5 million to the Jewell's son, George R. "Shorty" Jewell; and \$9.4 million to O'Connell and his mother, Irene O'Connell Kruse.

The award includes \$26.6 million in punitive damages.

The two families had asked the jury for \$120 million in damages.

The total figure included seven separate verdicts, made in 9-3 and 10-2 ballots by the jurors, making it the largest ever in a Sonoma County courtroom and follows what is believed to have been the longest jury trial in this county.

The jurors listened to three months of testimony and arguments before finally retiring to the deliberation room a week ago Wednesday.

Immediately after the verdict was announced, attorney David Flinn said the bank will contest the verdict.

"The bank feels the award is excessive. The dollar amounts are in never, never land. We obviously intend to appeal," Flinn said.

The award topped a week of bad news for the San Francisco-based bank which boasts \$5 billion

in assets and recorded about \$345 million in earnings last year.

While the Sonoma County apple case jury was deliberating, the bank lost a \$14.2 million fraud case in federal court in Los Angeles and a \$2.1 million award against the bank was upheld by the state Supreme Court. And then Wednesday, the bank reported a \$338 million loss in the second quarter of 1985 and forecasted continuing losses through the year.

The Sonoma County verdict could have been worse.

One juror, Joanne Graham, said that at one point jurors were considering awarding George M. Jewell \$30 million in punitive damages alone.

Jury foreman Sol Fishman said the panel plowed through hundreds of hours of documents and testimony before beginning to come to some conclusions during deliberations.

"It was almost hazardous," Fishman said of the deliberations. "We didn't start reaching agreements until probably Wednesday of this week. Then things began to speed up."

He said the panel took the first five days going through information and defining the complex issues they were charged with resolving and then began making decisions.

Basically, the jury was asked to determine whether the bank committed fraud against the two companies by manipulating its lending policies and then pulling its financial support out from under them.

Daniel O'Connell operated his late father's business, the James E. O'Connell Co. apple dehydrating plant.

George M. Jewell was once a leading independent grower, broker and trucker in the Sebastopol apple industry, and his son operated orchards and a fresh apple packing plant.

Attorneys for both families presented evidence alleging that the bank withdrew credit lines from the O'Connell company in the 1970s and then caused a lawsuit to be filed against the O'Connells which threatened the family business with a sheriff's sale to pay off debts.

## Appendix C

# DEMOCRAT

The Jewells and O'Connells claimed the bank's action was motivated by its desire to eliminate the competition they supplied for the struggling Sebastopol Apple Cooperative. The co-op at about the same time was deeply in debt to the bank. The bank eventually liquidated the co-op in 1983 to recover almost \$22 million in bad loans.

Crucial to both sides in the case were the testimonies of former Sebastopol branch manager William Sullivan and his successor, Roger "Rocky" Bunch, who took over in 1979 when Sullivan left the bank on medical leave.

The plaintiffs contended Sullivan and Bunch set the two families up to fail by manipulating them into untenable financial positions and then renegeing on promises.

Both managers denied the bank made promises of long-term loans or acted to deliberately harm the families' firms.

But according to one juror, "most of the jury felt they were not telling the truth."

"They were found wanting too many times on the veracity of what they were saying. Their testimony didn't stand up under cross-examination," the juror said.

Neither Sullivan nor Bunch were in the courtroom to hear Friday's verdict.

O'Connell, who has waited with his mother for a verdict since the jury got the case last week, wept as the decisions were read by Judge William Bettinelli.

Bettinelli presided over the case after deliberations got under way and trial Judge Laurence Sawyer went on vacation.

"I think it is a fair award," O'Connell said.

His mother winked to her daughters when she heard the judge read that the jury had awarded her \$100,000 for the emotional distress caused her when she thought her home would be sold out from under her first in a sheriff's sale and then in bankruptcy.

"They can't touch our property until there's a final judgment," O'Connell said later. He said he hopes the bank's appeal will be speeded up because of his mother's 71 years.

"We can ask for a priority review," he said.

George Jewell and his wife and son displayed little emotion as the judge read off the record awards for his family.

"We got apples to harvest," he said about immediate plans, indicating he'll reserve final judgment until the case is ultimately resolved in higher courts.

After the jury was excused, Flinn asked the court to delay executing the verdict for 60 days while the bank studies its options.

"This is the beginning of a long list of delays," said Jewell attorney Barry Cappello, who, along with the O'Connells' lawyers, opposed the bank request.

But Bettinelli granted the stay of execution for 60 days or until the bank files its appeal.

It was a small loss for Cappello, who on Friday recorded his second record verdict in Sonoma County.

Cappello represented Lumberman's Acceptance Corp. when it won a \$7.46 million damage claim against Union Bank in 1981, then

the largest judgment on record.

Bettinelli later said he believes the trial is the longest heard by a jury in county history.

"You've given away better than three months of your lives, almost too much to the system," he said as he excused the jurors.

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## Appendix D

**Exhibit 14**

### A word about "Quasi-Loan Commitments"

Occasionally a loan officer gives a "handshake" approval to a loan request before receiving the necessary committee approvals. Although this is not a new problem, it has become more important with the increased interest in "good faith and fair dealing". There was a recent case, for example, where a loan officer sent a letter which discussed a potential loan and included a proviso that "any financing arrangements were conditioned upon documentation being satisfactory in substance and form to all parties". The customer claimed it was a commitment but the bank said it was just a proposal for discussion purposes. The court sided with the customer and said that the bank had an obligation to make the loan after a "good faith" review of the documentation.

**Lesson:** Notify your customers, preferably in writing, of the loan approval process at your organization.

**Lesson:** Be careful drafting **any** proposal or commitment letter.

**Lesson:** If it isn't a commitment letter, write "this is not a commitment letter" at the top of the page.

### Another example

Imagine this conversation:

**Lender:** *"Mr. Jones, the bank is very supportive of your effort to buy Smith Manufacturing Company. They've been a long standing customer of our bank, and I don't see any reason that we wouldn't continue the same financing arrangements with you if you do buy them out."*

The lender has represented pretty clearly, although casually, that the current financing arrangement will continue in place if Mr. Jones buys Smith Manufacturing Company. If Mr. Jones buys the company based on that assurance, and the bank changes its mind, he will have a cause of action against the bank. A case in Missouri involving a "quasi-commitment" ended with an award of over \$3 million against the bank.

**Lesson:** The court may determine that the customer had a right to rely on your commitment, no matter how informally it was presented.

# Notes

LENDER LIABILITY  
PART II

Banks in Litigation

Gregg Neal  
Neal & Davis  
Shelbyville, Kentucky

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Section K



## LENDER LIABILITY

### I. CONTROL AND INTERFERENCE IN BORROWER'S AFFAIRS.

#### A. INTRODUCTION

1. Work - Outpractices of financial institutions are coming under closer scrutiny. Recent cases of lenders responsible for damages when the lender has assumed or exercised excessive control over the debtor's business. Loan documents give financial institutions broad authority over the affairs of the other debtors and sometimes these provisions are enforced if for illegitimate purposes.

#### B. COMMONLAW THEORIES OF LIABILITY

##### 1. Fraud.

a. Stirling v. Chemical Bank, 382 F.Supp. 1146 (S.D.N.Y. 1974) - Remanded & Appeal Dismissed 511 F.2d 1030 (2d Cir. NY 1975) Opinion Affd. 516 F.2d 1396 (2d Cir. NY 1975) - Fraud was claimed in this action where a creditor induced resignations of directors and officers with a fraudulent promise not to call loans. State National Bank of El Paso v. Farah Manufacturing Company, 678 S.W.2d 661 (Tex. 1984), Dismissed by agreement 3/6/85. In this case, the jury found that a bank acting alone or in conspiracy with other lenders committed acts of fraud, duress, and interference resulting in damages to the Farah Manufacturing Company. The jury awarded damages to Farah in the amount of \$18,947,348.77. The appellate court reduced the judgment by \$300,105.00 and affirmed the judgment as reduced in the amount of \$18,647,243.77 with interest at the rate of 9% per annum from the date of judgment until paid.

The facts in the case are complicated. The lender used a management change clause in a \$22,000,000 loan agreement to coerce the board of directors into taking action which was detrimental to Farah. The fraud action was based upon false representation made by the lender's that a default would be declared, and Farah would be bankrupted and padlocked if William Farah was elected the chief executive officer. The action of duress was based upon letters and statements made by the lender representatives blocking the election of Farah as the CEO and also blocking the election of additional directors who favored Farah. There was evidence that the loan to Farah was not in default when the warnings were issued without justification by the lenders. The tort of interference action was based upon the lenders interference with the lawful management and proper corporate governance by Farah of its own board by (1) installing a lender representative as CEO; (2) forcing Farah's resignation as a board member; (3) substituting a lender representative as chairman of the board; (4) preventing the election of Farah supporters to the board; (5) causing the board resignations of Farah supporters; (6) packing the board with lender supporters;

(7) installing a "consultant" as CEO; and (8) encouraging and financially supporting the costly litigation in a proxy fight against William Farah when he sought to restore lawful of management to Farah.

## 2. Duress.

a. In most jurisdictions, duress is used to avoid a contractual obligation rather than as an affirmative tort but it has been recognized as a tort in several jurisdictions. Pecos Construction Co., Inc. v. Mortgage Investment Company of El Paso, 459 P.2d 842 (N.M. 1969), Fizzell v. Meeker, 339 F.Supp. 624 (W.D. Mo. 1970). Sanders v. Republic National Bank of Dallas, 389 S.W.2d 551 (Tex. 1965), Continental Illinois National Bank & Trust Company of Chicago v. Stanley, 606 F.Supp. 558 (N.D. Ill. 1985). In Continental, Bank was granted a summary judgment when it sued Stanley seeking to recover on his personal guarantee of loans made by the banks to four operations controlled by him. The Court found that the guaranty was supported by consideration as it was executed simultaneously with the original credit. Subsequent amendments to the credit agreement increasing the amount of the credit, without the consent of Stanley did not exonerate him since the guaranty covered all present and future obligations. Stanley failed to establish by affidavit that there was any agreement to extend credit up to \$750,000,000 (the maximum set forth in the credit agreement). Stanley's allegations of economic duress were not supported, and Stanley's claims of misconduct by the banks with respect to borrower were insufficient to exonerate him from liability since the guaranty provided he would be liable notwithstanding any claim or defense that the borrowers may assert upon the invalidity of the underlying obligation.

## 3. Interference.

a. Interference may support a claim against a creditor if it is used to gain control or the control detrimentally affects the debtor's financial condition. Farah, Supra, Restatement (2nd) of Torts, Section 767. In the case of Melamed v. Lake County National Bank, 727 F.2d 1399 (CA6 1984). A bank representing a trustee brought an action for damages against a bank based upon an alleged fraudulent transfer of assets to the bank and for the bank's tortious interference with the debtor's business. A jury awarded the Plaintiff \$30,000 based upon the fraudulent transfer claim and \$475,000 based upon the interference claim. The Court reversed their jury award based on fraud since the bank held a lien on the assets preventing any diminution of the debtor's assets which is an essential element of a fraudulent transfer. The Court upheld the interference since the bank had required the president of the debtor to take a 50% reduction of salary; required the debtor to replace its accountant with one chosen by the bank; the bank's approval was required for all payments by the debtor; the bank had set forth a "13-point program" to "help salvage whatever is possible" from the debtor; and the bank suggested that the

landlord change the locks on the debtor's premises. However, the Court did reverse the damage award because the evidence was too general and imprecise. The Court held the measure for this tortious interference as the difference between the value of the business before and after the injury. The proper method would be to capitalize its earnings over a reasonable period. The jury could not consider claims brought by other creditors of the debtor, in determining damages.

Restatement (2nd) of Torts, Section 767:

"In determining whether an actor's conduct is intentionally interfering with a contract or a prospective contractual relationship of another is improper or not, consideration is given to the following factors:

- (a) The nature of the actor's conduct,
- (b) the actor's motive,
- (c) the interests of the other with which the actor's conduct interferes,
- (d) the interests sought to be advanced by the actor,
- (e) the social interest in protecting the freedom of an action of an actor and the contractual interest of the other,
- (f) the proximity or remoteness of the actor's conduct to the interference, and
- (g) the relations between the parties".

Restatement (2nd) of Torts, Section 769:

"One who, having a financial interest in the business of a third person, intentionally causes that person not to enter into a prospective contractual relation with another, does not interfere improperly with the other's relationship if he:

- (a) does not employ wrongful means, and
- (b) acts to protect his interest from being prejudiced by the relation.

See Lowell v. Mother's Cake and Cookie Co., 79 Cal. App., 3d 13, 22 (1978), and Del State Bank v. Salmon, 548 P.2d 1024 (Okla. 1976).

4. Negligence/Joint Venture

a. Dunson v. Stockton, Whatley, Davin & Co., 346 So. 2d 603 (Fla. 1977). Lender was held liable as a joint venturer of borrower. Connor v. Great Western Savings & Loan Association, 69 Cal. 2d 850 (1968). Lender held liable in tort for borrower's negligence in failing to conduct proper soil tests for construction.

5. Principal/Agent

a. Restatement (2nd) of Agency, Section 14-0, Comment "a":

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

See A. Gay Jenson Farms Company v. Cargill, Incorporated, 309 N.W.2d 285 (Minn. 1981), Krivo Industrial Supply Company v. National Distillers & Chemical Corporation, 483 F.2d 1098 (CA5 1973), Rev. Denied 490 F.2d 916 (1974). In Re: Prima Company, 98 F.2d 952 (CA7 1938).

6. Fiduciary.

a. Justice Cardozo defined the bank customer relationship as "not honesty alone, but a punctilio of honor, the most sensitive". Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928). A fiduciary relationship may require more than just a debtor/creditor relationship but one where the parties understand the special customer confidence that has been reposed. Umbaugh Pole Building Co., Inc., 390 N.E.2d 320, 323 (Ohio 1979). See Commercial Cotton Company, Inc. v. United California Bank, 163 Cal. App. 3d, 511 (1985).

7. Waiver of Jury Trial.

a. Some states allow the waiver of jury trial by statute. Jury trial waiver can be enforced under basic contract



principal. Annotation, Validity and Effect of Contractual Waiver of Trial by Jury. 73 ALR 2d 1332 (1976). However, courts are reluctant to enforce the waiver of jury trial as judges would rather have a jury deciding the issue rather than the court itself.

## II. GOOD FAITH AND FAIR DEALING

### A. UCC

#### 1. INTRODUCTION

Section 1-203 of the UCC provides:

"Every contract or duty within this act imposes an obligation of good faith in its performance or enforcement".

"Good Faith" is defined in UCC, Section 1-201 (19):

"Honesty in fact in the conduct or transaction concerned".

### B. Lender's Good Faith.

1. Yankton Production Credit Association v. Larsen, 365 N.W.2d 430 (Neb. 1985). In this case, the Court reversed the summary judgment granted in favor of the lender finding triable issue as to whether (1) PCA had made commitments to finance the expansion of the borrower's livestock feeding operation which could be enforced against the lender applying principles of promissory estoppel, despite provisions in the loan documents making all advancements discretionary; and (2) whether the PCA acted in good faith within the meaning of UCC Section 1-203, when it refused to loan the borrower the amount of the budgeted loan.

2. First National Bank in Libby v. Tombley, 689 P.2d 1226 (Mont. 1984). A bank officer promised the borrower that it would convert an indebtedness evidenced by a promissory note into an installment obligation if the principal amount was reduced and interest was brought current. The bank officer thereafter left town. A new officer on the account disclaimed knowledge of the commitment and, after consulting with the president of the bank, elected to off-set the debtor's bank account. The Court held that the Trial Court erred in refusing to permit a punitive damage claim to be asserted against the bank for breach of the obligation of good faith and fair dealing in UCC Section 1-203. The Court noted that breach of this obligation could be a tort as well as a breach of a contract. The Court also observed that the punitive damages claim could be based upon allegations of fraud.

3. Security Trust Company v. Wilson, 307 Ky. 152, 210 S.W.2d 336 (1948). A fiduciary duty exists in all cases where there has been a special confidence reposed in one who in equity

and good conscience is bound to act in good faith and with due regard to the interest of one reposing confidence.

4. Henkin, Inc. v. Berea Bank & Trust Company, Ky. App., 566 S.W.2d 420 (1978). A fiduciary duty between a bank and its customer fosters public confidence in the banking system. In this case, Henkin, Inc. gave a promissory note for \$160,000.00 payable in installments to Tinker, Inc. for the purchase of a radio station. The note was secured by a mortgage on real estate. Tinker offered to accept a 22.36% discount if Henkin would pay the note in full. Henkin applied to the bank for \$100,000.00 to pay off Tinker, and the bank turned down the application. The bank purchased the Henkin note from Tinker which had a balance of \$118,000.00 for \$95,000.00 in receipt of the assignment of the mortgage securing the note. Henkin was a few days late with its first installment payment to the bank, and the bank accelerated all future payments and started foreclosure proceedings against Henkin.

5. Bale v. Mammoth Cave Production Credit Association, Ky., 652 S.W.2d 851 (1983). In this case, a breach of fiduciary duty to its customer did not entitle the customer to an affirmative defense in a suit to enforce payment of a promissory note. However, it did afford the customer a basis for asserting a counterclaim for damages and lost business profits.

6. The Restatement 2nd of Contracts, Section 205, states that:

"Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."

Comment "d" provides:

"A complete catalog of types of bad faith is impossible but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abusive of a power to specify terms, and interference with or failure to cooperate in the other party's performance".

7. Fraud in the Inducement.

a. First National Bank in Lennox v. Brown, 181 N.W.2d 178 (Iowa 1970). A bank has a duty to reveal facts to a borrower before consummation of a loan transaction by which a loan would relieve the unfavorable position of a bank on a prior improvident loan. The breach of this duty by the bank gives rise to avoidance of the loan on the part of the borrower.

8. K.M.C. Co., Inc. v. Irvin Trust Co., 757 Fed.2d 752 (CA6 1985). The Court affirmed a \$7,500,000.00 jury verdict

against Irvin Trust for damages to K.M.C.'s business caused by the bank's termination of a revolving credit. The bank agreed to make discretionary advancements up to a maximum credit line of \$3,500,000.00 subject to a formula based upon a percentage of the value of inventory and eligible receivables. On March 1, 1982, the bank refused to advance \$800,000.00 requested by KMC which would have increased the loan balance to just under the \$3,500,000.00 maximum. The bank then called the loan which was on a demand basis.

The Court held the jury trial waiver clause, in the financing agreement was not enforceable applying federal law since KMC had not knowingly, nor voluntarily and intentionally waived the right to a jury trial. The Court upheld the obligation in good faith with regard to both the bank's discretionary decision as to whether to advance funds and its power to demand repayment of the loan. Personality conflicts between officers of the banking KMC were noted. The bank was adequately secured and would not have suffered losses in the event of liquidation. It was the bank's policy to provide notice before terminating finances, and the bank made a \$700,000.00 advance just three days after refusing the \$800,000.00 request in advance.

9. Roberts v. Parsons, Ky., 242 S.W. 594 (1922), where confidential relationships exist, the burden is on the defendant seeking to retain the benefits of the contract to show the perfect fairness of the transaction.

### III. MISREPRESENTATION AND FRAUD.

#### A. Credit Inquiries.

Reliance upon credit inquiries is important to the commercial transactions between banks. Likewise, it will apply to businesses who ask for information or references. Two areas of liability are fraud and negligence.

1. Sabin Meyer Regional Sales Corporation v. Citizens Bank, 502 F. Supp. 557 (N.D. Ga. 1980).

2. Nevada National Bank v. Gold Star Meat Company, Inc., 89 Nev. 427, 514 P. 2d 651 (1973).

#### B. Lender to Borrower.

Hall v. Carter, Ky., 324 S.W.2d 410 (1959). Fraud and deceit are not limited to affirmative or active acts if the circumstances surrounding the transaction impose a duty or an obligation on one of the parties to disclose material facts known to him and not known to the other party.

Johnson v. Cormney, Ky. App., 586 S.W.2d 23 (1980). Fraud may be established by evidence which is fully

circumstantial, even if each bit of circumstantial evidence in and of itself may seem trivial and unconvincing, a combination of all circumstances considered together may be decisive.

#### CONCLUSION

Suing the lender is a complex and expensive transaction. The law is unsettled in many areas. Defensive lending may be considered. However, the key to any good creditor - debtor relationship is good faith and fairness. Overreading is tolerated. Profiting from the debtor's business is forbidden. Common sense, not greed, should dictate.