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## 19th Annual Conference on Legal Issues For Financial Institutions

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

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*19th Annual*

*Conference On*

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*19th Annual*  
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**May 1999**

Presented by the  
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**19th Annual  
Conference On  
LEGAL ISSUES FOR FINANCIAL INSTITUTIONS**

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**CASE LAW AND NEW DEVELOPMENTS  
UPDATE**

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**SECTION A**

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

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# CASE LAW AND NEW DEVELOPMENTS UPDATE

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# Case Law Developments Update

## I. Federal Financial Services Modernization – H.R.10 & S.900.

### A. Different Views Of The Legislation's Status:

#### International Banking Regulator:

“Veto Threat Still Hangs Over FinMod.” After passing the Senate on a partisan vote, the ball on financial modernization legislation is now in the hands of the House Commerce Committee, which is expected to act on the bill in time for the full House to consider it before the July 4th recess.

#### Bank Mutual Fund Report:

After passing the Senate on a partisan vote, the ball on financial modernization legislation has now been passed to the House Commerce Committee, which is not expected to act until late June, postponing floor action in the House until late next month at the earliest.

### B. Summary Of HR 10 -- Exhibit 1.

## II. Judicial Developments.

### (Not Otherwise Within Scope Of Other Seminar Topics).

### A. Parol Evidence; Statute Of Frauds.

George Nichols III, Liquidator v. R. Dudley Webb, et al., Kentucky Court of Appeals, 98-CA-002487. Court of Appeals currently considering appeal from Circuit Court's decision that unconditional personal guarantees provided by the Webbs to Kentucky Central Life Insurance Company were, in fact, subject to various conditions before they could be enforced. Since those unwritten conditions had not been met, the Circuit Court held that the guarantors had no obligation to satisfy the unpaid promissory notes. Case involves the parol evidence rule, the statute of frauds, and various other doctrines bearing upon the ability of borrowers and guarantors to avoid the language of the written documents they signed. Kentucky Bankers Association has filed an *amicus curiae* brief urging the Court to decide the case in such a manner that bank can draft written loan agreements that put borrowers on notice that the agreements will be enforced as written.

### B. Duty of Good Faith.

Ousley v. First Commonwealth Bank of Prestonsburg, Kentucky Court of Appeals, No. 1997-CA-001938-MR (2/12/99) (petition for rehearing filed March 24, 1999). Kentucky Court of Appeals ruled on whether a former customer has a right to copies of bank account records. The Court held that “there is implied in the duty of good faith and fair dealing a

duty on the part of the bank to account to its customer at the customer's request. Thus, a present customer of a bank clearly has the right to ask for and receive records of his accounts and loans with a bank at any time. We likewise believe that this duty extends to former customers of a bank so long as the bank still has the records and the former customer is willing to pay the cost of obtaining the records."

Star Bank, Kenton County, Inc. v. Parnell, Kentucky Court of Appeals, No. 1996-CA-002788-MR (9/25/98) (motion for discretionary review pending). Bank's action in accelerating loan upon deeming itself insecure did not indicate a lack of good faith, even if bank was negligent in failing to acquire sufficient knowledge of dealerships financial condition before approving loan. Reversing jury verdict against bank. "Good faith" is honest in fact not negligence and "negligence cannot be considered when determining 'good faith.'"

**C. Promissory Notes.**

Hibbitts v. Cumberland Valley National Bank & Trust Co., Ky.App., 977 S.W.2d 252 (1998). Court of Appeals affirmed entry of summary judgment holding that bankruptcy reaffirmation agreement was valid obligation to pay debt even absent the execution of a new promissory note. The "reaffirmation agreement reinstates the terms of the promissory note and mortgage." Also, "it is well settled that no precise form is necessary to constitute a promissory note." No need to conduct discovery because discovery could not have uncovered any material fact or potential evidence.

**D. Check Fraud.**

Cockrell v. First Tennessee Bank, (W.D. Tenn. 98-2497-D/A). Noncustomer of bank attempted to cash checks drawn on the bank. The bank, as a condition of doing so, required that he place his thumbprint on the check. He refused, and the bank declined to cash the check. Noncustomer then filed suit alleging invasion of privacy, wrongful conversion, and other assorted legal theories. Trial court ruled for bank holding that since there was no contract between payee and bank, there was no breach of contract. Similarly, the bank had no fiduciary duty to noncustomer and did not convert the check. More importantly, the court held the bank was entirely reasonable in demanding the thumbprint as identification to prevent fraud, found the lawsuit frivolous and ordered the plaintiff to pay costs of any appeal in advance. Similar wins for banks in Koch v. Wells Fargo Bank (California); Raesz v. Bank of America Texas, N.A. (E.D. Tex.); and Barnhill v. Nationsbank (Virginia).

**E. Electronic Signatures.**

1. On May 6, 1999, the Comptroller of the Currency issued guidance on a national bank acting as a certification authority for electronic signatures, i.e., an on-line notary.
2. IRS Initiative. In an effort to streamline electronic filing of individual tax returns, the Internal Revenue Service recently awarded a contract to VeriSign, Inc. to supervise a pilot program with the goal of allowing taxpayers to use digital signatures. The digital signatures are intended to replace the paper form that

electronically-filing taxpayers must now sign and send via physical mail to the Internal Revenue Service. The forms give the IRS a means to verify the identity of the individual taxpayer not currently available with the electronic form. VeriSign will conduct a pilot which will use digital signatures to verify the filer, without using any paper forms. The pilot will be conducted in two phases: Phase One will employ digital signatures for communications and transactions between certain IRS employees; Phase Two will implement digital signatures in connection with the filing of IRS-required forms, and will also be tested by IRS employees. IRS officials intend to begin the pilot during the 1999 tax year

3. House Bill 708 enacted by the 1998 General Assembly (1998 Ky. Acts Ch. 363) (codified at KRS 369.010 *et seq.*) addresses electronic signatures and electronic records in transactions involving state government and also in transactions between private parties. However, the statute exempts from its scope wills, trusts, "conveyances of any interest in real property, and the "creation or transfer of any negotiable instrument or any instrument establishing title or an interest in title." Also, the statute does not obligate a person to accept an electronic record or electronic signature unless the parties "have freely and voluntarily agreed to" do so. The regulation codifying the statute in the insurance context is set forth at 806 KAR 14:130.
4. The Government Paperwork Elimination Act (a part of the Omnibus Consolidated Appropriations Act (Pub. Law 105-277) addresses electronic signatures at the federal government level.
5. Bellco First Federal Credit Union v. Kaspar, 125 F.3d 1358 (10<sup>th</sup> Cir. 9/30/97). A loan application taken over the telephone and entered into a computer without being seen or signed by borrowers is not a "writing" under §523(a)(2)(B) of the Bankruptcy Code. Thus, the lender could not argue that the debtors' obtained credit based upon the "use of a statement in writing" that was materially false thereby precluding them from discharging the debt in bankruptcy.
6. On July 15, 1998, the Federal Financial Institutions Examination Council issued a Guidance On Electronic Financial Services And Consumer Compliance. [<http://www.ffeec.gov/pr071598.htm>].
7. The Internet Law & Policy Forum maintains an extensive reference web-site on the issue. [<http://www.ilpf.org>].

**F. Telephonically Authorized Drafts.**

1. Payment method: payee obtains a customer's account agreement, including account number, routing numbers and transit numbers, typically by asking over the telephone to read the information from the MICR line on the customer's check. The payee uses this information to produce a draft on a computer with the necessary MICR information already encoded. The draft is not signed by the customer and typically contains information such as "By XZY as Authorized Signatory for Jane Doe" or



“customer authorized debit.” Upon receiving the statement (and after suffering buyer’s remorse), the customer demands the bank recredit the account.

2. Legal analysis.

Step 1: Has the midnight deadline passed? If not, dishonor the item.

Step 2: Is the draft an “item” which “authorized by the customer and in accordance with any agreement between the customer and bank”? If so, it is “properly payable” under KRS 355.4-401.

- a. Is the draft an “item”? “Item” is defined in KRS 355.4-104(1)(h) as “an instrument or a promise or order to pay money handled by a bank for collection of payment.” However, “payment orders governed by Article 4A” or “a credit or debit card slip” are excluded. An “instrument” is defined in KRS 355.3-104(2) as a “negotiable instrument”.
- b. Was the draft have to have the actual manual signature? KRS 355.1-201(39) defines “signed” as “includes any symbol executed or adopted by a party with present intention to authenticate a writing.”

Step 3: Did the draft create an overdraft? KRS 355.4-401(2) provides that a “customer is not liable for the amount of an overdraft if the customer neither signed the item nor benefitted from the proceeds of the item.”

Step 4: Does the bank have other defenses? Account holder negligence? Ratification? Customer benefitting from the payment of the item?

3. Possible solutions.

Solution 1: Amend the account agreement providing that the debit is “authorize” if the customer has given MICR information in person, over the phone, or otherwise regardless of whether or not the customer later believes the particular debit in question was not authorized.

Solution 2: Legislation. Texas effective September 1, 1997, amended its UCC provisions to adopt a non-standard warranty the every person in the forward collection process warrants to the payor bank that if the instrument is a “demand draft” the creation of the instrument according to the terms on its face was authorized by the person identified as the drawer.”

Solution 3: Clearinghouse Rules. The Clearinghouse Association of the Southwest implemented on January 1, 1996, a rule requiring the presenting bank to warrant that the check has no unauthorized signatures and is not counterfeit. Such clearinghouse rules are valid and govern under KRS 355.4-103(2)

**G. Truth In Lending Act Rescission Rights.**

Beach v. Ocwen Federal Bank, 118 S.Ct. 1408 (1998). Residential mortgage borrowers could not assert a right of rescission as an affirmative defense to the lender's foreclosure suit more than three years after the loan transaction closed. The three year time limit on the right of rescission provided by 15 U.S.C. §1635(f) is not just a statute of limitations but wholly extinguishes any right at the end of the three-year term. By comparison, the statute allows recoupment of damage claims to be asserted regardless of the time limits.

**H. Joint Accounts.**

Sroka-Calvert v. Watkins, Ky.App., 971 S.W.2d 823 (1998). Narrowly construing provisions of joint brokerage account agreement to preclude one joint owner from transferring ownership into his own name.

The undersigned jointly and severally agree that **each of them shall have the authority** on behalf of the joint account to buy, sell (including short sales) and otherwise deal in, through you as brokers, stocks, bonds and other securities and commodities, on margin or otherwise; to receive on behalf of the joint account demands, notices, confirmations, reports, statements of account and communications of every kind . . . and generally to deal with you on behalf of the joint account as fully and completely as if he alone were interest in said account, **all without notice to the others interested in said account.** [Court's emphasis].

Omission of the word "transfer" was the critical fact. Fact issues existed on whether spouse's signature was forged on transfer documents.

**I. Employment.**

Marques v. Bank of America, 69 Cal.Rptr.2d 154 (1997), cert. denied, 119 S.Ct. 65 (1998). A dismissed bank officer's employment discrimination claims under state law were not preempted by the National Bank Act. The authority granted to national banks by 12 U.S.C. §24 to dismiss officers "at pleasure" was superceded and repealed by implication by the later enactment of the federal anti-discrimination laws. Since the federal laws prohibited employment discrimination on various grounds and preserved more lenient state laws, state anti-discrimination laws did not interfere with 12 U.S.C. §24.

Landrum v. Braun, Ky.App., 978 S.W.2d 756 (1998). Recognizing a qualified privilege against claims of libel, slander, false light and intentional infliction of emotional distress for necessary communications between employees in the chain of command. Issue of existence of privilege is an issue of law for the court.

**J. Bank Examination Litigation.**

Rockwood Bank v. Gaia, 170 F.3d 833 (8<sup>th</sup> Cir. 1999). Bank and its president were not

protected by either absolute or qualified immunity under Missouri law for statements made during an FDIC examination if the statements were made “with malice”.

In re: Powell, 227 B.R. 61 (Bkrtcy.Vt. 1998). In lender liability litigation, bankruptcy court ordered Vermont Commissioner of Banker to produce reports of examination of the defendant bank and its holding company concerning credit administration practices at the bank despite the existence of the Vermont statute hold that such information “shall be confidential communications, shall not be subject to subpoena, and shall not be made public.” Court narrowly construed the statute and reasoned that an exception in the statute giving Commissioner discretionary authority to release such material to “civil and criminal law enforcement authorities” permitted the court to order production of the documents.

Sisters of Charity Health Systems, Inc. v. Raikes, Ky., 984 S.W.2d 464 (1998). Supreme Court narrowly construed the medical peer review privilege of KRS 311.377(2) to limit the protection to suits against peer review entities thereby ordering that production of such records be made in a medical malpractice lawsuit to which the peer review entities were not defendants.

#### **K. Punitive Damages.**

Williams v. Wilson, Ky., 972 S.W.2d 260 (1998). KRS 411.184(1), Kentucky’s statute on the circumstances under which punitive damages may be awarded, is unconstitutional insofar as it requires a plaintiff to show more than “gross negligence” on the part of the defendant before the plaintiff can secure punitive damages.

Owens-Corning Fiberglass Corp. v. Golightly, Ky., 976 S.W.2d 409 (1998). Affirming \$435,000 punitive damages award against manufacturer of asbestos-containing pipecovering in suit brought by former pipefitter suffering from asbestosis and lung cancer. Kentucky’s system of reviewing awards of punitive damages – the “first blush” rule at the trial level and the “clearly erroneous” standard at the appellate level – satisfies due process.

#### **L. Liens.**

Redondo Construction Corp. v. United States, 157 F.3d 1060 (6<sup>th</sup> Cir. 1998). IRS tax lien had priority over judgment lien claimant where judgment creditor did not comply with the registration requirements of Kentucky’s Uniform Enforcement Of Foreign Judgments Act (KRS 426.950 *et seq.*). Filing of *lis pendens* notice while judgment creditor attempted to set aside fraudulent conveyance of property did not create a lien. Rather, the judgment creditor needed to comply with the judgment lien filing requirements of KRS 426.720. In dicta, the Court indicated that a *nunc pro tunc* order can retroactively recognize an out-of-state judgment for purposes of actually enforcing that judgment within the state’s boundaries.

In re: Excell Engineering, 224 B.R. 582 (Bkrtcy.W.D.Ky. 1998) (Roberts, J.) Unpaid construction subcontractor violated bankruptcy automatic stay by filing, postpetition, a lien statement under KRS 376.210 against funds owed general contractor on government contract. Lien claim under KRS 376.210 does not relate back to a prepetition date, so safe harbor under Bankruptcy Code 362(b)(3) to post-petition lien filings was not available.

Furthermore, the subcontractor failed to perfect its lien by timely instituting a lawsuit in the face of a protest from the general contractor. Sanction imposed against subcontractor was payment of 100% of contractor's attorneys' fees and costs in litigating the validity of the claimed lien.

**M. Escheat.**

Implementation of 1998 state escheat amendments. KRS 393.130(3) mandates that the holder of interest bearing property which is presumed abandoned under Kentucky's escheat laws place such property "in an interest-bearing account made assignable to the department." Exhibit 2 contains draft regulations being considered by the Kentucky State Treasurer to implement the 1998 legislation. The first proposed regulation (20 KAR 1:080) regulates reports to be submitted to the Treasury Department concerning the account. The second proposed regulation (20 KAR 1:090) which would regulate how the interest bearing account is created and operated.

Cassady v. Hamilton, Franklin Circuit Court, No. 98-CI-00259. On March 18, 1999, the Franklin Circuit Court determined that Kentucky State Treasurer John Kennedy Hamilton had improperly expended escheat funds to purchase radio advertisements during the 1998 General Assembly urging voters to support escheat legislation which he supported. The Circuit Court held that escheat funds were private property in the protective custody of the state and the state statutes describing the permissible uses of such funds did not include the radio advertisements being challenged. Mr. Hamilton was ordered to personally repay the expenditures.

Citibank (South Dakota), N.A. v. South Dakota, (S.D.2d Jud. Cir. Ct., Civil No. 96-93). On January 11, 1996, bank sued to resolve dispute over proper characterization of funds that the bank received as obvious attempts by cardholders to make payments on credit card balances due from them but which the bank was unable to match to a specific account. South Dakota claimed that such funds constituted "abandoned property" and must be escheated. Citibank sued claiming that such funds belong to it and do not fit within the statutory definition of abandoned funds as those that are "payable or distributable" by the bank to someone else. On March 16, 1998, the court entered summary judgment for the bank, concluding that Citibank was the true owner of the funds and that they were not subject to escheat.

**N. Wills, Trusts, And Estates.**

McElroy v. Taylor, Ky., 977 S.W.2d 929 (1998). District Court has jurisdiction to determine whether guardian of incompetent surviving spouse properly acted to renounce (pursuant to KRS 392.080) the will of the deceased spouse. Court liberally construed the phrase "matters involving probate" in KRS 24A.120(2) (relating to a District Court's jurisdiction).

Sanders v. Pierce, Ky.App., 979 S.W.2d 457 (1998). Wife is required to renounce deceased husband's will within six months after probate. Failing to do so, she had no dower interest and could not bring an action asserting pre-death property transfers by deceased spouse as a fraud against dower. Despite being time barred from being able to renounce the will, the wife was not required to renounce the will in order to assert a claim for the exceptions

provided in KRS 391.030. The 1992 amendment of the statute construed as overruling the decision in Brown v. Sammons, Ky., 743 S.W.2d 23 (1988).

Goforth v. Gee, Ky., 975 S.W.2d 448 (1998). Trust construed as a support trust not a spendthrift trust when it authorized trustee "to pay such amount of the interest quarterly to my said daughter so that she may be maintained and cared for in accordance with her station in life." A trust is not a "spendthrift" trust to the extent the beneficiary "may demand it from the trustee". Thus, a judgment creditor of daughter could reach interest earnings on trust but could not reach the principal.

Bye v. Mattingly, Ky., 975 S.W.2d 451 (1998). Undue influence case where the jury found the will valid even though a partial disability order had been entered against the testator. Upholding the lucid interval doctrine and reaffirming Kentucky's "commit[ment] to the doctrine of testatorial absolutism." Thus, "[m]erely being an older person, possessing a failing memory, momentary forgetfulness, weakness of mental powers or lack of strict coherence in conversation does not render one incapable of validly executing a will."

**O. Automobile Leases.**

In re Reed, 226 B.R. 1 (Bkrcty.W.D.Ky. 1998) (Dickinson, J.). In the absent of evidence to the contrary, a consumer will generally be allowed six months in Chapter 13 plans to cure automobile lease arrearages. If a different cure period is proposed, the Court will engage in a case-by-case analysis of whether the cure is "prompt" and will consider the nature of the leased property, the provisions of the lease, the amount of the arrearage, the remaining term of the lease, and the provisions of the debtor's proposed plan.

**P. Arbitration.**

Badie v. Bank of America, 67 Cal.App.4th 779, 79 Cal.Rptr. 273 (1998) (review denied by California Supreme Court on 2/24/99). Bank of America could not change its existing deposit account agreements simply by mailing customers an insert adding an arbitration provision despite provision in original agreements permitting the bank to change "terms and conditions" on prior written notice to customers in their monthly statements. Appellate Court seemed to be resting its decision on (i) a narrow reading of the phrase "terms and conditions" as being limited to interest rates, fees, charges, grace periods, and the like (matters integral to the bank/creditor relationship) but not to the method and forum for dispute resolution and (b) the fact that the change in term procedure does not amount to a "knowing waiver" of a jury trial.

Harris v. Green Tree Financial Corp., (3<sup>rd</sup> Cir. No. 97-2029). Home equity loan contract contained a mandatory arbitration clause which the lender sought to invoke upon suit filed by the borrower. The District Court refused to enforce the arbitration clause because it was "one sided" in that it reserved to the lender the right to pursue judicial and nonjudicial remedies such as foreclosure outside the arbitration context. Oral argument in Third Circuit held on September 17, 1998.

Buck Run Baptist Church, Inc. v. Cumberland Surety Ins. Co., Ky., 983 S.W.2d 501 (1998).

Trial court erred in staying arbitration of dispute between owner and surety on performance bond for construction project where surety bond expressly incorporated provisions of owner-contractor agreement containing an arbitration clause.

"Kentucky has favored the enforcement of private arbitration contracts."

"In MYS Corp., this Court observed that there is a significant difference between an adhesion contract in which the parties have disparate bargaining power and a contract which voluntarily has been entered into by sophisticated and knowledgeable businessmen concerning a financial transaction of considerable magnitude. Here, the church had the advice of a professional architect who in fact recommended that it terminate the original construction contract. As noted in MYS Corp., the parties should not be free to repudiate promises to arbitrate."

Hill v. J.J.B. Hilliard, W.L. Lyons, Inc., Ky.App., 945 S.W.2d 948 (1996) (discretionary review denied). Female employee's claims of sexual harassment, retaliation, and violation of equal pay laws were required to be arbitrated pursuant to securities registration form requiring arbitration of claims "arising out of employment". However, claims against supervisor for assault, battery and false imprisonment arising out of alleged rape while on job trip was not within scope of arbitration clause. Similar result for slander counterclaim. "We will not expand the arbitration agreement merely for the sake of efficiency."

Floyd County Board of Education v. EUA Cogenex Corp., 19 F.Supp.2d 735 (E.D.Ky. 1998) (arbitrator's denial of continuance was fundamentally unfair).

Oldroyd v. Elmira Savings Bank, 134 F.3d 72 (2<sup>nd</sup> Cir. 1998). A former bank employee was required to arbitrate a claim that his discharge violated the whistleblower protection provisions of the FIRREA (12 U.S.C. §1831j).

**Q. Set-Off.**

In re: Alexander, 225 B.R. 145 (Bkrtcy.W.D.Ky. 1998) (Roberts, J.). IRS was not entitled to exercise a set-off against tax refund in which Chapter 7 debtor had claimed exemption, in order to reduce a dischargeable prepetition tax debt not secured by a tax lien. Tax refunds which were earned income credit and \$1,000 general exemption applied to protect taxpayer.

**III. PENDING LITIGATION THROUGHOUT THE COUNTRY.**

See attached ABA Report, "Status Of Important Banking Cases" (May 1, 1999) [Exhibit 3].

**IV. DEVELOPMENTS TO WATCH.**

**A. Federal Thrifts Owned By Nonbanks.**

March 16, 1999. "Principal's Virtual Bank Holding Its Own." Principal Financial Group, an insurance company that made a novel and closely scrutinized decision to open a virtual bank through a unitary thrift holding company structure, is already calling the experiment

a success. [Bank Mutual Fund Report, 476 words].

March 19, 1999. "Capital Briefs: Harris of Michigan Seeking Thrift Charter." Harris Financial Group of Troy, Mich., filed an application March 11 for a thrift charter, becoming the 48th nonbank with a request pending before the Office of Thrift Supervision. [American Banker, 135 words].

April 16, 1999. "Nonbanks Facing Long Waits For OTS Charter Approval." The Office of Thrift Supervision is taking roughly 14 months-or more than twice as long as usual-to process all but plain-vanilla charter applications. [American Banker, 654 words].

April 16, 1999. "Wisconsin Banks, Thrifts Push for Universal Charter." Wisconsin bankers are pushing for a bill that would allow state-chartered banks and thrifts-as well as national banks-to share each other's powers. [American Banker, 332 words].

April 23, 1999. "Insurer, Farm Group Get Thrift Charters." The Office of Thrift Supervision granted charters to two nonbanks this week. CNA Financial Corp., the Chicago-based insurer, won permission to convert its California-chartered trust company to a federal thrift. [American Banker, 188 words].

## **B. Internet Bill Paying.**

1. "On-Line Banking: HP Unit's Chief Aims To Be King Of The Hill In Internet Banking." The head of Hewlett-Packard Co.'s financial services division is unequivocal about his goal. "We're fighting to be No. 1 in Internet banking," said Olivier Trancart, general manager of the worldwide unit. [American Banker, April 22, 1999 (599 words)].
2. Fugitte, "The Battle For Retail Bank Customers," Kentucky Banker Magazine (May 1999) (Exhibit 4).

## **V. Something Ironic.**

United States v. Dezarn, 157 F.3d 1042 (6<sup>th</sup> Cir. 1993). Sixth Circuit affirmed the perjury conviction of Adjutant General of Kentucky National Guard who claimed he gave technically accurate, though misleading, answers to questions from Inspector General's office about a fundraising party for former Governor Brereton Jones. Sentence of 15 months incarceration and \$5,000 fine upheld.

**BILL SUMMARY AND STATUS REPORT FOR THE 106<sup>TH</sup> CONGRESS****Finance**

1. H.R.10: A bill to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, and other financial service providers, and for other purposes.

Sponsor: Rep Leach, James A. .- LATEST ACTION: 03/23/99 Reported to House from Committee on Banking and Financial Services, amended, H. Rept. 106-74 (Part 1) .

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2. H.R.833: A bill to amend title 11 of the United States Code, and for other purposes.

Sponsor: Rep Gekas, George W. .- LATEST ACTION: 05/12/99 Placed on calendar in Senate .

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3. S.576: An original bill to provide for improved monetary policy and regulatory reform in financial institution management and activities, to streamline financial regulatory agency actions, to provide for improved consumer credit disclosure, and for other purposes.

Sponsor: Sen Gramm, Phil .- LATEST ACTION: 03/10/99 Placed on calendar in Senate .

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4. S.625: A bill to amend title 11, United States Code, and for other purposes.

Sponsor: Sen Grassley, Charles E. .- LATEST ACTION: 05/11/99 Reported to Senate from the Committee on the Judiciary, amended, S. Rept. 106-49 .

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5. S.900: An original bill to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers, and for other purposes.

Sponsor: Sen Gramm, Phil .- LATEST ACTION: 05/06/99 Measure passed Senate, amended, roll call #105 (54-44) .

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**SUMMARY:**

(AS INTRODUCED)

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- Title I: Facilitating Affiliation Among Securities Firms, Insurance companies, and Depository Institutions
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  - Subtitle C: Subsidiaries of National Banks
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  - Subtitle E: Preservation of FTC Authority
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- Title III: Insurance
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  - Subtitle C: National Association of Registered Agents and Brokers
- Title IV: Unitary Savings and Loan Holding Companies

**Financial Services Act of 1999 - Title I: Facilitating Affiliation Among Securities Firms, Insurance Companies, and Depository Institutions - Subtitle A: Affiliations** - Amends the Banking Act of 1933 (Glass-Steagall Act) to repeal the prohibitions: (1) against affiliation of any Federal Reserve member bank with an entity engaged principally in securities activities (securities affiliate); and (2) against simultaneous service by any officer, director, or employee of a securities firm as an officer, director, or employee of any member bank (interlocking directorates).

(Sec. 102) Amends the Bank Holding Company Act of 1956 (BHCA) to exempt from its prohibition against interests in nonbanking organizations the shares of any company whose activities had been determined by the Board of Governors of the Federal Reserve System (the Board), as of the day before the date of enactment of this Act, to be so closely related to banking as to be a proper incident thereto.

(Sec. 103) Creates a statutory mechanism for the establishment of financial holding companies (FHCs) whose subsidiary depository institutions are well-capitalized and well-managed and meet other specified criteria. Instructs the Board to establish and apply comparable capital standards to a foreign bank with a subsidiary bank or commercial lending company in the United States.

Permits an FHC and a Board-supervised investment bank holding company (BHC) to engage in any activity and acquire the shares of any company whose activities have been determined by the Board to be either financial in nature, or incidental to financial activities. Mandates consultation and coordination, according to specified guidelines, between the Board and the Department of the Treasury regarding determination of whether an activity is financial in nature, or incidental to financial activities.

Includes among such activities any investments, lending, insurance, securities transactions, certain financial operations abroad, and ownership or control of banking interests. Requires an FHC to make assurances that risk management procedures adequately protect insured depository institution subsidiaries, including reasonable measures to preserve separate corporate identity and limited liability. Mandates notification to the Board of certain large business combinations with FHCs or wholesale FHCs.

Cites circumstances under which an FHC (and its foreign counterpart) may engage in nonfinancial activities. Permits FHCs which were not BHCs or foreign banks before becoming FHCs to retain limited non-financial activities and affiliations. Sets forth cross-marketing restrictions for FHC-controlled depository institutions.

(Sec. 104) Preempts State anti-affiliation laws restricting transactions among insured depository institutions, wholesale financial institutions, insurance concerns, and national banks. Cites exceptions to such preemption, especially for State regulation of the business of insurance, including the retention of State capitalization requirements for an insurance entity acquired by another entity, and specified consumer protections. Declares that this Act shall not affect State antitrust and general corporate law. Retains State oversight authority over specified financial activities other than insurance.

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Prohibits State regulation of the insurance activities of an insured depository institution or wholesale financial institution in any way that discriminates adversely between insured depository institutions or wholesale financial institutions and other entities engaged in insurance activities.

(Sec. 105) Requires that mutual bank holding companies be regulated on the same terms as bank holding companies.

(Sec. 106) Amends the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (RNIBBEA) to apply its prohibition against deposit production offices to interstate branches acquired or established under this Act, including all branches of a bank owned by an out-of-State BHC.

(Sec. 107) Amends the Federal Deposit Insurance Act (FDIA) to apply to any branch of a bank controlled by an out-of-State BHC certain requirements for branch closures by an interstate bank.

(Sec. 108) Authorizes well-capitalized and well-managed limited purpose banks to engage in any banking activity. (Maintains the restriction that such banks may accept demand deposits or make commercial loans, but not both.) Prohibits such banks from permitting any overdraft (including intraday overdrafts), or incurring overdrafts in their accounts at a Federal Reserve Bank, on behalf of an affiliate, with certain exceptions. Permits such banks to: (1) issue corporate credit cards; (2) cross market affiliates; and (3) avoid divestiture by correcting violations within six months of receiving notice from the Board.

(Sec. 109) Directs the Federal Trade Commission (FTC) to present interim reports to Congress regarding an ongoing multistage study of consumer privacy issues.

(Sec. 110) Directs the Comptroller General to study and report to Congress on the projected impact that the enactment of this Act will have on financial institutions with total assets of \$100 million or less.

**Subtitle B: Streamlining Supervision of Financial Holding Companies** - Prohibits the Board from imposing any capital or capital adequacy criteria upon a non-depository institution FHC subsidiary that is in compliance with State or Federal capitalization rules, or is registered under the Investment Advisers Act of 1940. Prohibits the Board, in developing capital adequacy requirements, from taking into consideration any affiliated investment company which is not a bank holding company nor controlled by one holding 25 percent or more shares of the investment company worth more than \$1 million.

Authorizes the Board to transfer its BHC oversight authority to the appropriate Federal banking agency if a BHC is not significantly engaged in non-banking activities.

Mandates Board deference to the SEC and relevant State securities and insurance authorities with respect to interpretations and enforcement of activities (functional regulation) within their respective jurisdictions.

(Sec. 112) Provides that a declaration filed by a company seeking to be an FHC shall satisfy BHC registration requirements but not any requirement to file an application to acquire a bank.

Revises BHCA divestiture procedures to permit a BHC to elect divestiture of either a nonbanking

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subsidiary or an insured depository institution.

(Sec. 113) Declares ineffective and non-enforceable any Board actions requiring an insurance company BHC or a registered securities broker-dealer BHC to provide assets to a subsidiary insured depository institution if the State insurance authority, or the SEC, determines in writing that such actions would have a material adverse effect on the BHC's financial condition. Permits the Board to order divestiture of the subsidiary in lieu of other action.

(Sec. 114) Authorizes the Board to restrict relationships or transactions between: (1) a BHC depository institution subsidiary and its affiliates (other than a subsidiary of the institution); and (2) a foreign bank and its U.S. affiliates.

(Sec. 115) Grants the SEC exclusive authority to examine and inspect any non-BHC registered investment company. Prohibits a Federal banking agency from inspecting or examining such a non-BHC company.

Permits the Federal Deposit Insurance Corporation (FDIC) to examine the affiliate of an insured depository institution in order to disclose fully the impact of their relationship upon such institution.

(Sec. 116) Prohibits the Board from taking any action under the BHCA or the FDIA against a BHC-regulated subsidiary unless it is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty by the subsidiary that poses a material risk to the financial safety, soundness or stability of an affiliated depository institution or to the domestic or international payment systems.

(Sec. 117) Declares it is the intent of Congress that the Board and State insurance regulators should: (1) coordinate their respective supervision of companies that control a depository institution and a company engaged in insurance activities; and (2) share relevant information on a confidential basis (including information regarding the financial health of the consolidated organization, and transactions and relationships between insurance companies and affiliated depository institutions). States that Federal banking agencies for depository institutions should also share information with State insurance regulators on a confidential basis regarding transactions and relationships between depository institutions and affiliated companies engaged in insurance activities. Sets forth guidelines for such information exchange and confidentiality.

(Sec. 118) Declares that BHCA restrictions placed upon Board authority over bank holding companies and their nonbank subsidiaries shall also limit the authority of the FDIC with respect to such companies and their nonbank subsidiaries.

(Sec. 119) Amends the FDIA to prohibit the use of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) to benefit any affiliates or subsidiaries of certain insured depository institutions in receivership, in default, or in danger of default, or of any insured depository institution in such circumstances that is acquiring another insured depository institutions.

**Subtitle C: Subsidiaries of National Banks** - Amends Federal law governing national banks to prohibit a subsidiary of a national bank from engaging in any activity, or owning any shares of a company engaged in any activity, that a national bank is not permitted to engage in directly, or that is conducted under terms or conditions other than those that would govern the conduct of the activity by a national bank. Authorizes a national bank to own a subsidiary engaged in activities that are not permissible for a national bank only if a national bank is specifically authorized by the express terms

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of a Federal statute to own or control the subsidiary.

(Sec. 121) Authorizes a national bank, with Comptroller of the Currency approval, to control a company that engages in agency activities determined to be financial in nature or incidental to such activities if: (1) the company engages in such activities solely as agent and not directly or indirectly as principal; and (2) the national bank and all its depository institution affiliates are well-capitalized and well-managed and have achieved a satisfactory or better record of meeting community credit needs under the Community Reinvestment Act of 1977 (CRA) at the institution's most recent examination.

(Sec. 122) Amends Federal criminal law to proscribe misrepresentations regarding depository institution liability for obligations of affiliates.

(Sec. 123) Amends the Federal Reserve Act to repeal: (1) the Board's power to restrict the percentage of individual bank capital and surplus represented by loans secured by stock or bond collateral; and (2) the Board's duty to establish such restrictions with a view to preventing the undue use of bank loans for the speculative carrying of securities.

**Subtitle D: Holding Companies; Wholesale Financial Institutions - Chapter 1: Wholesale Financial Holding Companies -** Sets forth a statutory mechanism for regulation of wholesale financial holding companies that do not control a bank other than a wholesale financial institution (WFI) or specified, limited-purpose institutions. Requires such a company to be a registered bank holding company predominantly engaged in certain financial activities, and in control of one or more WFIs. Specifies the limits of Board examinations of such companies.

Prohibits the Board, in developing capital adequacy requirements, from taking into consideration any affiliated investment company which is not a bank holding company nor controlled by one holding 25 percent or more shares of the investment company worth more than \$1 million.

Specifies the kinds of nonfinancial activities in which Board-supervised companies may engage.

Sets forth guidelines for the treatment of certain nonfinancial investments and affiliations of foreign banks operating within the United States as Board-supervised wholesale financial holding companies.

**Chapter 2: Wholesale Financial Institutions -** Amends the Revised Statutes to permit a national bank to operate as a noninsured national WFI subject to FRA and the regulatory authority of the Comptroller of the Currency. Amends FRA to prescribe procedural guidelines for State bank membership as a noninsured WFI in the Federal Reserve System, subject to FDIA enforcement authority and prompt corrective action requirements. Subjects such institutions to the Community Reinvestment Act of 1977.

Prohibits a WFI from receiving initial deposits of \$100,000 or less except on an incidental and occasional basis. Limits incidental deposits of \$100,000 or less to a maximum five percent of a WFI's total deposits.

Sets forth capital and managerial requirements for certain WFIs controlled by companies under the jurisdiction of either the SEC or the BHCA. Empowers the Comptroller of the Currency (in the case of a national WFI) and the Board to direct a WFI conservator or receiver to file a petition under title II of the Federal bankruptcy code.

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Amends FDIA to prescribe procedures whereby an insured State-chartered bank or a national bank may voluntarily terminate its status as an insured depository institution. Requires any such terminated bank to become a WFI in order to accept any deposits. Subjects a State bank that is a WFI to the Community Reinvestment Act of 1977.

Amends Federal bankruptcy law to prescribe WFI liquidation guidelines.

**Subtitle E: Preservation of FTC Authority** - Amends the BHCA to require the Board to notify the FTC of its approval of a proposed acquisition, merger, or consolidation which involves acquisition of nonbanking interests.

(Sec. 142) Directs certain Federal banking agencies to make data available to the Attorney General and the FTC that they deem necessary for antitrust review under specified statutes.

(Sec. 143) Excludes from FTC jurisdiction any nondepository institution subsidiary or affiliate of a bank or savings association.

Amends the Clayton Act to apply its premerger notification and waiting period requirements to any portion of a merger or acquisition transaction that does require notice under BHCA but does not require approval.

(Sec. 144) Instructs the Comptroller General to report annually to the Congress on market concentration in the financial services industry and its impact on consumers.

**Subtitle F: Applying the Principles of National Treatment and Equality of Competitive Opportunity to Foreign Banks and Foreign Financial Institutions** - Amends the International Banking Act of 1978 (IBA) to terminate the grandfathered authority of a foreign bank or company under the IBA to engage in any financial activity, if it files a BHCA declaration to function as a qualified BHC (QBHC). (Consequently, foreign banks with grandfathered affiliates would be permitted to keep them on the same terms and conditions that govern domestic banking organizations.)

(Sec. 152) Amends the FDIA to allow insured foreign banks and foreign WFIs to terminate deposit insurance voluntarily in the same manner and to the same extent as insured State or national banks.

(Sec. 153) Amends the International Banking Act of 1978 to authorize the Board to examine any affiliate of a foreign bank conducting business in any State in which the Board deems it necessary to determine and enforce compliance with Federal banking law.

**Subtitle G: Federal Home Loan Bank System Modernization** - Federal Home Loan Bank System Modernization Act of 1999 - Amends the Federal Home Loan Bank Act (FHLBA) to expand Federal Home Loan Bank (FHLB) membership parameters to make a Federal savings association's membership in the FHLB system voluntary instead of mandatory. Permits such an association to withdraw its membership (currently such withdrawal is prohibited).

(Sec. 164) Modifies guidelines governing long-term advances to: (1) allow advances to any community financial institution for small businesses, agricultural, rural development, or low-income community development lending; (2) make the cash (as well as the deposits) of an FHLB eligible

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collateral for securing a bank's interest in a loan or advance; and (3) repeal the 30 percent of capital cap on the aggregate amount of outstanding advances secured by real estate related collateral. Includes within the categories of collateral eligible for bank loan secured loans for small business, agriculture, rural development, or low-income community development, or securities representing a whole interest in such secured loans, in the case of any community financial institution. Authorizes an FHLB to renew certain advances on its own determination without concurrence by the Federal Housing Finance Board (FHFB). Requires an FHLB member with an advance secured by insufficient eligible collateral to reduce its level of outstanding advances according to a schedule determined by the FHLB (currently, by the FHF Board). Authorizes such Board to: (1) review the collateral standards applicable to each Federal home loan bank for designated classes of collateral; and (2) require an increase in such standards for safety and soundness purposes.

(Sec. 165) Revises eligibility criteria to permit certain community financial institutions to gain FHLB membership regardless of the percentage of total assets represented by residential mortgage loans.

(Sec. 166) Amends the FHLBA to increase from two years to four years the term of an elective director of a Federal home loan bank. Repeals the mandates for: (1) a procedure for informal review of certain supervisory decisions; and (2) the Housing Opportunity Hotline program.

Repeals: (1) the prohibition against an FHLB's acquisition of a bank building by purchase or over ten-year lease; (2) the requirement for FHFB approval of personnel decisions as well as the exercise of corporate powers by any FHLB; and (2) authorization for an FHLB president to be a member of the FHLB board.

Grants the FHFB power to: (1) issue charges upon an FHLB or any executive officer or director for violation of law or regulation in connection with the granting of any application or other request by the bank, or any written agreement between the bank and the FHFB, and take affirmative action to correct conditions resulting from violations or practices, or to limit FHLB activities; (2) address insufficiencies in capital levels resulting from automatic membership of a Federal savings association in the local FHLB; and (3) sue and be sued.

Repeals FHFB jurisdiction to approve the granting by an FHLB of a member's application to secure an advance.

Expands the mandate of FHLB Affordable Housing Programs to include providing subsidies (in addition to subsidized interest rates) on advances for member lending for low- and moderate-income housing.

Authorizes each FHLB board of directors to approve member requests for Affordable Housing Program subsidies.

Revises guidelines governing reserves and dividends to permit dividend payments out of previously retained earnings or current net earnings (currently, only out of net earnings). Repeals the requirement for: (1) FHFB approval for such dividend payments; and (2) investment of FHLB reserves exclusively in U.S. obligations or certain other Federal Government-related securities.

(Sec. 167) States that FHLB payments to the Resolution Funding Corporation to cover interest payments on obligations shall be a specified percentage of net earnings (currently an aggregate sum certain).

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**Subtitle H: Direct Activities of Banks** - Amends Federal banking law to provide that limitations placed on securities transactions by a national banking association for its own account do not apply to State, local, or municipal bond transactions by a well-capitalized national banking association.

**Subtitle I: Deposit Insurance Funds** - Directs the Board of Directors of the Federal Deposit Insurance Corporation to study and report to Congress on specified issues regarding the BIF and the SAIF, including their safety and soundness, and the adequacy of their reserve requirements in light of mergers and consolidations within the industry.

(Sec. 187) Amends the FDIA and the Deposit Insurance Funds Act of 1996 to eliminate the Special Reserve of the Savings Association Insurance Fund (SAIF), and the Deposit Insurance Fund (DIF), respectively (established to provide emergency funds if the reserve ratio of either fund remains below 50 percent of its designated ratio for one year).

**Subtitle J: Effective Date of Title** - Sets forth the effective date of title I of this Act.

**Title II: Functional Regulation - Subtitle A: Brokers and Dealers** - Amends the Securities Exchange Act of 1934 (Exchange Act) to include certain bank activities within the definition of "broker" and "dealer" (thus subjecting them to registration requirements and regulation under the Exchange Act).

(Sec. 203) Requires a registered securities association to create a limited qualification category, without a testing requirement, for certain bank employees effecting sales as part of a non-public primary securities offering (private placement sales).

(Sec. 204) Amends the FDIA to direct the appropriate Federal banking agencies to: (1) promulgate regulations and complaint procedures applicable to retail transactions, solicitations, advertising, or offers of any security by any insured depository institution or affiliate other than a registered broker or dealer; (2) jointly establish a grievance process for customer complaints against banks or bank employees arising in connection with securities sales or purchases; and (3) establish recordkeeping requirements for banks relying on exceptions and exemptions from the definitions of broker and dealer under the Exchange Act.

(Sec. 206) Defines traditional banking product. Amends the Securities Exchange Act of 1934 to authorize the SEC to determine by regulation that a bank that effects transaction in, or buys or sells, a new product should be subject to certain registration requirements. Sets forth procedural guidelines for the filing of a petition for judicial review by the Board of Governors of the Federal Reserve System or any aggrieved party.

(Sec. 207) Amends the Securities Exchange Act of 1934 to define: (1) derivative instrument so as to exclude a traditional banking product; (2) qualified investor; and (3) government security, so as to include a qualified Canadian government obligation.

**Subtitle B: Bank Investment Company Activities** - Amends the Investment Company Act of 1940 to authorize the SEC to prescribe conditions under which a bank or its affiliate serving as promoter, organizer, or principal underwriter for a registered management company or a registered unit investment trust may also serve as custodian of such company or trust. Permits the SEC to bring a civil action against a custodian for a registered investment company for breach of fiduciary duty



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involving personal misconduct.

(Sec. 212) Declares it is unlawful for an affiliate, promoter, or principal underwriter for a registered investment company to lend to it or its subsidiaries in contravention of SEC prescriptions.

(Sec. 213) Modifies the definition of "interested person" to identify transactions, services, and loans taking place during the six months preceding determination of an interested person which would make a person an affiliated person of a broker or dealer.

Prohibits a registered investment company from having a majority of its board of directors consisting of personnel or senior officers of the subsidiaries of any one bank, or of any single BHC, its affiliates and subsidiaries.

(Sec. 214) Modifies guidelines pertaining to unlawful misrepresentation of guarantees and the deceptive use of names.

(Sec. 215) Modifies the definition of "broker" to exclude any person who would be deemed a broker solely by reason of the fact that such person is an underwriter for one or more investment companies.

(Sec. 216) Modifies the definition of "dealer" to exclude an insurance or an investment company.

(Sec. 217) Amends the Investment Advisers Act of 1940 to modify the definition of investment adviser to remove the exclusion for banks that advise investment companies. Revises the definitions of broker and DEALER.

(Sec. 220) Mandates interagency sharing between the appropriate Federal banking agency and the SEC of examination results and other information pertaining to the investment advisory activities of a registered BHC and its separately identifiable departments or divisions.

(Sec. 221) Amends the Securities Act of 1933 and the Securities Exchange Act of 1934 to revise the exclusion from their purview of certain bank common trust funds to specify the exclusion of any interest or participation in any common trust fund or similar fund that is excluded from the definition of "investment company" under the Investment Company Act of 1940. Amends the Investment Company Act of 1940 to revise such exclusion guidelines for certain bank common trust funds.

(Sec. 222) Amends the Investment Company Act of 1940 to prescribe circumstances under which an investment adviser holding shares of an investment company in a fiduciary capacity must transfer the power to vote such shares to the beneficial owners or to another non-affiliated fiduciary.

**Subtitle C: SEC Supervision of Investment Bank Holding Companies - Amends the Securities Exchange Act of 1934 to permit certain investment bank holding companies that do not have a bank or savings association affiliate to elect SEC supervision.**

(Sec. 231) Provides for voluntary withdrawal from SEC supervision by specified investment bank holding companies. Sets forth the parameters of SEC supervision of investment bank holding companies, including authority to set capital adequacy standards. Instructs the SEC, in developing its rules, to consider use of debt and other liabilities (double leverage) by the supervised investment BHC in order to fund capital investments in affiliates.

## Bill Summary & Status

Prohibits the SEC from imposing capital adequacy requirements on regulated nonbanking entities (other than a broker or a dealer) that are in compliance with the capital requirements of another Federal regulatory body or State insurance authority.

Mandates SEC deference to appropriate regulatory banking agencies and State insurance regulators with respect to the banking and insurance laws under their purviews.

Grants the SEC backup inspection authority for certain wholesale financial holding companies for monitoring and compliance enforcement purposes.

**Subtitle D: Studies** - Directs the Comptroller General to report to Congress on the efficacy, costs, and benefits of requiring a federally-insured depository institution to disclose to its retail consumers through the use of a logo or seal that its investment or insurance products are not FDIC-insured.

(Sec. 242) Directs the Comptroller General to report to Congress regarding the efficacy and benefits of uniformly limiting commissions and costs incurred by customers in the acquisition of financial products.

• **Title III: Insurance - Subtitle A: State Regulation of Insurance** - Declares that the McCarran-Ferguson Act remains the law of the United States.

(Sec. 302) Mandates: (1) State licensure of any entity providing insurance in a State as principal or agent; and (2) State functional regulation of insurance sales activity.

(Sec. 304) Prohibits a national bank and its subsidiaries from providing insurance as principal in a State, except for certain authorized products (which may not include title insurance or taxable annuity contracts).

(Sec. 305) Prohibits national banks and subsidiaries from selling or underwriting title insurance, except for certain grandfathered banks and subsidiaries already doing so.

(Sec. 306) Establishes expedited dispute resolution for regulatory conflicts between State insurance regulators and Federal financial regulators.

(Sec. 307) Requires each Federal banking agency to: (1) issue consumer protection regulations (including physical segregation of banking activities from insurance product activities); and (2) prohibit discrimination against victims of domestic violence.

Expresses the sense of Congress that the States should adopt regulations prohibiting such discrimination regarding insurance products that are at least as strict as those under this Act.

Mandates that the Federal banking agencies jointly establish a consumer complaint mechanism to address violations of this Act expeditiously.

(Sec. 308) Preempts State law restricting: (1) insurance companies or insurance affiliates from becoming a financial holding company or acquiring control of a bank; and (2) the amount of an insurer's assets that can be invested in a bank (except that the insurer's State of domicile may limit such investments to five percent (or any higher threshold) of the insurer's admitted assets). Preempts State laws that restrict reorganization by an insurer from mutual form to stock form.

## Bill Summary & Status

**Subtitle B: Redomestication of Mutual Insurers** - Applies this title only to a mutual insurance company in a State which has not enacted a law expressly establishing reasonable terms for a mutual insurance company domiciliary to reorganize into a mutual holding company.

(Sec. 312) Authorizes a mutual insurer organized under the laws of any State to transfer its domicile to another State pursuant to a reorganization in which such insurer becomes a stock insurer that is a subsidiary of a mutual holding company. Requires prospective redomesticating insurers to comply with specified reorganization requirements of the State insurance regulator of the transferee domicile. Preempts State laws restricting such redomestication.

• **Subtitle B: National Association of Registered Agents and Brokers** - Sets forth a regulatory framework for uniform multistate licensing for insurance sales practices, to take effect only if a majority of the States have not enacted uniform laws and regulations governing the licensure of insurance sales by individuals and entities within three years after enactment of this Act.

(Sec. 322) Establishes the National Association of Registered Agents and Brokers (the Association) as a non-profit, non-Federal agency, to provide a mechanism for uniform licensing, appointment, continuing education, and other insurance producer sales qualification requirements which can be adopted and applied on a multistate basis, while preserving the right of States to regulate insurance producers and insurance-related consumer protection and unfair trade practices.

(Sec. 324) Subjects the Association (which shall not be considered a Federal agency or instrumentality) to regulation by the National Association of Insurance Commissioners. Requires the Association to establish an office of consumer complaints. Vests management of the Association in a board of directors. Cites circumstances under which Association rules preempt State regulation of insurance producers. Requires the Association to coordinate with the National Association of Securities Dealers in order to mitigate administrative burdens that may result from dual membership.

**Title IV: Unitary Savings and Loan Holding Companies** - Amends the Home Owners' Loan Act to prohibit new affiliations between savings and loan holding companies and certain commercial firms, except in specified circumstances.

(Sec. 402) Amends specified Federal law to declare that any depository institution the charter of which is converted from that of a Federal savings association to a national bank or a State bank after enactment of this Act may retain the term "Federal" in its name so long as it remains an insured depository institution.

**S.900 (Major Legislation)**  
**SPONSOR: Sen Gramm, Phil (introduced 04/28/99)**

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**SUMMARY:**

(AS INTRODUCED)

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- **Title I: Facilitating Affiliation Among Banks, Securities Firms, and Insurance Companies**
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- **Subtitle D: National Treatment of Foreign Financial Institutions**
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- **Title III: Regulatory Improvements**
- **Title IV: Federal Home Loan Bank System Modernization**
- **Title V: Functional Regulation of Brokers and Dealers**
- **Title VI: Unitary Savings and Loan Holding Companies**

Digest will follow.

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**DRAFT REGULATIONS CONCERNING THE REPORTING AND ACCOUNTING  
BY ESCHEAT HOLDERS OF INTEREST BEARING PROPERTY**

*PROPOSED KENTUCKY ADMINISTRATIVE REGULATIONS 20 KAR 1:080, and 20 KAR 1:090*

General Government Cabinet

Kentucky State Treasurer

(New Administrative Regulation)

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

RELATES TO: KRS 393.110

STATUTORY AUTHORITY: KRS 393.280, 393.110

NECESSITY, FUNCTION, AND CONFORMITY: KRS 393.110 mandates that the holder of unclaimed property annually makes certain reports to the State Treasurer concerning such property. This administrative regulation governs those reports, directing what must be included in the report and the filing of the report.

Section 1. Reports filed by all holders of unclaimed property that are not financial organizations.

All holders of any unclaimed property that are not financial organizations or banking organizations shall annually file with the Kentucky State Treasurer a report on such property. This report shall be made on Form 400A and shall be filed in the main office of the State Treasurer no later than the close of business on November first of each year.

Section 2. Remittance of unclaimed property.

All holders of unclaimed property that is not property held in an interest-bearing demand, savings, or time deposit, shall annually turn over to the State Treasurer such property. The property shall be turned over to the State Treasurer by the close of business on the first day of November at the main office of the State Treasurer. If it is not feasible to turn such property over to the State Treasurer at the main office, the holder of such property shall contact the State Treasurer prior to November first and make other arrangements for the remittance of the property.

Section 3. Holders of unclaimed property that are financial organizations or banking organizations.

All holders of unclaimed property that are financial organizations or banking organizations shall annually file with the State Treasurer a report on such property. The report shall be made on Form 400B. The report shall be filed at the main office of the State Treasurer no later than the close of business, November first each year.

Section 4. Reports on property held in interest bearing account.

When the holder of unclaimed property is required to place that property in an interest bearing account, the holder shall submit to the State Treasurer the following reports:

1.) Statements on the interest-bearing account holding unclaimed property. Such statements shall be the kind normally issued on interest-bearing accounts and shall be filed with the office of State Treasurer according to the holder's normal course of business but no less than quarterly. The statements shall include the value of the unclaimed property and the amount of interest paid on the account. The statements shall be filed at the main office of the State Treasurer.

2.) Reports on any amount paid out of an account holding unclaimed property. A report shall be filed within ten business days by any holder paying any amount out of such account. The report shall include the name, social security number and the address of the property owner, the amount paid, the portion of the amount that represents interest paid and the portion that represents the original amount of unclaimed property, the date that the property was presumed abandoned, if not paid to the owner to whom the amount was paid, proof of payment, an itemization of any fees or expenses charged against the account and an affidavit indicating:

(1) what specific proof was used in determining that the person that received the amount/payment was the rightful claimant, and

(2) that the procedures for paying a claim for unclaimed property as outlined in 20 KAR 1:040 were followed.

This report shall be filed at the main office of the State Treasurer.

Section 5. Incorporation by Reference.

(1) The following are incorporated by reference:

(a) Form 400A , "1998 Unclaimed Property Report/Remit Form" (Non Financial Institutions) 1998;

(b) Form 400B, "1998 Unclaimed Property Report/Remit Form" (Financial Institutions) 1998;

(2) These forms may be inspected, copied or obtained at the Kentucky State Treasurer, Capitol Annex, Room 183, Frankfort, Kentucky, 40601, Monday through Friday from 8:00 a.m. through 4:00 p.m., e.s.t.



General Government Cabinet

Kentucky State Treasurer

(New Administrative Regulation)

20 KAR 1:090. Accounts for unclaimed property that was held in an interest-bearing demand, savings or time deposit.

RELATES TO: KRS 393.130

STATUTORY AUTHORITY: KRS 393.110, 393.130 and 393.280

NECESSITY, FUNCTION, AND CONFORMITY: KRS 393.130 mandates that the holder of unclaimed property that is held in an interest-bearing demand, savings, or time deposit shall place such property in an interest-bearing account assignable to the Department. This administrative regulation governs those accounts.

Section 1. All holders of unclaimed property which is held in an interest-bearing demand, savings or time deposit account shall, from the time it is presumed abandoned, place such property in an interest-bearing account made assignable to the Department. A separate account shall be created for each reporting year. The account shall indicate in its title the reporting year relating to the property included in the account. The account shall yield the a weighted average rate of interest based the interest rates of the presumptively abandoned accounts held by the financial institution. The weighted average interest rate shall be calculated by multiplying the dollar value held in each account by the contractual interest rate for the account, adding the product for all presumptively abandoned accounts held by the financial institution together, and dividing the total by the total dollar value of those accounts. This average interest rate shall be paid on all accounts that are

assignable to the Department, and shall be calculated by the financial institution annually and reported to the Department. However, in the event that the owner of the unclaimed property claims the account, he shall receive the contractual rate of interest.

Section 2. Interest-bearing accounts holding presumptively abandoned property previously held in an interest-bearing demand, savings or time deposit interest-bearing account shall be automatically remitted to the Department after the expiration of ten years from the date that the account was opened, if the property has not been paid to a rightful claimant. The account shall be remitted to the Department along with any accumulated interest on the account.



**STATUS OF IMPORTANT BANKING CASES**

*The American Bankers Association, May 1, 1999*



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**STATUS OF IMPORTANT BANKING CASES**

May 1, 1999

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**NEW THIS MONTH:**

- \* 11th Circuit allows insurance commissioner to bar Retirement CD (§ 23)
- \* Oklahoma Supreme Court disallows branching by creation of interim banks (§ 7)
- \* Court issues preliminary injunction against Connecticut ATM fee ban. (§ 8)
- \* Amended complaint, defense motions filed in common bond case. (§ 16)
- \* Indenture trustee wins summary judgment in letter of credit case. (§ 31)

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

## ANTITRUST

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

## ARBITRATION

2. Harris v. Green Tree Financial Corp. (3d Cir. No. 97-2029). Home equity loan contract contained a mandatory arbitration clause which the lender sought to invoke upon suit filed by the borrower. District Court refused to enforce the arbitration agreement because it was "one-sided" in that it reserved to the lender the right to pursue judicial and nonjudicial remedies such as foreclosure outside the arbitration context. The lender appealed. On April 21, 1998, ABA and two co-sponsors filed amici brief supporting the lender, arguing that remedies such as foreclosure were reserved to the courts and could not be submitted to arbitration; there is no requirement of "mutuality" so long as a contract as a whole is supported by consideration; and the Federal Arbitration Act (which occupies the field) requires no such thing in any event. Oral argument was held September 17, 1998.

3. Badie v. Bank of America (Cal.App. 1, No. A068753). Provision of credit card contract reserved to the bank the right to alter terms, conditions, services and features of account upon notice to the consumer. Pursuant to that provision, the bank added a mandatory arbitration clause to its customers' contracts, advising them of same by means of a "statement stuffer." Consumers sued to enjoin implementation of the provision. On November 3, 1998, appeals court ruled in favor of consumers. A bank may reserve the right to alter terms and conditions of a contract, within limits, but here the addition of an arbitration clause was not an alteration of "terms and conditions." "Terms and conditions" set forth in the original contract dealt with interest rates, fees, charges, grace periods and the like—matters integral to the bank/creditor relationship—but they did not deal at all with the method and forum for dispute resolution, a matter collateral to the relationship. While parties may agree to arbitrate disputes, the court holds, it could not have been within the reasonable contemplation of the consumers here that they were agreeing to some future unspecified waiver of their rights to a trial by judge or jury. Bank of America filed a petition for review in the California Supreme Court. On January 4, ABA and four co-sponsors filed a "letter brief" as amici in support of that petition. The California Supreme Court denied review on February 24.

## BANKRUPTCY

4. Bank of America v. 203 N. LaSalle Street Partnership (S. Ct. No. 97-1418). On September 29, 1997, Seventh Circuit held that the "new value" exception to the absolute priority rule in bankruptcy, created by the Supreme Court in 1939, survived the subsequent enactment of the Bankruptcy Code (126 F.3d. 955). On February 19, 1998, the Second Circuit reached exactly

the opposite conclusion in Coltex Loop Central Three Partners (No. 96-5140). It is an issue that has divided the lower courts so much so that the Supreme Court granted certiorari in 1994 in In Re Bonner Mall Partnership, 2 F.3d 899 (9<sup>th</sup> Cir. 1993), in order to resolve the conflict. That case was, however, dismissed as moot when it settled. Cert. petition filed in LaSalle February 23, 1998; ABA and California Bankers supporting amici brief on April 1. Court granted certiorari May 4; Petitioner brief and supporting amici brief of ABA and California Bankers filed June 26. Oral argument held November 2.

### BRANCH BANKING

5. McQueen v. Ludwig (6<sup>th</sup> Cir. No. 97-2005). On February 26, 1996, the Commissioner of Financial Institutions of Michigan filed suit against the Comptroller of the Currency in federal district court to set aside the conversion of KeyCorp-owned Society Bank of Ann Arbor, Michigan to a national bank, the two-step relocation of its headquarters to Angola, Indiana, and its merger with Society National Bank of South Bend, thereby creating Michigan branches of an Indiana bank. On September 2, 1997, court granted summary judgment to the Comptroller, holding that the applicable statutes did not specifically address the precise questions raised by the litigation and that, therefore, the court had to defer to reasonable interpretations of those statutes by the Comptroller. (W.D. Mich. No. 5:96-CV-36). Commissioner appealed. Oral argument held September 22, 1998.

6. Bank One Utah v. Guttau. (8th Cir. No. 98-3166). National bank headquartered in Utah, with no branches in Iowa nevertheless installed ATMs in Sears stores in Iowa. State law prohibits the establishment of a "satellite terminal" in Iowa except by financial institutions with a business location in the state. Bank One challenged the restrictions alleging that federal law preempted this provision of the Iowa Code and alternatively that the state statute was unconstitutional as applied because it unduly burdened interstate commerce and denied equal protection of the laws to out-of-state businesses in favor of local ones. On July 24, 1998, in the course of denying a preliminary injunction, the District Court rejected each of those (and several related) arguments (S.D. Ia. No. 4-98-CV-10247). Case was argued on January 12 in the Eighth Circuit.

\* 7. Community Bankers Association v. Oklahoma State Banking Board (S. Ct. Okla. No. 91,465). Oklahoma remains a "limited" branching state, allowing only one de novo branch per bank, and even that must be in the bank's home town or in a town not more than 25 miles away that does not already have a bank. The exception to this general rule is that a bank may acquire pre-existing banks (or thrifts) and continue to operate them as branches without numerical or geographic limits. Armstrong Bankshares received approval from the Board under this exception to create an "interim" bank more than 25 miles away from its pre-existing subsidiary bank, in an already "banked" town, to have the original bank immediately "acquire" the interim bank, merge it into the original bank and operate it as a branch of the original bank. On March 30, 1999, the state Supreme Court overruled the Board, holding that the transaction was a sham and that the reality was that the holding company and its subsidiary were effectively creating a de novo branch in violation of the branching laws.

## CONSUMER PROTECTION

\* 8. Fleet Bank v. Burke (S. Ct. No. 98-1661) Connecticut law explicitly recognizes an interchange fee that may be imposed for ATM transactions. Connecticut Banking Commissioner concluded that there was a negative inference to be drawn from that, namely that other ATM fees could not be charged. Fleet sued to overturn that determination, and on September 30, 1998, U.S. District Court in Connecticut held that state law did allow bank to charge a fee to nondepositors who used Fleet ATMs (Fleet Bank v. Burke, D. Conn. No. 3:97cv133 (JBA)). Commissioner appealed. On November 9, Second Circuit vacated and remanded district court decision with instructions to dismiss the complaint, holding that "federal question jurisdiction is lacking because the lawsuit is primarily an attempt to have a federal court construe a state regulatory statute." (160 F.3d 883). Petition for Writ of Certiorari filed April 14, 1999. In the companion case in state court, on November 24, a judge refused to grant a temporary injunction against the Commissioner's cease and desist order that he had issued to the banks on November 10 (Fleet Bank v. Burke, Conn. Super. Ct. No. CV 98-0584565). However, on remand of the federal case, the Comptroller of the Currency intervened, asserting that he had sole jurisdiction to enforce laws, even state laws, applied to national banks, to the exclusion of the State Banking Commissioner here. On April 7, 1999, federal district court granted a preliminary injunction, concluding that the intervenor was likely to succeed on the merits of that claim.

\* 9. Riviere v. Banner Chevrolet (5th Cir. No. 97-31226). Truth in Lending Act authorizes private actions by consumers against "creditors." On November 4, 1998, court held that auto dealer who assigned buyers' loan to GMAC was not a creditor, but a mere "credit arranger" and, consequently, was not subject to suit for disclosure violations (158 F.3d 335). Consumer filed petition for rehearing and rehearing en banc. On November 24, four bank trade associations, including ABA, filed amici brief supporting consumer. Obviously, if the auto dealer is not the "creditor" then the purchaser of the loan is. The amici brief contends that the court applied statute and precedent from a time prior to enactment of the Truth in Lending Simplification Act and that the Act had legislatively reversed all of that. Almost simultaneously with the Fifth Circuit panel decision, a panel of the Eleventh Circuit held, on November 13, that the assignee of a similar dealer-originated auto loan was not liable for any Truth in Lending disclosure violations that were not apparent on the face of the disclosure document. (Ellis v. GMAC (11th Cir. No. 97-6963)). On January 27, the Fifth Circuit granted a panel rehearing in Riviere (166 F.3d 727). Oral argument is to be held the week of May 3.

10. Culpepper v. Inland Mortgage Co. (11<sup>th</sup> Cir. No. 97-6109) Section 2607 of RESPA permits payments to a settlement service provider for services actually performed, but prohibits the payment of fees or "kickbacks" solely to compensate one for a referral. This is one of a growing list of cases in which mortgage brokers were compensated, from the proceeds of settlements, by means of a "yield spread premium," i.e., the amount of compensation was dependent upon the rate of interest negotiated with the borrower above the "par" rate established by the lender, and in which plaintiffs maintain that such an arrangement is an unlawful kickback.

The District court held that the yield spread premium constituted lawful compensation for actual services provided (953 F. Supp. 367, N.D. Ala. Jan. 31, 1997). That decision was reversed by the Eleventh Circuit on January 9, 1998. The court held that the yield spread premium was a "referral fee" and not a payment for goods or services. The court also vacated the District Court's order in which a motion for class certification was declined since summary judgment was being granted to the defendants. The District Court is instructed to rule upon the class certification motion *ab initio* (132 F.3d 692).

On June 22, 1998, the court "denied" a petition for rehearing and rehearing en banc. It took the opportunity, however, to "address several concerns" raised in the petition. It held that yield spread premiums *can* be lawful in certain circumstances, that the panel's original opinion was "highly dependent upon the facts in the *current* record about *this...transaction*." It left open the possibility that Inland could prove facts at trial that were not before the District Court at the summary judgment stage (144 F.3d 717).

A similar case, in the Southern District of Florida, Gibson v. Imperial Credit, was dismissed February 25, 1997, on statute of limitations grounds. See also Mack v. GMAC (M.D. Ala. No. 95-T-1000-N) 1996 U.S. Dist. LEXIS 20319. A plaintiff motion for summary judgment was denied on June 19, 1997, and a motion to certify a class was denied on July 2 in Moniz v. Crossland Mortgage Corp. (D. Mass. No. 12260-WGY); a motion to certify a class was also denied in Briggs v. Countrywide Funding Corp. (M. D. Ala. No. 95-D-859-N) (but see: DuBose v. First Security Savings Bank (M.D. Ala., 1997 WL 4676600). Summary judgment was granted to the lender on September 5, 1997, in McWhorter v. Ford Consumer Finance Co. (N.D. Ga. No. 96-CV-0572-JOF).

Similar cases include Ryan v. National Mortgage Corp. (D. Mass. No. 97-10014 NG), Potchin v. Prudential Home Mortgage (E.D.N.Y. No. 97-524), Marinaccio v. Barnett Banks (S.D.N.Y. No. 97-00762)(court refused to certify a class in late October 1997), Taylor v. Flagstar Bank (M.D. Ala. No. 98-A-50-N)(7/21/98)(same), Chandler and Wagner v. Washtenaw Mortgage Co. (M.D. Ala. No. 94-A-1418-N)(7/29/98)(same), Schmitz v. Aegis Mortgage Corp. (D. Minn. No. 97-2142 (8/3/98)(same), Allen v. Fleet Mortgage Corp. (E.D.N.Y. No. 97-0065 MJL) and Conomos v. Chase Manhattan (S.D.N.Y. No. 97-0909)(motion for class certification denied March 17, 1998; yield spread premiums are not *per se* violations of RESPA). But see Mulligan v. Choice Mortgage Corp. (D. N.H., Civil No. 96-596-B, August 11, 1998)(class certified.); Brancheau v. Residential Mortgage Group (D. Minn. No. 97-00053 JRT) (9/4/98)(same).

On October 21, 1998, Congress enacted, as part of the HUD/Veterans Administration Appropriation Act, a requirement that HUD promulgate a clear position on the legality of mortgage broker fees within 90 days. On March 1, 1999 HUD published its final rule in the Federal Register (64 Fed.Reg. 10,080). It should have a still-to-be-determined, but nevertheless meaningful impact upon the outcome of this class of cases.



11. Stefiuk v. First Union National Bank of Florida (S.D. Fla. No. 98-1377). Noncustomer of a bank attempted to cash checks drawn on the bank. The bank, as a condition of doing so, imposed a one dollar fee upon the noncustomer. Plaintiff filed suit as a putative class action on June 15, 1998, alleging unjust enrichment and wrongful dishonor in violation of state law, and seeks federal court jurisdiction by claiming an illegal "tying" in violation of the Bank Holding Company Act, in that the bank will waive the fee if and only if the noncustomer becomes a customer by subscribing to one of several other enumerated services offered by the bank. On August 27, bank filed motion for judgment on the pleadings, pointing out that there is a specific exclusion in the Bank Holding Company Act for "tying" to deposit accounts, that a payee of a check has no standing to sue over "wrongful dishonor" (only the account owner does), and that any "enrichment" of the bank is not "unjust" because it is entirely legal to charge a fee for services provided.

12. Heller v. First Town Mortgage Corp. (S.D.N.Y. No. 97 CIV 8575 JSM). Section 10(a) of RESPA establishes the federal formula for calculating the maximum amount that a mortgage company may require to be kept in escrow for taxes and insurance. Three U.S. Courts of Appeals and numerous federal district courts have held that there is no private right of action to enforce Section 10(a). A 1980 Sixth Circuit decision, however, reaches the opposite conclusion, and on September 11, 1998, the court in this case adopted the minority view in allowing a borrower's suit to proceed over a claimed excess escrow requirement.

13. Patterson v. NationsBank (20th Jud. Cir. St. Clair County IL No. 97L665B). This class action lawsuit challenges alleged practice of bank in ordering the payment of checks presented from largest to smallest. Where there are insufficient funds to honor all checks presented on any given day, this practice is said to maximize the bank's receipt of overdraft fees. Plaintiff class contends that the practice violates state Consumer Fraud Act, is a breach of contract and a breach of the duty of good faith and fair dealing. In late summer, 1998, court denied motion to dismiss and the bank has sought an interlocutory appeal to the Illinois Court of Appeals. Shortly after the court's refusal to dismiss the case, a second class action was filed in the same court. (Kennedy v. Magna Bank (20th Jud. Cir., St. Clair County IL, No. 98L806A). A similar case in California was withdrawn when it became apparent that the bank was not actually ordering presented checks in the manner alleged (Sturm v. Wells Fargo). A state court in Kentucky dismissed a similar case for failure to state a claim upon which relief could be granted (Stephens v. PNC Bank of Kentucky, No. 98-CI-04051, Jefferson Cir.Ct., Div. 12). A Tennessee appeals court has held that banks may process checks in any order they choose. Smith v. First Union, 958 S.W.2d 113 (Tenn.App. 1997) Other such cases now in progress include Kalifeh v. AmSouth, No. CV-98-2022 (Cir. Ct. Mobile County, AL), Rago v. Compass Bank, No. 98-2384 (Cir. Ct. Mobile County, AL) and Shelley v. AmSouth, No. 97-1170-RV (S.D. Ala.).

14. First Massachusetts Bank v. Marengo (Worcester District Ct. [Mass.] No. 9862 CV 409). After borrower became delinquent in making payments on unsecured line of credit, bank collected a portion of the debt by offset against the borrower's checking account and sued for the balance. The borrower has counterclaimed that the offset was unlawful in that the only

money in the checking account was the borrower's Social Security and Supplemental Security Income benefits. Federal law, 42 U.S.C. § 407(a), provides that no such benefits "shall be subject to execution, levy, attachment, garnishment or other legal process." In a similar case, the Texas First District Court of Appeals held that offset was a self-help remedy, did not fit within the statutory language of "execution, levy," etc., and was not, therefore, unlawful. (Derryberry v. NationsBank of Texas, No. 01-95-01438-CV [March 5, 1998] (unpublished)). The U.S. Supreme Court denied certiorari January 25, 1999. (No.98-842). Other lower courts are split on the matter: Tom v. First American Credit Union, 151 F.3d 1289 (10th Cir. 1998) and Crawford v. Gould, 56 F.3d 1162 (9th Cir. 1995) disagree with the Texas court; Frazier v. Marine Midland, 702 F. Supp. 1000 (W.D.N.Y. 1988) and In re Gillespie, 41 B.R. 810 (Bankr. D. Colo. 1984) both come out on the other side.

### CREDIT UNIONS

15. National Association of State Credit Union Supervisors v. NCUA (4th Cir. No. 95-2905). In November, 1994, NCUA adopted a final rule designed to limit the influence of credit union trade associations on "corporate" credit unions, i.e., credit unions whose members are other credit unions. Corporate credit unions exist primarily to provide investment and liquidity services to their member credit unions. The rules provide that a majority of a corporate's directors may not serve as officers, directors or employees of a credit union trade association or an affiliate thereof. The rule applies not only to federally chartered, but also federally insured/state chartered corporate credit unions. On February 3, 1995, credit union trade association filed suit claiming violations of the Administrative Procedure Act in that the adoption of the rule was arbitrary and capricious and in excess of the agency's statutory authority. On February 28, the trade association for state credit union supervisors filed a companion case as well. On September 25, 1995, court ruled in favor of NCUA holding that the issuance of the rules in question was well within the statutory authority of the agency. NASCUS filed notice of appeal on October 25, 1995; CUNA did not appeal. Oral argument held October 30, 1996 (sic).

\* 16. American Bankers Association v. National Credit Union Administration (D.D.C. No. 99-42). On January 8, ABA filed suit to enjoin implementation of NCUA's new "field of membership" rules, alleging that in numerous respects the rule exceeds the limits on membership that Congress left in the law when it amended the Federal Credit Union Act last August. In addition, the agency ordered most of the new regulation into effect two days after publication, whereas the Administrative Procedure Act requires a 30-day delay. Plaintiff has sought a preliminary injunction as to those parts put immediately into effect, but even so the agency approved over 60 additions to credit union fields of membership under the authority of the new rule on the first business day it was in effect and over 170 in the first week. The complaint also challenged the legitimacy of those portions of the rule that went into effect in March, but did not, on grounds of ripeness, seek a preliminary injunction on those portions. CUNA and NAFCU filed petitions to intervene on January 12, IBAA did so as well on January 15. On March 4, a small upstate New York federal credit union intervened in the case as a plaintiff, complaining of illegal competitive injury to the credit union as a result of NCUA's bias in favor of ever-larger

FCUs. On March 10, court denied a motion for a preliminary injunction. With respect to most of the issues raised by the motion, the court found an insufficient likelihood of success on the merits; with respect to the one issue upon which there was a great likelihood of success, the motion was denied on the grounds of failure to show irreparable injury. ABA filed amended complaint on April 1 asserting specific instances where agency implementation of its rules violated the statute. NCUA and intervening trade associations filed motions for partial summary judgment on April 15. ABA response to those motions is due May 31.

17. Metropolitan Service Federal Credit Union v. National Credit Union Administration (E.D. Pa. No. 96-CV-7855). South Philadelphia military facility with its own credit union was slated to close with its functions and personnel to be transferred to pre-existing North Philadelphia facility with its own credit union. The two credit unions had discussed merger between themselves, but South Philadelphia credit union was, instead, approved to merge with a Toledo, Ohio, non-defense-oriented credit union. On November 26, 1996, disappointed merger partner sued NCUA claiming that there was no common bond among the members of the merged credit union, and that lack of a common bond violated the Federal Credit Union Act. On April 17, 1998, court held that the merger was illegal because it resulted in the mixing of dissimilar common bonds. The court directed NCUA to propose to the court a plan for divestiture of illegal members by the acquiring Toledo credit union, which the agency did. The court, however, vacated the earlier order on March 25, 1999 in light of the new Credit Union Membership Access Act and implementing regulations.

18. Colonial Bank v. Colorado Financial Services Board (Colo.App. No. 97 CA 0436). On December 28, 1995, five banks and two associations challenged approval of conversion by Gates Credit Union from employment-based to a "community" credit union, the "community" in question consisting of about 300,000 people. State law allows "community" credit unions to serve areas not exceeding 25,000 people, but also grants some apparent leeway to regulator, the extent of which is at issue in the case. On January 31, 1997, the District Court affirmed the Board's order, holding that there was no requirement in Colorado law for a single common bond, there was no abuse of discretion, the decision was supported by enough evidence, and the statute granted the Board apparently unlimited power to "otherwise authorize" credit union fields of membership. Bankers appealed. On May 14, 1998, appeals court affirmed, substantially for the reasons set forth in the trial court opinion.

#### ENFORCEMENT

19. Lee v. Bankers Trust (2d Cir. No. 98-7504). After an investigation into certain of his activities by the bank, an employee resigned and filed suit for defamation contending, among other things, that the bank had filed a "suspicious activities report" with the local U.S. Attorney concerning the employee. The bank moved to dismiss and the district court granted that motion. On February 10, 1999, the Second Circuit affirmed, holding that SARs were required to be filed by law and that the bank was immune from civil liability for having done so (if, in fact, it had: The court points out that it is illegal for the bank to either admit or deny that it had done

so). The immunity is unqualified, and there is no obligation that the SAR filings be done "in good faith."

20. DeMartini v. Mechanics Bank (Cal.App.3d No. AO 79928, Div. 3). Part owner of a business attempted to withdraw funds from corporate account and deposit them in her own account at a different bank. Bank advised corporate officer who, in turn, notified police, and the part owner was arrested. She later sued the bank for "false imprisonment." San Francisco Superior Court dismissed the suit and she appealed. On March 30, 1998, California Bankers Association and ABA filed amici curiae brief contending that bank was immune from such litigation under the "safe harbor" provisions of the Annunzio-Wylie Act.

#### ENVIRONMENTAL LAW

21. Canadyne-Georgia Corp. v. NationsBank (11th Cir. No. 97-9357). CERCLA imposes liability for cleanup costs upon the "owner" of contaminated property, but does not define "owner." Consequently, courts have held that state law determines who is and is not an "owner" of property. In this case, the court looked to Georgia law to determine that a testamentary trustee did not possess all of the incidents of ownership of the property in question and, therefore, was not an "owner." "Where the privileges of ownership are restricted, the obligations of ownership should be limited accordingly." (M.D. Ga. No. 5:96-CV-114-1 (DF)). On a petition for reconsideration, plaintiff argued that "federal common law" should control, not state law. On November 10, 1997, court denied petition but found it to be a close question and recommended that the Eleventh Circuit grant an interlocutory appeal. In April, 1998, the Eleventh Circuit did so. On June 25, ABA filed amicus brief urging the court to uphold the lower court decision so as to retain the viability of trusteeships of potentially contaminated real property.

#### PRODUCTS & SERVICES

22. Independent Bankers Association of America v. Board of Governors of the Federal Reserve System (D.C. Cir. No. 98-1482). Federal Reserve approved the merger of Citicorp, a bank holding company, with Travelers Insurance. The approval will require the divestiture of nonconforming assets or activities several years from now unless federal law changes in the interim so as to allow such an affiliation. Nevertheless, the Independent Bankers filed a Petition for Review of the Board's Order on October 21, 1998. ABA Securities Association filed a motion for leave to appear as amicus curiae supporting the Federal Reserve on December 18. Opening briefs due May 12; ABASA brief due June 28; oral argument October 1.

\* 23. Blackfeet National Bank v. Nelson (11th Cir. No. 96-3021). \$12 million asset bank on Indian reservation in Montana is offering "retirement CDs" to customers, wherever found. The retirement CD purports to be a tax-advantaged instrument and in many respects resembles an annuity. FDIC and Comptroller have concluded that it is, nonetheless, a "deposit" instrument within the power of national banks to offer. Insurance Commissioner of Florida instituted an administrative proceeding by issuing an Order to Show Cause alleging that the bank

was unlawfully engaged in the insurance business in Florida (because the CD was advertised in the Wall Street Journal, a newspaper known to be read by some Floridians and because annuities are "insurance" under Florida law). Bank filed suit. On June 13, 1996, district court granted summary judgment to Commissioner (N.D. Fla. No. 94-40496-WS), following the reasoning of the Seventh Circuit in American Deposit v. Schacht, 84 F.3d 834 (1996). Blackfeet appealed. ABA and three co-sponsors filed amici brief February 18, 1997, arguing that annuities are not insurance for McCarran-Ferguson Act purposes; federal law therefore prevails over contrary state law; and under federal law, national banks have the right to offer retirement CDs to customers. On April 7, 1999, Eleventh Circuit affirmed.

24. Independent Insurance Agents of America v. Hawke (D.D.C. No. 98-CV-562 JLG) In December, 1997, Comptroller's office issued an authorization to national banks to sell crop insurance as agent pursuant to the banks' "incidental powers" under Section 24(Seventh) of the National Bank Act. On March 4, 1998, IIAA and four other insurance trade associations sued, alleging that Section 92 limits the sales of insurance by national banks to those located in small places, whereas the Comptroller's ruling here would authorize such sales by banks wherever they are located. On March 23, 1999, court granted summary judgment to the Agents. The court held that Section 92 is a limitation on the rights of national banks to sell insurance generally since it grants that power only to small-town banks. The court said that only one exception to that limitation had been carved out by the D.C. Circuit--for credit life insurance--but that crop insurance was not the same thing, and that if the D.C. Circuit wished to expand its exception, IT could do so; the District Court was not about to on its own authority.

25. Association of Banks in Insurance v. Duryee. (S.D. Ohio No. C2 98-1120). On November 6, 1998, ABI, ABA Insurance Association, Ohio Bankers Association and Huntington National Bank sued state Superintendent of Insurance for declaratory judgment and injunction against enforcement of state's "controlled business" statutes that do not allow licensing of banks as title insurance agents and place limitations upon the market that may be served by a banks' offering of other types of insurance. With respect to national banks located and doing business in places with a population not exceeding 5,000 population, those state laws are preempted by federal law. Superintendent filed answer on December 17. The Independent Insurance Agents of America and a coalition of other industry trade associations filed a petition for leave to intervene in the case as defendants. On January 25, plaintiffs filed a motion for summary judgment. Commissioner's motion for summary judgment filed March 1. Plaintiff's reply to it was filed on March 15.

26. Steele v. First Deposit National Bank (Ala. Ct. Civ. App. No. 2970854). National bank sold "credit protection" contracts to customers whereby, for a fee of 49 cents per hundred dollars, bank would agree to suspend payments on outstanding debts for up to nine months, during which no interest would accrue, in the event of the borrower's unemployment, illness or disability. Consumer sued, alleging that this constituted the sale of insurance without a license in violation of Alabama law, which was not preempted by federal law because of the McCarran-Ferguson Act. Trial court dismissed complaint and on February 5, 1999, Court of Civil Appeals affirmed, holding that the credit protection contracts did not constitute "insurance"

for purposes of the McCarran-Ferguson Act in that the product did not have the effect of spreading risk, was not an integral part of the relationship between the parties, and was not a product limited to entities within the insurance business. Consequently, McCarran-Ferguson did not protect Alabama insurance laws from preemption and they were in fact preempted by the "incidental powers" clause of the National Bank Act.

#### TAX

27. American Society of Association Executives v. U.S. (D.C. Cir. No. 98-5563). Lobbying organization filed suit challenging constitutionality of new tax law abolishing the deductibility, as an ordinary and necessary business expense, of that portion of dues paid to a trade association that is used for purposes of lobbying. Association argued that the law imposes content-based restrictions on speech, petition and association, and therefore violates the First Amendment. On October 28, 1998, district court held that the law had a rational relation to a legitimate government purpose and therefore passed the minimal test for constitutionality (D.D.C. No. 95-918). ASAE appealed.

28. PNC Bancorp, Inc. v. Commissioner of Internal Revenue. (U.S.T.C. Docket Nos. 16002-95, 16003-95, 16109-96, 16110-96). In 1995, PNC Bancorp, as successor to two banking institutions, sued the IRS in U.S. Tax Court claiming that loan origination costs should be fully deductible as ordinary and necessary business expenses. In 1995, the IRS issued a notice of deficiency to each PNC Bancorp bank contending that a portion of categories of each bank's loan origination costs must be allocated to completed loans and capitalized. PNC Bancorp claims that such costs should not be considered capital expenditures under provisions of the Internal Revenue Code, as interpreted by the Supreme Court, nor should financial accounting rules govern for federal tax purposes in this case. A trial was held on May 22 and 23, 1997. ABA filed a post-trial amicus brief with the Tax Court on August 6, 1997. On June 8, 1998, court held that the loan origination costs in questions were not ordinary and necessary business expenses that could be deducted in the year incurred, but rather, since they were incurred in order to produce new assets, they had to be amortized over the life of the assets. PNC has appealed to the Third Circuit.

29. Norwest v. Commissioner of Internal Revenue. (U.S.T.C. Docket No. 13908-92). Section 41 of the Internal Revenue Code provides a tax credit for certain expenses incurred by a business in research and experimentation. A bank holding company engaged in research and experimentation activities in developing internal use computer software, but the IRS denied a claim for tax credits, contending that the activities in question did not satisfy the statutory and regulatory criteria. The holding company sued in Tax Court. On February 12, ABA filed an amicus curiae brief supportive of the taxpayer, arguing that denial of the credit in this case, for the stated reasons, would effectively bar banks from ever taking advantage of Section 41—a result Congress clearly did not intend. On June 29, 1998, court determined that only one of the eight representative internal use software systems developed by the bank met all seven requirements set forth in the Act and its legislative history for the credit.

## MISCELLANEOUS

30. Independent Bankers Association of America v. Farm Credit Administration. (D.C. Cir. No. 98-5020) On April 9, 1997, ABA and IBAA sued for declaratory judgment that new regulations of the Farm Credit Administration exceeded the statutory power of the agency and authorized Farm Credit instrumentalities to provide services not allowed by law to customers they were not permitted to serve by law. On June 25, 1997, plaintiffs filed a motion for a preliminary injunction which court determined to treat as a motion for summary judgment. On November 21, 1997 court granted summary judgment to the agency. The court held that the plaintiffs had standing, but that the court was obligated to defer to "reasonable" interpretations of the law by the agency charged with its administration (986 F. Supp. 633, D.D.C.). Bankers appealed. On January 19, 1999, Circuit held that FCA had exceeded plain language of statute in allowing System lending to owners of rural housing who did not reside in such housing, and in allowing Farm Credit Bank lending to farm-related businesses for purposes other than initial working capital, structures and equipment. Other regulatory expansions of System powers to lend to farm related businesses, and processing or marketing operations, and the expansion of the definition of "bona fide farmer" were upheld by the court (164 F.3d 661).

31. Parsons Main v. Brown & Root (D. Mass. No. 98-CV-10131-REK). Indenture trustee was directed by the owner of the project financed by bonds held in the trust to draw upon a letter of credit. The owner certified that it was entitled to the draw because the contractor which had posted the letter had defaulted in some material respect in its performance. Trustee did draw against the letter, and the contractor sued, claiming that the trustee had a duty to conduct an independent investigation into whether there had been a material default. Trustee filed motion for summary judgment. On January 27, ABA filed supporting amicus brief contending that the conduct of any such independent investigation would be inconsistent with, and deleterious of the entire point of both letters of credit transactions and trust indentures. On April 14, court held that under the undisputed facts, trustee acted in good faith in determining that the owner had made *its* certification in good faith, and that the trustee was, therefore, entitled to summary judgment.

## CALENDAR

May 3 (week of)	Oral argument in <u>Riviere v. Banner Chevrolet</u>
May 12	Petitioner brief due in <u>IBAA v. Federal Reserve</u>
May 31	ABA brief due in <u>ABA v. NCUA</u>
June 28	ABASA brief due in <u>IBAA v. Federal Reserve</u>
October 1	Oral argument in <u>IBAA v. Federal Reserve</u>

# The battle for retail bank customers

by James R. Fugitte

**“When the elephants fight the grass suffers.”**

— *Indian proverb*

**J**ust when you thought your retail customers were safe from new sources of competition — when it looked like all the brokerage houses, credit unions, big bank holding companies, finance companies, and insurance companies had taken their best shot at removing your retail customers (or at least the profitable business) — you’re faced with the coming battle for bill payment.

Americans (unlike most of the rest of the world) pay bills at their mailbox. They receive a detailed bill. They review the billed amount, determine the amount they will pay and mail a check. It takes time and money to find checks, buy stamps, and mail envelopes. In the 90s time is more valuable than money as you can tell from the ATM surcharges people are willing to pay.

Do you remember when we decided that credit card statements had to have descriptive billing? How long ago was that?

Today your customers have a number of ways to pay bills. They can arrange for an automatic debit from their account, a charge to their credit card, or they can arrange to have the bill paid by a

**“It costs the average large biller around \$1.50 to print and mail a bill. Processing the check that the customer sends back may run about 50 cents. That \$2 amounts to billions in the U.S. economy. If your company’s stock is trading at 25 times earnings you can boost next quarter’s market price nicely by shifting only a fraction of your billing and account receivable workload to electronic commerce.”**

non-bank third party. These alternatives have drawbacks compared to the old-fashioned method.

While automatic debits are convenient and reliable they take control away from the customer. The consumer doesn’t decide when to pay or how much to pay. Automatic debits meet their convenience needs if they trust the merchant or vendor and normally maintain an appropriate account balance. Billing detail is on their mailed statement.

Credit cards are seldom used to make consumer bill payments. Business applications are more widespread. The consumer may have control over the timing of the payment and the amount. However, many customers try to avoid credit card transactions to keep from building debt.

Third-party bill payers have existed for years; many evolved from bank trust departments. These services are relatively expensive. Private banking clients are the biggest users. Non-bank bill payers combine the convenience of automatic bill payment with some personal review of the bill being paid. Customer control depends on the specifics of their

arrangement with the bill payer.

## The New Era

The banking industry is now posed for a radical change. What if the consumer doesn’t receive bills through the mail? No trips to the mail box, no envelopes to open, no checks to write, and no stamps to buy. Powerful? Yep — a lot of consumer convenience. But it’s even more important to the company mailing the bill. It costs the average large biller around \$1.50 to print and mail a bill. Processing the check that the customer sends back may run about 50 cents. That \$2 amounts to billions in the U.S. economy. If your company’s stock is trading at 25 times earnings you can boost next quarter’s market price nicely by shifting only a fraction of your billing and account receivable workload to electronic commerce. Your company saves processing dollars, improves the speed of cash flow, and improves collections all at once.

**First lesson** — Electronic bill payment will grow rapidly in the future because the biller wants a

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solution, not because of customer convenience.

Don't get me wrong. Customer acceptance is important and growing. In fact consumers are adopting electronic bill payment much faster than they adopted ATMs. In the case of ATMs most users waited until they wanted money after the bank closed for the day to try the new device — electronic bill presentment will be offered by the merchant along with a reason to accept it, i.e. discount, frequent user points, etc.

The biller doesn't care where the bill goes after it leaves the company. The company wants it to cost less to deliver and bring the money back quicker. The consumer is the one who will choose a bill destination. Each merchant will electronically mail the detailed bill to the selected or registered electronic address. The consumer simply wants a convenient way to receive and pay bills.

**Second lesson** — The consumer will only act in her/his best interest.

The consumer will not act solely to save money for the biller or the bank. They will instruct the biller to deliver their bills to the most convenient address only with an incentive. That incentive could be the time they save with an easier bill payment method, it could be a merchant incentive, or it could be information that they gain about their personal finances. Whatever the motivation, the destination must be a place where they can easily review it, modify it, and pay it. The current contenders for the "electronic bill box", think e-mail box for bills, are: portals, banks, PCs, and third parties. Who cares which one they choose? After all they can change addresses in a twitch of their mouse.

**Third lesson** — Any bill address election other than your

**"To pay the bill they click on the 'pay now' option and confirm the number of the transaction account they want to pay it from. Call Me Bill has actually reserved the domain name 'pointclickpay.com.' The customer has no tie to your bank. They can change accounts at the drop of a hat without worrying about outstanding checks, unused checks, lists of merchants to pay, envelopes, transfers, etc."**

bank releases your customer to move their transaction account.

Assume the consumer chooses to have bills delivered to their personal home page at [www.excite.com](http://www.excite.com). They see a "you have bills" box when they log on the Internet via their home page. The customer simply clicks the box to see all of the bills they've received since the last time they open their bill box. They review each bill and decide to either return it, pay it now, or pay it later.

To pay the bill they click on the "pay now" option and confirm the number of the transaction account they want to pay it from. Call Me Bill has actually reserved the domain name "pointclickpay.com." The customer has no tie to your bank. They can change accounts at the drop of a hat without worrying about outstanding checks, unused checks, lists of merchants to pay, envelopes, transfers, etc. In fact they may just go ahead and open an Excite bank account specifically for Internet bill payment? It could automatically debit their regular account and make the money available to pay bills. It could also help them budget their monthly bills by taking a predetermined amount from each pay day to escrow for bill received later in the month. If the kids need dental work it won't mean a bad credit rating or leaving the rent unpaid because these items are budgeted and paid automatically.

Why would the consumer choose a portal like Excite or Ya-

hoo rather than a bank? Because the portal is more convenience and cheaper. The portal can be cheaper because it wants to sell your customer a lot more than bill payment. The portal wants to use the customer information derived from bill payment to offer all sorts of things to your customer including financial products like mortgage loans. For example, assume that I'm paying most of your bills and I notice that your mortgage payment amount has remained constant for the past three years — would you be a good target for refinancing?

The portal location will appeal to consumers who want a basic alternative to writing checks. Those who want a great deal of control over their personal finances and budgeting will choose the software PC option. They'll install Quicken on their computer and have their bills transferred there where they can automatically be entered into their budgeting and payment program. They can not only pay the electric bill but they can compare this months usage to the same month last year, compare the percent of their income going to pay for electricity compared to others, perhaps even e-mail an electric bill comparison to a new provider of electricity for a price quote. This method is great for taxes and noticing unusual changes but only a small portion of the population has the computer literacy to handle PC banking.

Those seeking an easy solution go to the portal and the smart go to Quicken. Who's left for banks?

**Fourth Lesson** — The community bank market for retail services is becoming the financial users that don't trust the Internet.

Most financial services "power users" have already dramatically reduced the share of business they do with banks — otherwise the tremendous growth in upper income Americans would have propelled bank deposits like it has the Dow Jones Industrial Average.

Most of your retail customers are classified either as matures, born before 1946, or Xers, born after 1970. The mature consumer is afraid of technology and the Xer doesn't have enough money to enter the higher return markets. Both classes need a traditional delivery system. The mature because it's comfortable and the Xer because it's cheap. The bank keeps hoping the Xer will grow up and act more like a mature. Unfortunately, technology is becoming more appealing to both groups.

When a mature finds out that WebTV will allow him/her to chat with a grandchild over the living room TV it won't be long until the same channel (portal) offers higher rate insured bank deposits. Xer's are simpler. They want a lot of service at little or no cost. And markets are giving it to them — 40 percent + of employers now have 401ks because administration costs have fallen. Xer's will concentrate their savings in these "open" vehicles.

**Fifth lesson** — You don't have to do everything the younger

generation wants in technology but you have to do enough to maintain a relationship with them.

Here's a commercial for bill payment. It's the day to day activity that has the highest convenience payoff to the consumer. And if you're a young person without a budget it's the method by which the bank can give you advice. If you're a baby boomer with aging parents it's the way you can manage to pay their bills and yours every month. Point, click, and pay — as easy as it gets.

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**"Customer retention is the primary reason banks offer electronic bill payment.**

**They plan to begin a relationship with customers that will evolve into the type of budgeting and lending activity in the future that will prove very profitable."**

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If not bill pay then what service will tie the consumer to the bank? There are a number of anchor services: mortgage loans, 401k plans, insurance, and regular checking accounts. There are also significant competitors in each of these product areas. Customer retention is the primary reason banks offer electronic bill payment. They plan to begin a relationship with customers that will evolve into the type of budgeting and lending activity in the future that will prove very profitable.

The typical bank made little money when it installed the first ATM. The ATM was considerably cheaper than visiting a teller on a

cost accounting basis but if you had the teller anyway — it saved nothing. Internet banking and bill payment is cheaper for you than a visit to the bank, calling the bank, or writing a check. Every non-paper item does save money, but it's hard to cost justify Internet banking on that basis.

**Sixth lesson** — Internet banking builds a fee platform for tomorrow.

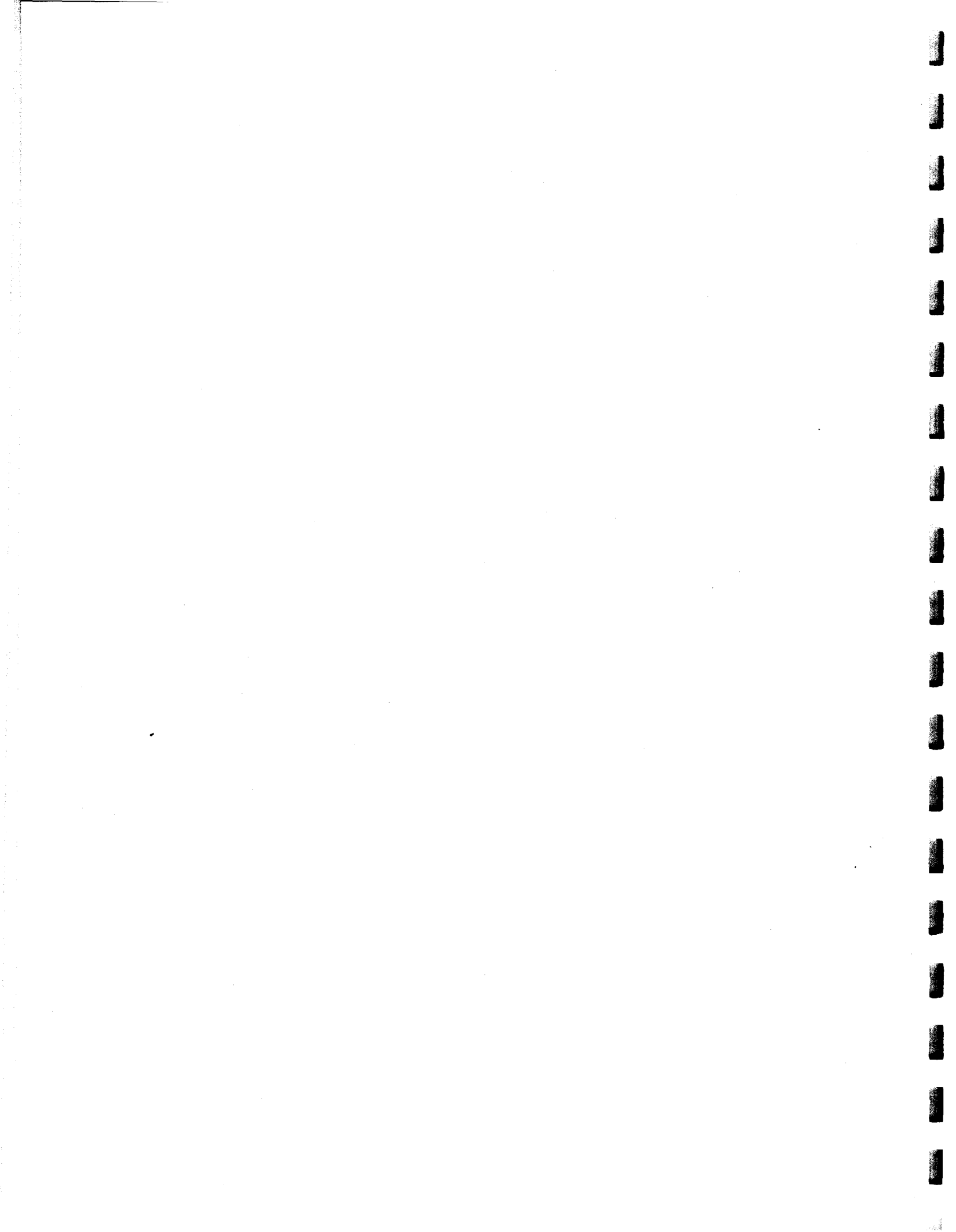
MCI taught us that revenue follows customers. Eventually if you want to increase profits you must first increase revenue. That's why portals are so highly valued on the stock market. Yahoo may appear overvalued but on a per customer basis it is worth only \$1,200. Will Yahoo be able to control the delivery of goods and services to its 17 million customers? Will Yahoo be able to sell them enough to generate \$1,200 in profits? Yahoo isn't asking those questions yet; they're simply trying to get another million customers.

To build a defense to the coming assault for your retail customer you need to offer a basic Internet banking solution free. It won't pay for itself until a significant number of your customers are using it. That may not be too long. There are community banks today that have over 20 percent of their personal checking accounts using Internet banking. Some credit unions are now over 50 percent. Convenience does sell.

If you'd like to know more about the emerging bill presentment and payment market you can send me an e-mail at jimrf@fortknoxnational.com and I'll add you to my list server. About once a month I share an observation about the industry.

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*James R. Fugitte is chairman of the board of Call Me Bill, L.L.C., and vice chairman of the board and CEO of Fort Knox National Bank.*



**ELECTRONIC RESOURCES  
FOR  
FINANCIAL INSTITUTIONS COUNSEL**

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**SECTION B**



**ELECTRONIC RESOURCES  
FOR FINANCIAL INSTITUTIONS COUNSEL**

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## I. Introduction

The Internet has evolved from a resource used primarily by computer professionals, to one used, more and more, by the lay citizen. The Internet has become an entertainment center, a marketplace for products and ideas, but more importantly for the practicing attorney, it has become a vast resource of information from which one might help one's client. Statutory, administrative and judicial materials are becoming increasingly available over the Internet, as is a variety of information on a whole range of topics, from Bankruptcy to Interest Rates, and beyond. It is becoming possible to research a client's case without ever leaving one's desk. The Internet has opened up a Pandora's box for attorneys, and like that box the Internet can be either a hindrance or a great help for those who delve into it.

There are many benefits to using the Internet in one's legal practice. Cost is one major factor. Used properly the Internet can save an attorney money in research costs. Materials that previously had to be copied from a book or downloaded from an expensive commercial database can now be found on the Internet at little or no cost to the user. But caution must be exercised for not every nugget of gold found on the Internet is true gold. A recent New York State Bar Association Ethics Opinion warns attorneys that "[w]hen relying upon legal research obtained through the Internet, the lawyer must insure the reliability of such information."<sup>1</sup> These are words to live by for attorneys who plan to increase their usage of the Internet as a tool for legal research.

At the same time that great caution should be exercised when using the Internet for legal research, there are indications that it might be considered imprudent for an attorney to ignore the Internet in his/her research. The courts have advised that lawyers brush up on their online skills if they are to represent their clients effectively. In Whirlpool Financial Corp. v. GN Holdings, Inc.,<sup>2</sup> the court opined that people need to know how to find current information on the Internet.

"In today's society, with the advent of the 'information superhighway,' federal and state legislation and regulations, as well as information regarding industry trends, are easily accessed."<sup>3</sup> The court went on to admonish the plaintiff's attorney for failing to uncover information that was easily accessible in the public domain.

In McNamara v. United States<sup>4</sup> the court, in dealing with an ineffective assistance of counsel claim, was clearly concerned that lawyers keep on top of the latest developments in legal research so that they could aid their clients in an effective manner. "In the modern environment of law practice, the law changes rapidly as a matter of course. One consequence of this modern environment, and of dramatic advancements in technology, is the advent of extensive resources for staying abreast of developments in

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<sup>1</sup> New York State Bar Association Ethics Opinion 709 (9/16/98). Found in ABA/BNA Lawyers' Manual on Professional Conduct, 1101:6106.

<sup>2</sup> 67 F.3d 605 (7th Cir. 1995).

<sup>3</sup> Id. at 610.

<sup>4</sup> 867 F.Supp. 369 (E.D.VA. 1994), rev'd, 74 F.3d 514 (4th Cir. 1996).



the law." The court went on to note that "[a]s technology and resources develop, the minimum knowledge and preparation required of lawyers develops as well."<sup>5</sup> (Although the Court of Appeals reversed this court's holding on the Strickland claim, the lower court's reasoning on the issue of legal research cautions us not to ignore new legal research tools.)

## II. Evaluating Legal Information on the Internet

Before we begin to explore the plethora of resources available to the attorney on the Internet, prudence suggests that we examine first how to approach information found through the Internet. Like all legal resources which an attorney relies upon in the course of practice, there are skills which must be tapped when using, and evaluating the information found. The Internet is no different than a book one picks up in the library. The same questions a legal researcher asks prior to relying on a printed resource must be asked before relying on a resource found online. A lawyer who relies too heavily on information obtained through the Internet without attempting to verify the accuracy of this information runs the risk of not only losing one's case, but could also possibly land an attorney in trouble with the Bar Association.<sup>6</sup>

To a large degree, lawyers tend to research in one main area; primary legal resources. The Internet is fast becoming a gold mine for primary legal information.<sup>7</sup> Attorneys can find the current version of the Kentucky Revised Statutes<sup>8</sup>, the Kentucky Administrative Regulations<sup>9</sup>, and to a much lesser extent, some Kentucky Supreme Court opinions<sup>10</sup>, over the Internet. These sources are all made available to the public by various branches of the Kentucky government, yet even on these pages a lawyer can not blindly accept what he or she reads. The Administrative Office of the Courts' page includes a warning<sup>11</sup>

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<sup>5</sup> Id. at 374, 375 n.3.

<sup>6</sup> Professor Catherine J. Lanctot & Professor James Edward Maule, The Internet -- Hip Or Hype? Legal Ethics and the Internet, (visited January 4, 1999) <<http://www.law.vill.edu/vcilp/MacCrate/mcle/lanctot.htm>>.

<sup>7</sup> For an excellent review of Kentucky Legal materials available over the Internet please see: Kurt X. Metzmeier, Kentucky Legal Research on the Internet, 86 KY L. J. 971 (1997-98).

<sup>8</sup> <http://www.lrc.state.ky.us/statrev/frontpg.htm>

<sup>9</sup> <http://www.lrc.state.ky.us/kar/frntpage.htm>

<sup>10</sup> <http://www.aoc.state.ky.us/>

<sup>11</sup> Disclaimer: No endorsement is intended or made of this or any hypertext link, service, or information either by its inclusion or exclusion from this site. Even though all attempts are made to insure the correctness and suitability of information under our control and to correct any errors brought to our attention, no representation or guarantee can be made as to the correctness or suitability of that information or any linked information presented, referenced, or implied. **All critical information should be independently verified.** (Page visited April 27, 1999) <<http://www.aoc.state.ky.us/introjava.htm>>.

and on the site with published opinions of the Kentucky Supreme Court, a disclaimer warns that: "These opinions are not intended to be used for Legal Research. They are being provided for Informational Purposes only."<sup>12</sup> Therefore an attorney who reads a case from this web site would be wise to verify the accuracy in the official printed reports.<sup>13</sup>

Life is made easier when a Web site has the courtesy to tell it's readers up front not to rely on the information found at the site. This is usually not the case with most Web pages you will visit. The question then, is how does one decide whether or not to trust what they find online? In order to answer this question one must learn to evaluate with a critical eye any information found on the Internet. To do this five questions must be asked of each web page visited.

These questions are:

- 1) Accuracy,
- 2) Authority,
- 3) Objectivity,
- 4) Currency, and
- 5) Coverage.<sup>14</sup>

These questions should sound familiar. They are the same questions a competent legal researcher should be asking of any legal resource relied upon. When asking these questions of web sites you should try and focus on the following points:

#### **A. Accuracy & Authority**

- How reliable is the information?
- Has anyone double checked the information?

Remember that it is very easy to post information on the Internet. There is very little regulation of what is posted on the Internet, so you must try and determine if there is anyone in charge of the information posted on a given Web site. If there is no one listed as being responsible for a given site, this is a good indicator that you should not put too much trust into any information found at that web site. Even if the site lists who posted the information it is often hard to verify how qualified that person is to post said information. It is best to stay with web sites maintained by educational institutions, government agencies, or well established, and respected organizations.

#### **B. Objectivity**

- Is this a neutral analysis of the topic being covered?

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<sup>12</sup> Ibid.

<sup>13</sup> West's South Western Reporter 2nd.

<sup>14</sup> Marsha Tate & Jan Alexander, *Teaching Critical Evaluation for World Wide Web Resources*, 16 Computers in Libraries 49 (Nov./Dec. 1996)

Try to determine why a web page has been created. Is this a publishing company, professional or trade organization, government agency, non-profit, for profit, etc. Every group has its own agenda and it is important to find out what this agenda is, before placing too much reliance on a given site. If you are looking for information on gun control and you go to the National Rifle Association's web site<sup>15</sup>, you should realize that this group has a definite bias. This does not mean that the information found at a particular site is faulty, simply that you need to realize that you are getting the information through the filter of a biased publisher.

Often Objectivity is not a problem when dealing with government or educational sites that are simply posting judicial opinions, regulations or statutes online.<sup>16</sup> These sites offer a straight forward republishing of primary legal materials and nothing more. If you are trying to find the most current banking law for a particular State, try that State's web site before relying on the information found at another site..

### **C. Currency**

- When was the work published?
- When was it last updated, or how often will it be updated?

Unlike many other disciplines, current information is vital for attorneys as they represent their clients. No other discipline pays as much attention to continually updating information as the law. Think of the money spent annually on pocket parts, advance sheets, and looseleaf filings by law libraries in an effort to keep their collections up to date. The same is true for materials posted to, and found on the Internet. Be very wary of a site that does not tell you when the last time the information found there was updated. Even when it does tell you, try to find some current information. If a site claims to have all the current case law on an issue, try and search for some recent cases. If the newest case found is close to a year old (for example) chances are you are not getting the most current information available. In the same way you would not rely on a book that was published in 1994 for current information on a topic, do not place your reliance on a web site which either does not give any currency information, or which has not been updated recently.

### **D. Coverage**

- What is included? What is not included?

You find a book in the library on Lender Liability. Great you think, as you open it up, but inside you find no table of contents, and no index at the back of the book. This type of resource is of little use to a legal researcher. Not only does it take extra time (which we all know equals money)

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<sup>15</sup> <http://www.nra.org>

<sup>16</sup> For example the Kentucky Legislative Research Commission's page includes the full text of the Kentucky Revised Statutes. This is just a simple republishing of the Statutes, but caution must be taken as the page warns that these are an unofficial version of the statutes.  
<<http://www.lrc.state.ky.us/statrev/frontpg.htm>>.

but it causes one to have little trust in a resource that omits such vital information. This is the type of thinking that should take place when you find a web site. How is it laid out? Is there something akin to a table of contents? Is there a way to search the contents of the site? If the answer is no to these questions then you must ask yourself, how accurate will any information on this site be? Furthermore, how much time do you want to waste surfing through the various web pages that make up this one site? Remember, time is worth just as much when looking through printed materials as it is when looking for information online.

These five questions should help you in determining whether or not to rely on materials you find on the Internet. Try and stick to web sites maintained by educational institutions and governmental bodies. These sites tend to be the best maintained, and often carry the only, or most authoritative information in a given area of research. You should exercise as much diligence in searching for material on the Internet as you do when looking for information in the books. As lawyers move more and more to reliance on the Internet for finding information, the duty to insure the reliability of such information goes along with it.

### **III. Primary Legal Resources on the Internet**

Let us now turn to the business of where one can find primary legal material on the Internet. First we will look at Federal primary sources (case law, statutory law, and regulations) and then turn to primary sources for State law. We will then turn to resources that would be of particular use to attorneys working with financial institutions.

#### **A. Federal Material**

The federal government is the largest producer of legal information in the world. Fortunately for American attorneys, the federal government is also a big proponent of disseminating a large part of this information directly to the public via the Internet. As an added bonus there is normally no charge for this information, presumably since it is paid for out of our tax dollars to begin with. In this section we will look at finding the United States Code, bills, regulations, and case law from the three levels of United States Courts.

##### **1. Statutory Material**

###### **a. Bills**

It is often imperative for attorneys to keep abreast of new or proposed laws that might affect their clients interests. Often this is done by reading newspapers and current awareness periodicals. One short coming of these resources is that they do not reprint the text of the bill. Now the Internet can be used in conjunction with these sources to find the full text of federal bills.

The Library of Congress maintains *Thomas: Legislative Information on the Internet* at <http://thomas.loc.gov>. This site is chock full of great current material about the goings on of the United States Congress. You will find bills (in all its versions, from introduction to passage) from the current Congress as well as information about House and Senate members and committees.

Thomas contains an archive of past bills. The full text of past bills is available from the 101<sup>st</sup> Congress on, and a summary of bills is available back to the 93<sup>rd</sup> Congress.

## **b. Public Laws**

Public Laws first appear as Slip Laws. The law is eventually broken up and placed by subject into the various titles of the United States Code. It normally takes about a week for a Slip Law to appear in print. Now Slip Laws are placed on the Internet as soon as they are released. Public Laws found on the GPO Access Service [<http://www.access.gpo.gov/nara/index.html>] are considered official versions of the law.<sup>17</sup>

## **c. United States Code**

The United States Code (U.S.C.) is also found on the Internet. Unfortunately the version on the Internet is simply just the text of the Code as it appears in the official print source. Most attorneys tend to shy away from the official version of the U.S.C. as it does not have all the nice features that annotated codes provide the researcher. Nonetheless, if all you want is the language of a Code section, then it is available for free on the Internet at a variety of places.

GPO Access: [http://www.access.gpo.gov/su\\_docs/aces/aaces002.html](http://www.access.gpo.gov/su_docs/aces/aaces002.html)

Cornell: <http://www4.law.cornell.edu/uscode/>

U.S. House of Representatives: <http://uscode.house.gov/usc.htm>

Caution needs to be exercised when using the online versions of the U.S.C. One needs to pay attention to the date on the Code version that you are searching. Often the versions being searched will be up to two years out of date. In order to bring your Code section up to date, you must run your search through the Public Laws site to see if any changes have occurred to your law.<sup>18</sup>

## **2. Case Law**

### **a. United States Supreme Court**

In the late 1980's the United States Supreme Court initiated a study to determine the feasibility of releasing their opinions directly onto the Internet as they are decided. This became known as Project Hermes, and in 1990 the Supreme Court began to electronically disseminate it's decisions online.<sup>19</sup> Since then the availability of United States Supreme Court opinions on the Internet has

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<sup>17</sup> See <http://www.nara.gov/fedreg/nfpubs.html#publaw>

<sup>18</sup> See Sally J. Kelley, *How to use the Internet to Find and Update the United States Code*, 7 Perspectives 23 (Fall 1998) an online version of this article is available at <http://law.uark.edu/arklaw/aglaw/usc/uscupdate.htm>

<sup>19</sup> J. Myron Jacobstein et al., *Fundamentals of Legal Research* 47 (7<sup>th</sup> ed. 1998)

far outpaced that envisioned by Project Hermes.

Through Project Hermes the public can access recent Supreme Court decisions within minutes of their release from the court. The Supreme Court itself only set its sights on future cases, but schools like Cornell and some commercial companies set about putting the full text of older cases onto the Internet. In 1996 the U.S. Air Force released the contents of its FLITE (Federal Legal Information Through Electronics) service which contains over 7,000 Supreme Court opinions dating from 1937 through 1975, from volumes 300 through 422 of U.S. Reports.<sup>20</sup> Today it is now possible to find United States Supreme Court cases going back to its inception over the Internet.

Cornell's Legal Information Institute provides access to cases from 1990 to present including a collection of 610 historical cases. <http://supct.law.cornell.edu/supct/>

The FLITE database of cases from 1937-1975 can be found at FedWorld. <http://www.fedworld.gov/supcourt/index.htm>

FindLaw provides a searchable database of cases from 1893 to present. <http://www.findlaw.com/casecode/supreme.html>

USSCPlus.com by InfoSynthesis, Inc. contains 9,917 cases, including complete coverage from 1931 to present plus some 300 additional earlier leading cases dating as far back as 1793. <http://www.uscplus.com/>

It is also possible to get a variety of other information about the court including court calendar, schedule of oral arguments, court rules, biographical information of current and former justices, and even the audio of some of the oral arguments (found at <http://oyez.nwu.edu/>). Most of this current awareness information can be found at any of the sites listed above.

#### **b. United States Courts of Appeals**

The Circuit Courts have their opinions available on the Internet but not to the same extent as that of the Supreme Court. For the most part the Circuits have allowed academic institutions (i.e. law school libraries) to put their opinions on the Internet. Opinions of the Circuits are generally available from 1995 to the present. The exact dates vary by Circuit. For example, "[t]he opinions of the Sixth Circuit since January 1995 are brought to you by the Hugh F. Macmillan Law Library, Emory University School of Law, in cooperation with the United States Court of Appeals for the Sixth Circuit. All cases are in full text on the Web, or can be downloaded. The files to

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<sup>20</sup> Interestingly enough this file had previously been determined to be exempt from release under the Freedom of Information Act by the U.S. District Court for the Northern District of California. That decision was not appealed. Nonetheless, the Air Force has agreed as a matter of discretion to release these materials. See <http://www.fedworld.gov/supcourt/index.htm>.

download are located at the end of each case."<sup>21</sup>

The Federal Court Locator of the Center for Information Law and Policy at Villanova University provides links to the United States Supreme Court, the 13 Circuit Courts, and the District and Bankruptcy Courts that have a presence on the Internet. It can be located at <http://www.law.vill.edu/Fed-Ct/fedcourt.html>

First Circuit <http://www.law.emory.edu/1circuit/>

Second Circuit <http://www.law.pace.edu/lawlib/legal/us-legal/judiciary/second-circuit.html>

Third Circuit <http://www.law.vill.edu/Fed-Ct/ca03.html>

Fourth Circuit <http://www.law.emory.edu/4circuit/>

Fifth Circuit <http://www.law.utexas.edu/us5th/us5th.html>

Sixth Circuit <http://www.law.emory.edu/6circuit/>

Seventh Circuit <http://www.kentlaw.edu/7circuit/>

Eighth Circuit <http://www.wulaw.wustl.edu/8th.cir/>

Ninth Circuit <http://www.law.vill.edu/Fed-Ct/ca09.html>

Tenth Circuit <http://www.kscourts.org/ca10/>

Eleventh Circuit <http://www.law.emory.edu/11circuit/>

D.C. Circuit <http://www.ll.georgetown.edu/Fed-Ct/cadc.html>

Federal Circuit <http://www.ll.georgetown.edu/Fed-Ct/cafed.html>

### **c. United States District and Bankruptcy Courts**

The District and Bankruptcy courts are new comers to the placement of free opinions on the Internet. The Federal Court Locator (mentioned above) is a good resource to use to see if a particular court has a Web site. Many of the Courts with web sites offer more than just judicial opinions. For example the Western District of Kentucky's Web site is full of useful information to attorneys. You can find the Court's docket, calendar, local rules, phone numbers, use the Electronic Case Filing System (user must register to use this service), court supplied forms, court filing fee schedule, jury information, and find a collection (not comprehensive) of recent court

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<sup>21</sup> Taken from <http://www.law.emory.edu/6circuit/>

decisions. The Court's Web address is <http://www.kywd.uscourts.gov/>

### **3. Administrative Law**

#### **a. Federal Register**

The Federal Register is the first place to find new and proposed regulations from administrative agencies. As such, the Federal Register is an extremely important document for attorneys working in the banking and financial industries. Previously, lawyers had to wait for a copy of the Federal Register to reach their desk by mail. This is no longer the case. Now the Federal Register is available for free over the Internet. Daily issues are uploaded each morning at 6 a.m. Unlike much of the other information found on the Internet, the text of the Federal Register online is official.<sup>22</sup>

The Federal Register is available from volume 59 (1994) to the present. It is possible to do a full text search of all the issues from volume 60 (1995) to the present. It is also possible to search by page number, or simply browse through the Register's daily table of contents. The Federal Register can be found at: [http://www.access.gpo.gov/su\\_docs/aces/aces140.html](http://www.access.gpo.gov/su_docs/aces/aces140.html)

#### **b. Code of Federal Regulations**

The government has also been kind enough to place the full text of the current edition of the Code of Federal Regulations (CFR) on the Internet to compliment the Federal Register. The CFR on the Internet is updated as often as the print version. You can search the full text of the CFR, retrieve a particular section, or simply browse through a particular title. The CFR can be found at: <http://www.access.gpo.gov/nara/cfr/index.html>

Once a CFR section has been found it is not enough to just trust that it is still good law. Since the Federal Register comes out every day, and the CFR is only updated once a year, it is necessary to check that your CFR section has not been affected by any new regulations published in the Federal Register. Normally one turns to the monthly print title *List of CFR Sections Affected (LSA)* to update a CFR section. This title is also available on the Internet. It is now possible to find and update a CFR section from your desktop, all at no charge. The LSA can be found at: <http://www.access.gpo.gov/nara/lsa/aboutlsa.html>

#### **c. Administrative Agencies and Decisions**

Most federal agencies have established a presence for themselves on the Internet. They use their

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<sup>22</sup> 1 C.F.R. 5.10 (1998) reads: "Pursuant to section 1506 of title 44, United States Code, the Administrative Committee publishes the Federal Register in the following formats: paper; microfiche; and online on GPO Access (44 U.S.C. 4101)"



Web sites as a place to disseminate information about themselves. Normally at an agency Web site you can find the following types of information: history, purpose, powers, personnel, regulations, and some times administrative decisions. The following Web site compiles a list of administrative agencies with a presence on the Internet.

Federal Web Locator: <http://www.law.vill.edu/Fed-Agency/fedwebloc.html>

## **B. State Materials**

The States have not been as quick to embrace the Internet as the federal government. The variety of information available varies from State to State. Interestingly enough there does not appear to be any corollary between the size or wealth of a given State and its presence on the Internet. For example, Alaska and Vermont were among the first States to make their judicial opinions available on the Internet. Today most States have a large amount of legal information posted on their Web sites. Over half the States provide access to their statutes, regulations and recent judicial opinions on the Internet.

### **1. Statutory Material**

Most States have placed a version of their Code onto the Internet. One of the main drawbacks to these Codes is that they do not contain the editorial features that accompany the Annotated Codes that most attorneys use when doing statutory research. But if all you want is the plain text of the Code then the Internet provides a free way to look at the desired provision. Caution should be exercised when using Codes online. Make sure that you are looking at an up to date version of the Code. There is often a lag time between the passage of an Act and its integration into a State's compiled Code.

Kentucky was one of the first State's to place it's Code online for all to see.<sup>23</sup> Although the Kentucky Revised Statutes (KRS) online are not official<sup>24</sup> they provide an easy interface for

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<sup>23</sup> On March 6, 1996 the General Assembly of the Commonwealth of Kentucky passed HB 413, an act relating to legislative publications. This act charged the Legislative Research Commission (LRC) with the task of making certain legislative documents available to the public in electronic format.

#### **7.500 Public access to electronic form of Kentucky Constitution, statutes, acts, and administrative regulations. (Effective September 1, 1996)**

(1) The Legislative Research Commission shall make available to the public in electronic form the following texts:

- (a) The Constitution of Kentucky;
- (b) The Kentucky Revised Statutes;
- (c) The Kentucky Acts; and
- (d) The administrative regulations comprising the Kentucky Administrative Regulations Service and the Administrative Register of Kentucky

<sup>24</sup> The files making up this Internet version of the *Kentucky Revised Statutes* do not constitute official text of the statutes and are intended for informational purposes only. No representation is made as

looking up the text of a particular section. The KRS can be accessed either through a full text search engine, or by chapter and section number.

## 2. Case Law

The publication pattern of judicial opinions on the Internet mirrors that of the print reporters. For the most part only appellate level decisions can be found (when available at all) over the Internet. Unlike the Federal Courts, the States have not farmed out the publication of their judicial opinions over the Internet. Each State that posts its decisions online, usually does through on the State's judiciaries Web site. The amount of decisions placed online varies from State to State, and the best thing to do is to simply check the State you are interested in to see what the breadth of coverage is.

Kentucky is far behind most of the other States in its placement of judicial opinions on the Internet. Currently only a test batch of ten Kentucky Supreme Court decisions have been placed online.<sup>25</sup>The Kentucky Court of Justice page does contain useful information to attorneys, despite its lack of judicial opinions. Information appears for the Supreme Court, Court of Appeals, Circuit and District Courts. This information includes judges for each court, phone numbers, locations, forms (60+), local rules (for some but not all the counties), and other valuable information. The Kentucky Court of Justice page can be found at: <http://www.aoc.state.ky.us/introjava.htm>

To find links to courts in other States visit these Web sites:

<http://www.law.cornell.edu/states/index.html>

<http://www.findlaw.com/11stategov/index.html>

## 3. Administrative Law

Administrative Codes and Registers were among the last pieces of primary legal materials to appear on the Internet. Again, like with the statutes, not all States have placed their administrative materials online. States that have placed their judicial opinions or State Statutes online have not necessarily placed their administrative material there as well. Another anomaly with State administrative materials is that some States have placed their Administrative Code and/or Register online, but the same does not appear on either Westlaw or Lexis. Kentucky is a perfect example of this phenomenon.

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to the accuracy or completeness of these sections. The certified versions of the Kentucky Revised Statutes should be consulted for all matters requiring reliance on the statutory text. [Taken from the KRS Web site at : <http://www.lrc.state.ky.us/statrev/frontpg.htm>]

<sup>25</sup> These cases appear with the following warning: Note: These opinions are not intended to be used for Legal Research. They are being provided for Informational Purposes only.

The same Act that charged the Legislative Research Commission (LRC) with placing the KRS online, also had the LRC place the Kentucky Administrative Regulations (KAR) online.<sup>26</sup> Like the KRS, the KAR online is not considered official. The KAR online is not updated in the same manner as the print KAR, i.e. with the print Administrative Register of Kentucky. The KAR online is:

**The administrative regulations available on the Internet are:**

- 1) administrative regulations in effect as of the 15th of the previous month;
- 2) emergency and new administrative regulations filed by noon on the 15th of the previous month; and
- 3) proposed amendments to administrative regulations filed by noon on the 15th of the previous month.

The KAR can be found at: <http://www.lrc.state.ky.us/kar/frmpage.htm>

Links to Administrative Codes and/or Registers from other States can be found at:  
<http://www.nass.org/acr/acrdir.htm>

#### **IV. Banking and Financial Sites**

The banking and financial industry are some of the most heavily regulated industries in the United States. Attorneys working for these companies must keep abreast of all the changes that develop throughout the year. The Internet has become a great place to find current information on financial information, both legal and otherwise. One of the best places on the Internet to find information on a given industry is to find a Web site set up by an association that covers that particular industry. In the financial field there are numerous associations that fill this description and their Web sites are particularly helpful in providing links to key online information. Two useful sites are:

American Bankers Association <http://www.aba.com/aba/AboutABA/homepage.asp>

Kentucky Bankers Association <http://www.kybanks.com/>

##### **A. Federal Sites**

###### **Federal Deposit Insurance Corporation**

The following Web sites provides lots of useful information including, but not limited to: Official documents, laws and regulations, current information (including statistics), press releases, and links to other government and financial sites of interest.

<http://www.fdic.gov/>



###### **Board of Governors of the Federal Reserve System**

This web site includes the Board's regulations, forms, reports to Congress, statistics, press releases, links to all the Federal Reserve Banks, and much more.

<http://www.bog.frb.fed.us/>



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<sup>26</sup> See note 23.

**Securities and Exchange Commission**  
<http://www.sec.gov/index.html>



**Comptroller of the Currency**  
<http://www.occ.treas.gov/>



**Department of the Treasury**  
<http://www.treas.gov>



## **B. Kentucky Sites**

### **Secretary of State**

<http://www.sos.state.ky.us/>

This site has information including:

On-Line Business Database enabling you to search for detailed information on over 360,000 Kentucky businesses,

Business Filing Forms -- Save time by downloading, printing and using these official business filing forms,

Name Availability Search -- Perform a preliminary check of name availability for business entities,

Kentucky Lien Information System Search -- Search for Uniform Commercial Code filings.

### **Department of Financial Institutions**

<http://www.dfi.state.ky.us/>

This site provides essential information for those working with financial institutions in Kentucky. Including information from the Division of Financial Institutions which has:

Division Information (Bank Branch, Credit Union Branch, and Compliance Branch),

Mortgage license status,

Bank Activities,

Balance Sheets for KY Banks



### **Department of Insurance**

<http://www.doi.state.ky.us/>

This site includes bulletins and advisory opinions, reports and fees, news releases, laws and regulations, and much more.

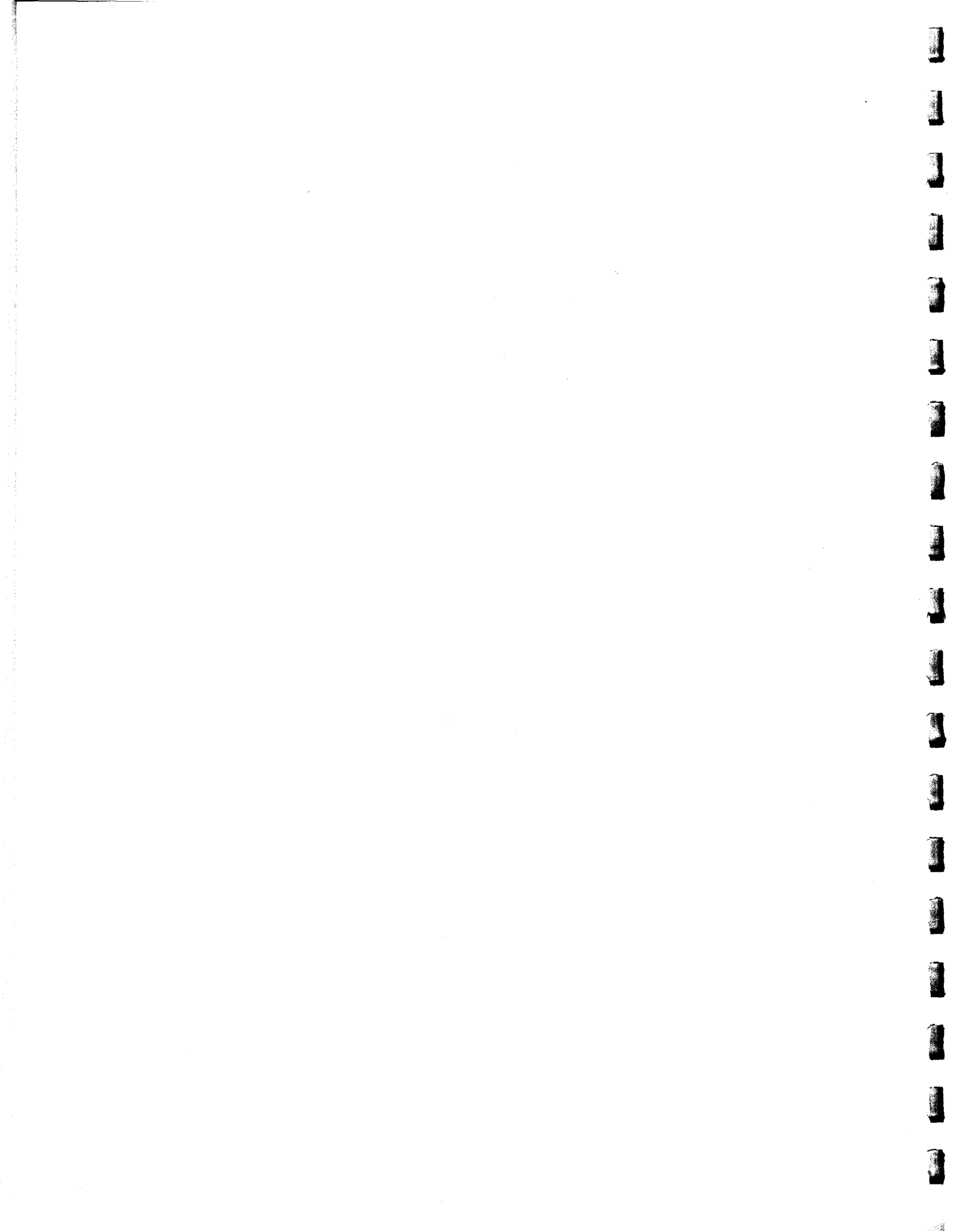
### **C. News and Financial Information**

NASDAQ	<a href="http://www.nasdaq.com/">http://www.nasdaq.com/</a>
New York Stock Exchange	<a href="http://www.nyse.com/">http://www.nyse.com/</a>
Bankrate.com	<a href="http://www.bankrate.com/brm/default.asp">http://www.bankrate.com/brm/default.asp</a>
CNN FN	<a href="http://www.cnnfn.com/">http://www.cnnfn.com/</a>
Dun & Bradstreet	<a href="http://www.dnb.com/">http://www.dnb.com/</a>
New York Times	<a href="http://www.nytimes.com/">http://www.nytimes.com/</a>
Wall Street Journal	<a href="http://www.wsj.com/">http://www.wsj.com/</a>
Louisville Courier-Journal	<a href="http://www.courier-journal.com/">http://www.courier-journal.com/</a>
Lexington Herald-Leader	<a href="http://www.kentuckyconnect.com/heraldleader/index.htm">http://www.kentuckyconnect.com/heraldleader/index.htm</a>

**REGULATORY COMPLIANCE UPDATE:**

**The Real Estate Settlement and Procedures Act  
(RESPA)**

**Garry L. Throckmorton  
Senior Vice President  
Republic Bank & Trust Company  
Louisville, Kentucky**



**REGULATORY COMPLIANCE UPDATE:**  
The Real Estate Settlement Procedures Act

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**Homeowner Protection Act**  
**New Private Mortgage Insurance Rules**



## Federal Restrictions on Private Mortgage Insurance (PMI)

### Background

Congress passed new legislation last year that imposes restrictions and disclosure requirements on banks that require borrowers to purchase PMI. The new rules mandated by the Homeowners Protection Act of 1998 (S. 318) go into effect on July 29, 1999. All "residential mortgage transactions" originated on that date and beyond with PMI are covered, as well as this type of existing loans.

### Coverage

The cancellation and termination provisions of the Homeowners Protection Act apply to residential mortgage loans originated one year after the enactment date. Certain disclosure provisions apply to existing residential mortgage loans and future residential mortgage loans. Bank paid PMI loans are exempt from the termination and general disclosure provisions of the new law, but require specific bank-paid PMI disclosures.

### Overview of New Rules

1. Specific points in time are established when the borrower may cancel the PMI coverage or it terminates automatically:
  - When the loan-to-value (LTV) ratio reaches 78% PMI is automatically cancelled if the borrower(s) have a good payment history.
  - When the LTV ratio reaches 80% the borrower(s) may request the PMI to be cancelled if he/she has a good payment history and the value of the property has not deteriorated.
  - Upon reaching the mid-point of the loan PMI must be cancelled
2. New disclosures regarding PMI are required at the time of commitment, at closing, and during the term of the loan:
  - Closing disclosure for either fixed- or variable-rate mortgage loans (ARM).
  - Annual disclosure of the borrower's PMI cancellation rights.
  - Cancellation date disclosure for ARM loans.
  - Termination disclosure within 30 days after termination of PMI.

## New Rules for PMI

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3. Banks cannot charge fees to cover the cost of making the required disclosures and notices.
4. The new law contains civil liability provisions for violations:
  - Up to \$2000 per violation for individual actions, cost of action, and reasonable attorney fees.
  - Up to the lesser of \$500,000 or 1% of net worth of an *insured institution* in class actions.
5. The new contains a federal preemption *except* for state laws enacted prior to January 2, 1998 and amendments to such laws made not later than 2 years after enactment of the Homeowners Protection Act.

### Cancellation Requirements

PMI Cancellation Date – The day the principal balance reaches 80 percent of the original value of the property securing the loan, a borrower may cancel the PMI coverage. To cancel, the borrower must:

1. Send a written cancellation request,
2. Have a “good payment history,” and
3. Provides evidence that the value of the property has not declined and certifies that there is no subordinate lien on the property.

The PMI premiums must terminate no more than 30 days after the date of the request or the date the borrower meets the evidence or certification requirements, *whichever is later*.

Automatic Termination Date –When the principal balance reaches 78% of the original value (based solely on the amortization schedule rather than the borrower's actual payments), and the borrower is current on their payments, PMI automatically terminates. If the borrower is not current at this point on payments, PMI automatically terminates no later than 30 days after he/she becomes current.

Final Termination Date – The new law requires cancellation of PMI at the midpoint of the amortization schedule regardless of whether the borrower is current or not. Specifically, PMI must end on the first day of the month

## **New Rules for PMI**

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immediately following the midpoint of the amortization schedule. No payments may be required after 30 days following this date.

*Exceptions* – The new law exempts “high risk” loans from both the 80% LTV borrower-initiated cancellation and the 78% LTV automatic termination requirements. However, PMI is subject to termination when:

- Fannie Mae and Freddie Mac “high risk mortgages” reach the midpoint of maturity, and
- “High risk mortgage,” *by any other definition*, is scheduled to reach 77% of the original value of the property securing the loan. Such loan is also subject to final termination at the midpoint of the amortization schedule.

### **Disclosure Requirements**

#### **Existing Residential Mortgage Loans**

All existing borrowers and borrowers whose loans are originated before the end of the 12-month period following the effective date of the new law, must receive an annual disclosure. It must explain that PMI may be cancelled (if allowed by the bank) and tell how to contact the bank to get cancellation information. The notice may be included in either the:

- Annual escrow disclosure statement, or
- IRS Form 1098 Mortgage Interest Statement

Note: The IRS will have to issue a revised form for this purpose.

#### **Future Residential Mortgage Loans**

Loans originated after the end of the 12-month period following the effective date of the new law require the following:

*At the loan closing:*

*Fixed Rate Loans with PMI* – Borrower must get a written amortization schedule (showing P&I payments, accrued interest, and the amount of principal remaining after each payment), and a written notice containing the borrower-initiated cancellation (i.e., 80% LTV) requirements:

## New Rules for PMI

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- The date the borrower can cancel PMI based on the initial amortization schedule;
- A statement that the borrower may request cancellation *before* the scheduled cancellation date based on actual principal payments;
- Disclose the automatic termination date (78% LTV based on the amortization schedule), and
- Explain the high-risk mortgage exemption and state whether it applies to the particular loan.

Adjustable Rate Loans with PMI – Similar written notice containing:

- A statement that the borrower may request the PMI to be cancelled when the 80% LTV is reached;
- An explanation of the automatic termination provision (i.e., 78% LTV) and the fact that the PMI will be terminated on that date or as soon after that date that the borrower becomes current on the loan (if applicable); and
- Explain the high-risk mortgage exemption and state whether it applies to the particular loan.

High Risk Loans – A written notice describing that PMI will terminate at the midpoint of the loan.

Note: There is no reference in this section of the requirements to the 77% LTV automatic termination requirements for bank-defined high risk loans.

*After the loan closing:*

Annual Notice – The notice must disclose the borrower's PMI cancellation rights and a telephone number that the borrower can call to find out whether he/she can cancel.

ARM Loan Cancellation Date Disclosure – Borrower's with ARM loans must be notified when the 80% LTV date is reached.

## **New Rules for PMI**

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Verification of Cancellation – Within 30 days of canceling PMI, a written notice that verifies such action must be sent to the borrower. The notice must explain that PMI has been terminated, the bank no longer has PMI, and that no further PMI premiums or charges will be due in connection with the loan.

Note: This notice must be sent to all borrower's whose PMI is terminated, regardless of when the loan was originated in relation to the effective date of the new law.

Declination Notice – If the PMI cannot be cancelled or terminated for cause e.g., poor payment history, a descriptive decline notice must be sent to the borrower.

### **Bank Paid Mortgage Insurance**

Covered loans where the bank pays the mortgage insurance are exempt from the cancellation and disclosure requirements described above. There are, however, two special disclosure requirements.

Commitment Disclosure – At commitment (rather than at closing), the bank must provide a notice that explains:

- Bank paid PMI may not be cancelled or terminated, but borrower paid PMI would be cancelled or terminated.
- Bank paid PMI usually results in higher interest rates on loans.
- The advantages and disadvantages of bank paid PMI together with a 10-year analysis of the varying costs and benefits of a loan with bank paid PMI compared to a borrower paid PMI transaction.
- Bank paid PMI may be tax-deductible.

Servicing Disclosure – At the point PMI would be eligible for automatic termination if the PMI had been borrower paid, a notice explaining that the PMI would otherwise have been terminated at this juncture of the loan term had the borrower been paying the PMI. The notice must also suggest that the borrower may wish to check out other financing options so as possibly to eliminate bank paid PMI.



**Key Definitions**

“Residential Mortgage Transaction” -- Any transaction where a bank takes a consensual security interest in a single-family dwelling that is the *primary residence* of the borrower to finance the *acquisition, initial construction, or refinancing* of that dwelling.

“Good Payment History” – The borrower has not, in the 12-month period preceding the date he/she requested PMI to be cancelled, been 30 days late with any payment. Also, in the 12-month period preceding the first 12-month period, the borrower has not been 60 or more days late with any payment.

“Automatic Termination Date” – The day the principal balance reaches or was originally scheduled to reach 78 percent of the original value of the property securing the loan.

“High Risk Loans” – Defined by FNMA and FHLMC guidelines or designated by the bank as high risk based on a higher original principal loan balance.

One Hundred Fifth Congress  
of the  
United States of America

AT THE SECOND SESSION

*Begun and held at the City of Washington on Tuesday,  
the twenty-seventh day of January, one thousand nine hundred and ninety-eight*

An Act

To require automatic cancellation and notice of cancellation rights with respect to private mortgage insurance which is required as a condition for entering into a residential mortgage transaction, to abolish the Thrift Depositor Protection Oversight Board, and for other purposes.

*Be it enacted by the Senate and House of Representatives of  
the United States of America in Congress assembled,*

**SECTION 1. SHORT TITLE; TABLE OF CONTENTS.**

(a) **SHORT TITLE.**—This Act may be cited as the “Homeowners Protection Act of 1998”.

(b) **TABLE OF CONTENTS.**—The table of contents for this Act is as follows:

- Sec. 1. Short title; table of contents.
- Sec. 2. Definitions.
- Sec. 3. Termination of private mortgage insurance.
- Sec. 4. Disclosure requirements.
- Sec. 5. Notification upon cancellation or termination.
- Sec. 6. Disclosure requirements for lender paid mortgage insurance.
- Sec. 7. Fees for disclosures.
- Sec. 8. Civil liability.
- Sec. 9. Effect on other laws and agreements.
- Sec. 10. Enforcement.
- Sec. 11. Construction.
- Sec. 12. Amendment to Higher Education Act of 1965.
- Sec. 13. Effective date.
- Sec. 14. Abolishment of the Thrift Depositor Protection Oversight Board.

**SEC. 2. DEFINITIONS.**

In this Act, the following definitions shall apply:

(1) **ADJUSTABLE RATE MORTGAGE.**—The term “adjustable rate mortgage” means a residential mortgage that has an interest rate that is subject to change.

(2) **CANCELLATION DATE.**—The term “cancellation date” means—

(A) with respect to a fixed rate mortgage, at the option of the mortgagor, the date on which the principal balance of the mortgage—

(i) based solely on the initial amortization schedule for that mortgage, and irrespective of the outstanding balance for that mortgage on that date, is first scheduled to reach 80 percent of the original value of the property securing the loan; or

(ii) based solely on actual payments, reaches 80 percent of the original value of the property securing the loan; and

(B) with respect to an adjustable rate mortgage, at the option of the mortgagor, the date on which the principal balance of the mortgage—

(i) based solely on amortization schedules for that mortgage, and irrespective of the outstanding balance for that mortgage on that date, is first scheduled to reach 80 percent of the original value of the property securing the loan; or

(ii) based solely on actual payments, first reaches 80 percent of the original value of the property securing the loan.

(3) FIXED RATE MORTGAGE.—The term “fixed rate mortgage” means a residential mortgage that has an interest rate that is not subject to change.

(4) GOOD PAYMENT HISTORY.—The term “good payment history” means, with respect to a mortgagor, that the mortgagor has not—

(A) made a mortgage payment that was 60 days or longer past due during the 12-month period beginning 24 months before the date on which the mortgage reaches the cancellation date; or

(B) made a mortgage payment that was 30 days or longer past due during the 12-month period preceding the date on which the mortgage reaches the cancellation date.

(5) INITIAL AMORTIZATION SCHEDULE.—The term “initial amortization schedule” means a schedule established at the time at which a residential mortgage transaction is consummated with respect to a fixed rate mortgage, showing—

(A) the amount of principal and interest that is due at regular intervals to retire the principal balance and accrued interest over the amortization period of the loan; and

(B) the unpaid principal balance of the loan after each scheduled payment is made.

(6) MORTGAGE INSURANCE.—The term “mortgage insurance” means insurance, including any mortgage guaranty insurance, against the nonpayment of, or default on, an individual mortgage or loan involved in a residential mortgage transaction.

(7) MORTGAGE INSURER.—The term “mortgage insurer” means a provider of private mortgage insurance, as described in this Act, that is authorized to transact such business in the State in which the provider is transacting such business.

(8) MORTGAGEE.—The term “mortgagee” means the holder of a residential mortgage at the time at which that mortgage transaction is consummated.

(9) MORTGAGOR.—The term “mortgagor” means the original borrower under a residential mortgage or his or her successors or assignees.

(10) ORIGINAL VALUE.—The term “original value”, with respect to a residential mortgage, means the lesser of the sales price of the property securing the mortgage, as reflected in the contract, or the appraised value at the time at which the subject residential mortgage transaction was consummated.

(11) PRIVATE MORTGAGE INSURANCE.—The term “private mortgage insurance” means mortgage insurance other than mortgage insurance made available under the National Housing Act, title 38 of the United States Code, or title V of the Housing Act of 1949.

(12) RESIDENTIAL MORTGAGE.—The term “residential mortgage” means a mortgage, loan, or other evidence of a security

interest created with respect to a single-family dwelling that is the primary residence of the mortgagor.

(13) RESIDENTIAL MORTGAGE TRANSACTION.—The term “residential mortgage transaction” means a transaction consummated on or after the date that is 1 year after the date of enactment of this Act, in which a mortgage, deed of trust, purchase money security interest arising under an installment sales contract, or equivalent consensual security interest is created or retained against a single-family dwelling that is the primary residence of the mortgagor to finance the acquisition, initial construction, or refinancing of that dwelling.

(14) SERVICER.—The term “servicer” has the same meaning as in section 6(i)(2) of the Real Estate Settlement Procedures Act of 1974, with respect to a residential mortgage.

(15) SINGLE-FAMILY DWELLING.—The term “single-family dwelling” means a residence consisting of 1 family dwelling unit.

(16) TERMINATION DATE.—The term “termination date” means—

(A) with respect to a fixed rate mortgage, the date on which the principal balance of the mortgage, based solely on the initial amortization schedule for that mortgage, and irrespective of the outstanding balance for that mortgage on that date, is first scheduled to reach 78 percent of the original value of the property securing the loan; and

(B) with respect to an adjustable rate mortgage, the date on which the principal balance of the mortgage, based solely on amortization schedules for that mortgage, and irrespective of the outstanding balance for that mortgage on that date, is first scheduled to reach 78 percent of the original value of the property securing the loan.

### SEC. 3. TERMINATION OF PRIVATE MORTGAGE INSURANCE.

(a) BORROWER CANCELLATION.—A requirement for private mortgage insurance in connection with a residential mortgage transaction shall be canceled on the cancellation date, if the mortgagor—

(1) submits a request in writing to the servicer that cancellation be initiated;

(2) has a good payment history with respect to the residential mortgage; and

(3) has satisfied any requirement of the holder of the mortgage (as of the date of a request under paragraph (1)) for—

(A) evidence (of a type established in advance and made known to the mortgagor by the servicer promptly upon receipt of a request under paragraph (1)) that the value of the property securing the mortgage has not declined below the original value of the property; and

(B) certification that the equity of the mortgagor in the residence securing the mortgage is unencumbered by a subordinate lien.

(b) AUTOMATIC TERMINATION.—A requirement for private mortgage insurance in connection with a residential mortgage transaction shall terminate with respect to payments for that mortgage insurance made by the mortgagor—

(1) on the termination date if, on that date, the mortgagor is current on the payments required by the terms of the residential mortgage transaction; or

(2) on the date after the termination date on which the mortgagor becomes current on the payments required by the terms of the residential mortgage transaction.

(c) FINAL TERMINATION.—If a requirement for private mortgage insurance is not otherwise canceled or terminated in accordance with subsection (a) or (b), in no case may such a requirement be imposed beyond the first day of the month immediately following the date that is the midpoint of the amortization period of the loan if the mortgagor is current on the payments required by the terms of the mortgage.

(d) NO FURTHER PAYMENTS.—No payments or premiums may be required from the mortgagor in connection with a private mortgage insurance requirement terminated or canceled under this section—

(1) in the case of cancellation under subsection (a), more than 30 days after the later of—

(A) the date on which a request under subsection (a)(1) is received; or

(B) the date on which the mortgagor satisfies any evidence and certification requirements under subsection (a)(3);

(2) in the case of termination under subsection (b), more than 30 days after the termination date or the date referred to in subsection (b)(2), as applicable; and

(3) in the case of termination under subsection (c), more than 30 days after the final termination date established under that subsection.

(e) RETURN OF UNEARNED PREMIUMS.—

(1) IN GENERAL.—Not later than 45 days after the termination or cancellation of a private mortgage insurance requirement under this section, all unearned premiums for private mortgage insurance shall be returned to the mortgagor by the servicer.

(2) TRANSFER OF FUNDS TO SERVICER.—Not later than 30 days after notification by the servicer of termination or cancellation of private mortgage insurance under this Act with respect to a mortgagor, a mortgage insurer that is in possession of any unearned premiums of that mortgagor shall transfer to the servicer of the subject mortgage an amount equal to the amount of the unearned premiums for repayment in accordance with paragraph (1).

(f) EXCEPTIONS FOR HIGH RISK LOANS.—

(1) IN GENERAL.—The termination and cancellation provisions in subsections (a) and (b) do not apply to any residential mortgage or mortgage transaction that, at the time at which the residential mortgage transaction is consummated, has high risks associated with the extension of the loan—

(A) as determined in accordance with guidelines published by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, in the case of a mortgage loan with an original principal balance that does not exceed the applicable annual conforming loan limit for the secondary market established pursuant to

section 305(a)(2) of the Federal Home Loan Mortgage Corporation Act, so as to require the imposition or continuation of a private mortgage insurance requirement beyond the terms specified in subsection (a) or (b) of section 3; or (B) as determined by the mortgagee in the case of any other mortgage, except that termination shall occur—

(i) with respect to a fixed rate mortgage, on the date on which the principal balance of the mortgage, based solely on the initial amortization schedule for that mortgage, and irrespective of the outstanding balance for that mortgage on that date, is first scheduled to reach 77 percent of the original value of the property securing the loan; and

(ii) with respect to an adjustable rate mortgage, on the date on which the principal balance of the mortgage, based solely on amortization schedules for that mortgage, and irrespective of the outstanding balance for that mortgage on that date, is first scheduled to reach 77 percent of the original value of the property securing the loan.

(2) TERMINATION AT MIDPOINT.—A private mortgage insurance requirement in connection with a residential mortgage or mortgage transaction described in paragraph (1) shall terminate in accordance with subsection (c).

(3) RULE OF CONSTRUCTION.—Nothing in this subsection may be construed to require a mortgage or mortgage transaction described in paragraph (1)(A) to be purchased by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation.

(4) GAO REPORT.—Not later than 2 years after the date of the enactment of this Act, the Comptroller General of the United States shall submit to the Congress a report describing the volume and characteristics of residential mortgages and residential mortgage transactions that, pursuant to paragraph (1) of this subsection, are exempt from the application of subsections (a) and (b). The report shall—

(A) determine the number or volume of such mortgages and transactions compared to residential mortgages and residential mortgage transactions that are not classified as high-risk for purposes of paragraph (1); and

(B) identify the characteristics of such mortgages and transactions that result in their classification (for purposes of paragraph (1)) as having high risks associated with the extension of the loan and describe such characteristics, including—

(i) the income levels and races of the mortgagors involved;

(ii) the amount of the downpayments involved and the downpayments expressed as percentages of the acquisition costs of the properties involved;

(iii) the types and locations of the properties involved;

(iv) the mortgage principal amounts; and

(v) any other characteristics of such mortgages and transactions that may contribute to their classification as high risk for purposes of paragraph (1), including whether such mortgages are purchase-money mortgages or refinancings and whether and to what extent such loans are low-documentation loans.

**SEC. 4. DISCLOSURE REQUIREMENTS.**

**(a) DISCLOSURES FOR NEW MORTGAGES AT TIME OF TRANSACTION.—**

**(1) DISCLOSURES FOR NON-EXEMPTED TRANSACTIONS.—**In any case in which private mortgage insurance is required in connection with a residential mortgage or mortgage transaction (other than a mortgage or mortgage transaction described in section 3(f)(1)), at the time at which the transaction is consummated, the mortgagee shall provide to the mortgagor—

(A) if the transaction relates to a fixed rate mortgage—

(i) a written initial amortization schedule; and

(ii) written notice—

(I) that the mortgagor may cancel the requirement in accordance with section 3(a) of this Act indicating the date on which the mortgagor may request cancellation, based solely on the initial amortization schedule;

(II) that the mortgagor may request cancellation in accordance with section 3(a) of this Act earlier than provided for in the initial amortization schedule, based on actual payments;

(III) that the requirement for private mortgage insurance will automatically terminate on the termination date in accordance with section 3(b) of this Act, and what that termination date is with respect to that mortgage; and

(IV) that there are exemptions to the right to cancellation and automatic termination of a requirement for private mortgage insurance in accordance with section 3(f) of this Act, and whether such an exemption applies at that time to that transaction; and

(B) if the transaction relates to an adjustable rate mortgage, a written notice that—

(i) the mortgagor may cancel the requirement in accordance with section 3(a) of this Act on the cancellation date, and that the servicer will notify the mortgagor when the cancellation date is reached;

(ii) the requirement for private mortgage insurance will automatically terminate on the termination date, and that on the termination date, the mortgagor will be notified of the termination or that the requirement will be terminated as soon as the mortgagor is current on loan payments; and

(iii) there are exemptions to the right of cancellation and automatic termination of a requirement for private mortgage insurance in accordance with section 3(f) of this Act, and whether such an exemption applies at that time to that transaction.

(2) DISCLOSURES FOR EXCEPTED TRANSACTIONS.—In the case of a mortgage or mortgage transaction described in section 3(f)(1), at the time at which the transaction is consummated, the mortgagee shall provide written notice to the mortgagor that in no case may private mortgage insurance be required beyond the date that is the midpoint of the amortization period of the loan, if the mortgagor is current on payments required by the terms of the residential mortgage.

(3) ANNUAL DISCLOSURES.—If private mortgage insurance is required in connection with a residential mortgage transaction, the servicer shall disclose to the mortgagor in each such transaction in an annual written statement—

(A) the rights of the mortgagor under this Act to cancellation or termination of the private mortgage insurance requirement; and

(B) an address and telephone number that the mortgagor may use to contact the servicer to determine whether the mortgagor may cancel the private mortgage insurance.

(4) APPLICABILITY.—Paragraphs (1) through (3) shall apply with respect to each residential mortgage transaction consummated on or after the date that is 1 year after the date of enactment of this Act.

(b) DISCLOSURES FOR EXISTING MORTGAGES.—If private mortgage insurance was required in connection with a residential mortgage entered into at any time before the effective date of this Act, the servicer shall disclose to the mortgagor in each such transaction in an annual written statement—

(1) that the private mortgage insurance may, under certain circumstances, be canceled by the mortgagor (with the consent of the mortgagee or in accordance with applicable State law); and

(2) an address and telephone number that the mortgagor may use to contact the servicer to determine whether the mortgagor may cancel the private mortgage insurance.

(c) INCLUSION IN OTHER ANNUAL NOTICES.—The information and disclosures required under subsection (b) and paragraphs (1)(B) and (3) of subsection (a) may be provided on the annual disclosure relating to the escrow account made as required under the Real Estate Settlement Procedures Act of 1974, or as part of the annual disclosure of interest payments made pursuant to Internal Revenue Service regulations, and on a form promulgated by the Internal Revenue Service for that purpose.

(d) STANDARDIZED FORMS.—The mortgagee or servicer may use standardized forms for the provision of disclosures required under this section.

**SEC. 5. NOTIFICATION UPON CANCELLATION OR TERMINATION.**

(a) IN GENERAL.—Not later than 30 days after the date of cancellation or termination of a private mortgage insurance requirement in accordance with this Act, the servicer shall notify the mortgagor in writing—

(1) that the private mortgage insurance has terminated and that the mortgagor no longer has private mortgage insurance; and

(2) that no further premiums, payments, or other fees shall be due or payable by the mortgagor in connection with the private mortgage insurance.



(b) NOTICE OF GROUNDS.—

(1) IN GENERAL.—If a servicer determines that a mortgage did not meet the requirements for termination or cancellation of private mortgage insurance under subsection (a) or (b) of section 3, the servicer shall provide written notice to the mortgagor of the grounds relied on to make the determination (including the results of any appraisal used to make the determination).

(2) TIMING.—Notice required by paragraph (1) shall be provided—

(A) with respect to cancellation of private mortgage insurance under section 3(a), not later than 30 days after the later of—

(i) the date on which a request is received under section 3(a)(1); or

(ii) the date on which the mortgagor satisfies any evidence and certification requirements under section 3(a)(3); and

(B) with respect to termination of private mortgage insurance under section 3(b), not later than 30 days after the scheduled termination date.

**SEC. 6. DISCLOSURE REQUIREMENTS FOR LENDER PAID MORTGAGE INSURANCE.**

(a) DEFINITIONS.—For purposes of this section—

(1) the term “borrower paid mortgage insurance” means private mortgage insurance that is required in connection with a residential mortgage transaction, payments for which are made by the borrower;

(2) the term “lender paid mortgage insurance” means private mortgage insurance that is required in connection with a residential mortgage transaction, payments for which are made by a person other than the borrower; and

(3) the term “loan commitment” means a prospective mortgagee’s written confirmation of its approval, including any applicable closing conditions, of the application of a prospective mortgagor for a residential mortgage loan.

(b) EXCLUSION.—Sections 3 through 5 do not apply in the case of lender paid mortgage insurance.

(c) NOTICES TO MORTGAGOR.—In the case of lender paid mortgage insurance that is required in connection with a residential mortgage or a residential mortgage transaction—

(1) not later than the date on which a loan commitment is made for the residential mortgage transaction, the prospective mortgagee shall provide to the prospective mortgagor a written notice—

(A) that lender paid mortgage insurance differs from borrower paid mortgage insurance, in that lender paid mortgage insurance may not be canceled by the mortgagor, while borrower paid mortgage insurance could be cancelable by the mortgagor in accordance with section 3(a) of this Act, and could automatically terminate on the termination date in accordance with section 3(b) of this Act;

(B) that lender paid mortgage insurance—

(i) usually results in a residential mortgage having a higher interest rate than it would in the case of borrower paid mortgage insurance; and

(ii) terminates only when the residential mortgage is refinanced, paid off, or otherwise terminated; and

(C) that lender paid mortgage insurance and borrower paid mortgage insurance both have benefits and disadvantages, including a generic analysis of the differing costs and benefits of a residential mortgage in the case lender paid mortgage insurance versus borrower paid mortgage insurance over a 10-year period, assuming prevailing interest and property appreciation rates;

(D) that lender paid mortgage insurance may be tax-deductible for purposes of Federal income taxes, if the mortgagor itemizes expenses for that purpose; and

(2) not later than 30 days after the termination date that would apply in the case of borrower paid mortgage insurance, the servicer shall provide to the mortgagor a written notice indicating that the mortgagor may wish to review financing options that could eliminate the requirement for private mortgage insurance in connection with the residential mortgage.

(d) STANDARD FORMS.—The servicer of a residential mortgage may develop and use a standardized form or forms for the provision of notices to the mortgagor, as required under subsection (c).

SEC. 7. FEES FOR DISCLOSURES.

No fee or other cost may be imposed on any mortgagor with respect to the provision of any notice or information to the mortgagor pursuant to this Act.

SEC. 8. CIVIL LIABILITY.

(a) IN GENERAL.—Any servicer, mortgagee, or mortgage insurer that violates a provision of this Act shall be liable to each mortgagor to whom the violation relates for—

(1) in the case of an action by an individual, or a class action in which the liable party is not subject to section 10, any actual damages sustained by the mortgagor as a result of the violation, including interest (at a rate determined by the court) on the amount of actual damages, accruing from the date on which the violation commences;

(2) in the case of—

(A) an action by an individual, such statutory damages as the court may allow, not to exceed \$2,000; and

(B) in the case of a class action—

(i) in which the liable party is subject to section 10, such amount as the court may allow, except that the total recovery under this subparagraph in any class action or series of class actions arising out of the same violation by the same liable party shall not exceed the lesser of \$500,000 or 1 percent of the net worth of the liable party, as determined by the court; and

(ii) in which the liable party is not subject to section 10, such amount as the court may allow, not to exceed \$1,000 as to each member of the class, except that the total recovery under this subparagraph in any class action or series of class actions arising out of the same violation by the same liable party shall

not exceed the lesser of \$500,000 or 1 percent of the gross revenues of the liable party, as determined by the court;

(3) costs of the action; and

(4) reasonable attorney fees, as determined by the court.

(b) TIMING OF ACTIONS.—No action may be brought by a mortgagor under subsection (a) later than 2 years after the date of the discovery of the violation that is the subject of the action.

(c) LIMITATIONS ON LIABILITY.—

(1) IN GENERAL.—With respect to a residential mortgage transaction, the failure of a servicer to comply with the requirements of this Act due to the failure of a mortgage insurer or a mortgagee to comply with the requirements of this Act, shall not be construed to be a violation of this Act by the servicer.

(2) RULE OF CONSTRUCTION.—Nothing in paragraph (1) shall be construed to impose any additional requirement or liability on a mortgage insurer, a mortgagee, or a holder of a residential mortgage.

#### SEC. 9. EFFECT ON OTHER LAWS AND AGREEMENTS.

(a) EFFECT ON STATE LAW.—

(1) IN GENERAL.—With respect to any residential mortgage or residential mortgage transaction consummated after the effective date of this Act, and except as provided in paragraph (2), the provisions of this Act shall supersede any provisions of the law of any State relating to requirements for obtaining or maintaining private mortgage insurance in connection with residential mortgage transactions, cancellation or automatic termination of such private mortgage insurance, any disclosure of information addressed by this Act, and any other matter specifically addressed by this Act.

(2) PROTECTION OF EXISTING STATE LAWS.—

(A) IN GENERAL.—The provisions of this Act do not supersede protected State laws, except to the extent that the protected State laws are inconsistent with any provision of this Act, and then only to the extent of the inconsistency.

(B) INCONSISTENCIES.—A protected State law shall not be considered to be inconsistent with a provision of this Act if the protected State law—

(i) requires termination of private mortgage insurance or other mortgage guaranty insurance—

(I) at a date earlier than as provided in this Act; or

(II) when a mortgage principal balance is achieved that is higher than as provided in this Act; or

(ii) requires disclosure of information—

(I) that provides more information than the information required by this Act; or

(II) more often or at a date earlier than is required by this Act.

(C) PROTECTED STATE LAWS.—For purposes of this paragraph, the term “protected State law” means a State law—

(i) regarding any requirements relating to private mortgage insurance in connection with residential mortgage transactions;

(ii) that was enacted not later than 2 years after the date of the enactment of this Act; and

(iii) that is the law of a State that had in effect, on or before January 2, 1998, any State law described in clause (i).

(b) EFFECT ON OTHER AGREEMENTS.—The provisions of this Act shall supersede any conflicting provision contained in any agreement relating to the servicing of a residential mortgage loan entered into by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or any private investor or note holder (or any successors thereto).

SEC. 10. ENFORCEMENT.

(a) IN GENERAL.—Compliance with the requirements imposed under this Act shall be enforced under—

(1) section 8 of the Federal Deposit Insurance Act—

(A) by the appropriate Federal banking agency (as defined in section 3(q) of the Federal Deposit Insurance Act) in the case of insured depository institutions (as defined in section 3(c)(2) of such Act);

(B) by the Federal Deposit Insurance Corporation in the case of depository institutions described in clause (i), (ii), or (iii) of section 19(b)(1)(A) of the Federal Reserve Act that are not insured depository institutions (as defined in section 3(c)(2) of the Federal Deposit Insurance Act); and

(C) by the Director of the Office of Thrift Supervision in the case of depository institutions described in clause (v) and or (vi) of section 19(b)(1)(A) of the Federal Reserve Act that are not insured depository institutions (as defined in section 3(c)(2) of the Federal Deposit Insurance Act);

(2) the Federal Credit Union Act, by the National Credit Union Administration Board in the case of depository institutions described in clause (iv) of section 19(b)(1)(A) of the Federal Reserve Act; and

(3) part C of title V of the Farm Credit Act of 1971 (12 U.S.C. 2261 et seq.), by the Farm Credit Administration in the case of an institution that is a member of the Farm Credit System.

(b) ADDITIONAL ENFORCEMENT POWERS.—

(1) VIOLATION OF THIS ACT TREATED AS VIOLATION OF OTHER ACTS.—For purposes of the exercise by any agency referred to in subsection (a) of such agency's powers under any Act referred to in such subsection, a violation of a requirement imposed under this Act shall be deemed to be a violation of a requirement imposed under that Act.

(2) ENFORCEMENT AUTHORITY UNDER OTHER ACTS.—In addition to the powers of any agency referred to in subsection (a) under any provision of law specifically referred to in such subsection, each such agency may exercise, for purposes of enforcing compliance with any requirement imposed under this Act, any other authority conferred on such agency by law.

(c) ENFORCEMENT AND REIMBURSEMENT.—In carrying out its enforcement activities under this section, each agency referred to in subsection (a) shall—

(1) notify the mortgagee or servicer of any failure of the mortgagee or servicer to comply with 1 or more provisions of this Act;

(2) with respect to each such failure to comply, require the mortgagee or servicer, as applicable, to correct the account of the mortgagor to reflect the date on which the mortgage insurance should have been canceled or terminated under this Act; and

(3) require the mortgagee or servicer, as applicable, to reimburse the mortgagor in an amount equal to the total unearned premiums paid by the mortgagor after the date on which the obligation to pay those premiums ceased under this Act.

SEC. 11. CONSTRUCTION.

(a) PMI NOT REQUIRED.—Nothing in this Act shall be construed to impose any requirement for private mortgage insurance in connection with a residential mortgage transaction.

(b) NO PRECLUSION OF CANCELLATION OR TERMINATION AGREEMENTS.—Nothing in this Act shall be construed to preclude cancellation or termination, by agreement between a mortgagor and the holder of the mortgage, of a requirement for private mortgage insurance in connection with a residential mortgage transaction before the cancellation or termination date established by this Act for the mortgage.

SEC. 12. AMENDMENT TO HIGHER EDUCATION ACT OF 1965.

Section 481(a)(4) of the Higher Education Act of 1965 (20 U.S.C. 1088(a)(4)) is amended by—

(1) inserting the subparagraph designation “(A)” immediately after the paragraph designation “(4)”;

(2) redesignating subparagraphs (A) and (B) as clauses (i) and (ii), respectively; and

(3) adding at the end thereof the following new subparagraph:

“(B) Subparagraph (A)(i) shall not apply to a nonprofit institution whose primary function is to provide health care educational services (or an affiliate of such an institution that has the power, by contract or ownership interest, to direct or cause the direction of the institution’s management or policies) that files for bankruptcy under chapter 11 of title 11 of the United States Code between July 1, and December 31, 1998.”.

SEC. 13. EFFECTIVE DATE.

This Act, other than section 14, shall become effective 1 year after the date of enactment of this Act.

SEC. 14. ABOLISHMENT OF THE THRIFT DEPOSITOR PROTECTION OVERSIGHT BOARD.

(a) IN GENERAL.—Effective at the end of the 3-month period beginning on the date of enactment of this Act, the Thrift Depositor Protection Oversight Board established under section 21A of the Federal Home Loan Bank Act (hereafter in this section referred to as the “Oversight Board”) is hereby abolished.

(b) DISPOSITION OF AFFAIRS.—

(1) POWER OF CHAIRPERSON.—Effective on the date of enactment of this Act, the Chairperson of the Oversight Board (or the designee of the Chairperson) may exercise on behalf of the Oversight Board any power of the Oversight Board necessary to settle and conclude the affairs of the Oversight Board.

(2) AVAILABILITY OF FUNDS.—Funds available to the Oversight Board shall be available to the Chairperson of the Oversight Board to pay expenses incurred in carrying out paragraph (1).

(c) SAVINGS PROVISION.—

(1) EXISTING RIGHTS, DUTIES, AND OBLIGATIONS NOT AFFECTED.—No provision of this section shall be construed as affecting the validity of any right, duty, or obligation of the United States, the Oversight Board, the Resolution Trust Corporation, or any other person that—

(A) arises under or pursuant to the Federal Home Loan Bank Act, or any other provision of law applicable with respect to the Oversight Board; and

(B) existed on the day before the abolishment of the Oversight Board in accordance with subsection (a).

(2) CONTINUATION OF SUITS.—No action or other proceeding commenced by or against the Oversight Board with respect to any function of the Oversight Board shall abate by reason of the enactment of this section.

(3) LIABILITIES.—

(A) IN GENERAL.—All liabilities arising out of the operation of the Oversight Board during the period beginning on August 9, 1989, and the date that is 3 months after the date of enactment of this Act shall remain the direct liabilities of the United States.

(B) NO SUBSTITUTION.—The Secretary of the Treasury shall not be substituted for the Oversight Board as a party to any action or proceeding referred to in subparagraph (A).

(4) CONTINUATIONS OF ORDERS, RESOLUTIONS, DETERMINATIONS, AND REGULATIONS PERTAINING TO THE RESOLUTION FUNDING CORPORATION.—

(A) IN GENERAL.—All orders, resolutions, determinations, and regulations regarding the Resolution Funding Corporation shall continue in effect according to the terms of such orders, resolutions, determinations, and regulations until modified, terminated, set aside, or superseded in accordance with applicable law if such orders, resolutions, determinations, or regulations—

(i) have been issued, made, and prescribed, or allowed to become effective by the Oversight Board, or by a court of competent jurisdiction, in the performance of functions transferred by this section; and

(ii) are in effect at the end of the 3-month period beginning on the date of enactment of this section.

(B) ENFORCEABILITY OF ORDERS, RESOLUTIONS, DETERMINATIONS, AND REGULATIONS BEFORE TRANSFER.—Before the effective date of the transfer of the authority and duties of the Resolution Funding Corporation to the Secretary of the Treasury under subsection (d), all orders, resolutions, determinations, and regulations pertaining to

the Resolution Funding Corporation shall be enforceable by and against the United States.

(C) ENFORCEABILITY OF ORDERS, RESOLUTIONS, DETERMINATIONS, AND REGULATIONS AFTER TRANSFER.—On and after the effective date of the transfer of the authority and duties of the Resolution Funding Corporation to the Secretary of the Treasury under subsection (d), all orders, resolutions, determinations, and regulations pertaining to the Resolution Funding Corporation shall be enforceable by and against the Secretary of the Treasury.

(d) TRANSFER OF THRIFT DEPOSITOR PROTECTION OVERSIGHT BOARD AUTHORITY AND DUTIES OF RESOLUTION FUNDING CORPORATION TO SECRETARY OF THE TREASURY.—Effective at the end of the 3-month period beginning on the date of enactment of this Act, the authority and duties of the Oversight Board under sections 21A(a)(6)(I) and 21B of the Federal Home Loan Bank Act are transferred to the Secretary of the Treasury (or the designee of the Secretary).

(e) MEMBERSHIP OF THE AFFORDABLE HOUSING ADVISORY BOARD.—Effective on the date of enactment of this Act, section 14(b)(2) of the Resolution Trust Corporation Completion Act (12 U.S.C. 1831q note) is amended—

(1) by striking subparagraph (C); and

(2) by redesignating subparagraphs (D) and (E) as subparagraphs (C) and (D), respectively.

(f) TIME OF MEETINGS OF THE AFFORDABLE HOUSING ADVISORY BOARD.—

(1) IN GENERAL.—Section 14(b)(6)(A) of the Resolution Trust Corporation Completion Act (12 U.S.C. 1831q note) is amended—

(A) by striking “4 times a year, or more frequently if requested by the Thrift Depositor Protection Oversight Board or” and inserting “2 times a year or at the request of”; and

(B) by striking the second sentence.

(2) CLERICAL AMENDMENT.—Section 14(b)(6)(A) of the Resolution Trust Corporation Completion Act (12 U.S.C. 1831q note) is amended, in the subparagraph heading, by striking “AND LOCATION”.

*Speaker of the House of Representatives.*

*Vice President of the United States and  
President of the Senate.*

# **New HUD Policy Statement**

## **Mortgage Broker Fees**





**HUD Policy Statement on the Legality of Payments by Lenders to Mortgage  
Brokers under the RESPA**

**I. Background**

A. Financial industry seeking guidance

1. Over 100 law suits on yield spread premiums
2. Courts split in their decisions
  - a) Some decisions..."prohibited referral fees under RESPA"
  - b) Other decisions..."permissible based on reasonable payment"
  - c) Some courts denied class action status
  - d) Other courts have certified class action status

B. Congress' Position

1. "Congress never intended payments by lenders to mortgage brokers for goods and facilities actually furnished or for services actually performed to be violations of...RESPA."
2. RESPA intended to protect consumers
  - a) Unnecessarily high settlement charges caused by abusive practices.

**II. HUD's Policy Statement**

A. Coverage

1. Fees paid to mortgage brokers
  - a) Mortgage broker: "a person (not an employee or exclusive agent of a lender) who brings a borrower and lender together to obtain a federally-related mortgage loan, and who renders..."settlement services" (24 CFR 3500.2(b)."

## HUD Policy Statement

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- B. Secondary Market Exemption
  - 1. Loans originated and closed in the name of the mortgage brokers
    - a) Funded with the broker's own funds or warehouse line of credit.
- C. HUD's Conclusions
  - 1. Yield spread premiums are not illegal *per se*
    - a) Not pronounced legal in individual cases or classes of transactions
  - 2. Fees that violate Section 8 of RESPA are illegal
- D. HUD's Fee Analysis
  - 1. Goods or facilities must actually be furnished for broker fees to be legal
  - 2. Fees must reasonably relate to the value of goods or facilities actually furnished or performed
- E. Total Broker Compensation
  - 1. Direct and indirect compensation and fees
    - a) Includes interest rate paid by borrower
    - b) Combination of compensation, fees and interest rate
  - 2. Higher interest rates
    - a) Alone cannot justify higher total fees to brokers

# **federal register**

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**Monday  
March 1, 1999**

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**Part IV**

**Department of  
Housing and Urban  
Development**

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**24 CFR Part 3500  
Real Estate Settlement Procedures Act  
(RESPA) Statement of Policy 1999-1  
Regarding Lender Payments to Mortgage  
Brokers; Final Rule**

**DEPARTMENT OF HOUSING AND  
URBAN DEVELOPMENT**

**24 CFR Part 3500**

[Docket No. FR-4450-N-01]

RIN 2502-AH33

**Real Estate Settlement Procedures Act  
(RESPA) Statement of Policy 1999-1  
Regarding Lender Payments to  
Mortgage Brokers**

**AGENCY:** Office of the Assistant Secretary for Housing-Federal Housing Commissioner, HUD.

**ACTION:** Statement of Policy 1999-1.

**SUMMARY:** This Statement of Policy sets forth the Department of Housing and Urban Development's position on the legality of lender payments to mortgage brokers in connection with federally related mortgage loans under the Real Estate Settlement Procedures Act ("RESPA") and HUD's implementing regulations. While this statement satisfies the Conferees' directive in the Conference Report on the 1999 HUD Appropriations Act that the Department clarify its position on this subject, HUD believes that broad legislative reform along the lines specified in the HUD/Federal Reserve Board Report remains the most effective way to resolve the difficulties and legal uncertainties under RESPA and the Truth in Lending Act (TILA) for industry and consumers alike. Statutory changes like those recommended in the Report would, if adopted, provide the most balanced approach to resolving these contentious issues by providing consumers with better and firmer information about the costs associated with home-secured credit transactions and providing creditors and mortgage brokers with clearer rules. Such an approach is far preferable to piecemeal actions.

**EFFECTIVE DATE:** This Statement of Policy is effective March 1, 1999.

**FOR FURTHER INFORMATION CONTACT:** Rebecca J. Holtz, Director RESPA/ILS Division Room 9146, Department of Housing and Urban Development, Washington, DC 20410; telephone 202-708-4560, or (for legal questions) Kenneth A. Markison, Assistant General Counsel for GSE/RESPA or Rodrigo Alba, Attorney for RESPA, Room 9262, Department of Housing and Urban Development, Washington, DC 20410; telephone 202-708-3137 (these are not toll free numbers). Hearing or speech-impaired individuals may access these numbers via TTY by calling the toll-free Federal Information Relay Service at 1-800-877-8339.

**SUPPLEMENTARY INFORMATION:** This Preamble to the Statement of Policy includes descriptions of current practices in the industry. It is not intended to take positions with respect to the legality or illegality of any practices; such positions are set forth in the Statement of Policy itself.

**I. Background**

**A. General Background**

The Conference Report on the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act, 1999 (H.R. Conf. Rep. No. 105-769, 105th Cong., 2d Sess. 260 (1998)) (FY 1999 HUD Appropriations Act) directs HUD to clarify its position on lender payments to mortgage brokers within 90 days after the enactment of the FY 1999 HUD Appropriations Act on October 21, 1998. The Report states that "Congress never intended payments by lenders to mortgage brokers for goods or facilities actually furnished or for services actually performed to be violations of [Sections 8](a) or (b) of the Real Estate Settlement Procedures Act (12 U.S.C. 2601 *et seq.*) (RESPA))" (Id.). The Report also states that the Conferees "are concerned about the legal uncertainty that continues absent such a policy statement" and "expect HUD to work with representatives of industry, Federal agencies, consumer groups, and other interested parties on this policy statement" (Id.).

This issue of lender payments, or indirect fees, to mortgage brokers has proven particularly troublesome for industry and consumers alike. It has been the subject of litigation in more than 150 cases nationwide (see additional discussion below). To understand the issue and HUD's position regarding the legality of these payments requires background information concerning the nature of the services provided by mortgage brokers and their compensation, as well as the applicable legal requirements under RESPA.

During the last seven years, HUD has conducted three rulemakings respecting mortgage broker fees. These rulemakings first addressed definitional issues and issues concerning disclosure of payments to mortgage brokers in transactions covered under RESPA. (See 57 FR 49600 (November 2, 1992); 60 FR 47650 (September 13, 1995).) Most recently in a regulatory negotiation (see 60 FR 54794 (October 25, 1995) and 60 FR 63008 (December 8, 1995)) and then a proposed rule (62 FR 53912 (October 16, 1997)), HUD addressed the issue of the legality of payments to brokers

under RESPA. In the latter, HUD proposed that payments from lenders to mortgage brokers be presumed legal if the mortgage broker met certain specified conditions, including disclosing its role in the transaction and its total compensation through a binding contract with the borrower. This rulemaking is pending.

In July 1998, HUD and the Board of Governors of the Federal Reserve delivered to Congress a joint report containing legislative proposals to reform RESPA and the Truth in Lending Act. If the proposals in this reform package were to be adopted, the disclosure and legality issues raised herein would be resolved for any mortgage broker following certain of the proposed requirements, and consumers would be offered significant new protections.

**B. Mortgage Brokerage Industry**

When RESPA was enacted in 1974, single family mortgages were largely originated and held by savings and loans, commercial banks, and mortgage bankers. During the 1980's and 1990's, the rise of secondary mortgage market financing resulted in new wholesale and retail entities to compete with the traditional funding entities to provide mortgage financing. This made possible the origination of loans by retail entities that worked with prospective borrowers, collected application information, and otherwise processed the data required to complete the mortgage transaction. These retail entities generally operated with the intent of developing the origination package, and then immediately transmitting it to a wholesale lender who funded the loan. The rise in technology permitted much more effective and faster exchange of information and funds between originators and lenders for the retail transaction.

Entities that provide mortgage origination or retail services and that bring a borrower and a lender together to obtain a loan (usually without providing the funds for loans) are generally referred to as "mortgage brokers." These entities serve as intermediaries between the consumer and the entity funding the loan, and currently initiate an estimated half of all home mortgages made each year in the United States. Mortgage brokers generally fit into two broad categories: those that hold themselves out as representing the borrower in shopping for a loan, and those that simply offer loans as do other retailers of loans. The first type may have an agency relationship with the borrower and, in some states, may be found to owe a

responsibility to the borrower in connection with the agency representation. The second type, while not representing the borrower, may make loans available to consumers from any number of funding sources with which the mortgage broker has a business relationship.

Mortgage brokers provide various services in processing mortgage loans, such as filling out the application, ordering required reports and documents, counseling the borrower and participating in the loan closing. They may also offer goods and facilities, such as reports, equipment, and office space to carry out their functions. The level of services mortgage brokers provide in particular transactions depends on the level of difficulty involved in qualifying applicants for particular loan programs. For example, applicants have differences in credit ratings, employment status, levels of debt, or experience that will translate into various degrees of effort required for processing a loan. Also, the mortgage broker may be required to perform various levels of services under different servicing or processing arrangements with wholesale lenders.

Mortgage brokers vary in their methods of collecting compensation for their work in arranging, processing, and closing mortgage loans. In a given transaction, a broker may receive compensation directly from the borrower, indirectly in fees paid by the wholesaler or lender providing the mortgage loan funds, or through a combination of both.

Where a broker receives direct compensation from a borrower, the broker's fee is likely charged to the borrower at or before closing, as a percentage of the loan amount (e.g., 1% of the loan amount) and through direct fees (such as an application fee, document preparation fee, processing fee, etc.).

Brokers also may receive indirect compensation from lenders or wholesalers. Such indirect fees may be referred to as "back funded payments," "servicing release premiums," or "yield spread premiums." These indirect fees paid to mortgage brokers may be based upon the interest rate of each loan entered into by the broker with the borrower. These fees have been the subject of much contention and litigation. Another method of indirect compensation, also the subject of significant controversy and uncertainty, is "volume-based" compensation. This generally involves compensation to a mortgage broker by a lender based on the volume of loans that the mortgage broker delivers to the lender in a fixed

period of time. The compensation may come in the form of: (1) a cash payment to the broker based on the amount of loans the broker delivers to the lender in excess of a "threshold" or "floor amount"; or (2) provision of a lower "start rate" (often called a discount) for such loans; the compensation to the broker results from the difference in yield between the "start rate" and the loan rate. Volume based compensation may be received at settlement or well after a particular loan has closed.

Payments to brokers by lenders, characterized as yield spread premiums, are based on the interest rate and points of the loan entered into as compared to the par rate offered by the lender to the mortgage broker for that particular loan (e.g., a loan of 8% and no points where the par rate is 7.50% will command a greater premium for the broker than a loan with a par rate of 7.75% and no points).<sup>1</sup> In determining the price of a loan, mortgage brokers rely on rate quotes issued by lenders, sometimes several times a day. When a lender agrees to purchase a loan from a broker, the broker receives the then applicable pricing for the loan based on the difference between the rate reflected in the rate quote and the rate of the loan entered into by the borrower. In some cases, the broker can increase its revenues by arranging a loan with the consumer at a particular rate and then, based on market changes or other factors which decrease the par rate, increase his or her fees. Some consumers allege that the compensation system for brokers results in higher loan rates for borrowers and/or that this compensation system is illegal under RESPA.

Lender payments to mortgage brokers may reduce the up-front costs to consumers. This allows consumers to obtain loans without paying direct fees themselves.<sup>2</sup> Where a broker is not compensated by the consumer through a direct fee, or is partially compensated through a direct fee, the interest rate of the loan is increased to compensate the broker or the fee is added to principal. In any of the compensation methods described, all costs are ultimately paid by the consumer, whether through direct fees or through the interest rate.

<sup>1</sup> The term "par rate" refers to the rate offered to the broker (through the lender's price sheets) at which the lender will fund 100% of the loan with no premiums or discounts to the broker.

<sup>2</sup> In many instances, these loans are called "no cost" or "no fee" loans. This terminology, however, may prove confusing because in such cases the costs are still paid by the borrower through a higher interest rate on the loan or by adding fees to principal. HUD's regulations implementing RESPA use the name "no cost" or "no point" loans consistent with industry practice.

### C. Coverage of This Policy Statement

HUD's RESPA rules, found at 24 CFR part 3500 (Regulation X), define a mortgage broker to be "a person (not an employee or exclusive agent of a lender) who brings a borrower and lender together to obtain a federally-related mortgage loan, and who renders \* \* \* 'settlement services'" (24 CFR 3500.2(b)). In table funding, mortgage brokers may process and close loans in their own names. However, at or about the time of settlement, they transfer these loans to the lender, and the lender simultaneously advances the monies to fund the loan. In transactions where mortgage brokers function as intermediaries, the broker also provides loan origination services, but the loan funds are provided by the lender and the loan is closed in the lender's name.

In other cases, mortgage brokers may originate and close loans in their own name using their own funds or warehouse lines of credit, and then sell the loans after settlement in the secondary market. In such transactions, mortgage brokers effectively act as lenders under HUD's RESPA rules. Accordingly, the transfer of the loan obligation by, and payment to, these brokers after the initial funding is outside of RESPA's coverage under the secondary market exemption, found at 24 CFR 3500.5(b)(7), which states that payments to and from other loan sources following settlement are exempt from disclosure requirements and Section 8 restrictions. HUD's rule provides that in determining what constitutes a *bona fide* transfer in the secondary market, HUD considers the real source of funding and the real interest of the funding lender. (24 CFR 3500.5(b)(7).)

Because this Statement of Policy focuses on the legality of lender payments to mortgage brokers in transactions subject to RESPA, the coverage of this statement is restricted to payments to mortgage brokers in table-funded and intermediary broker transactions. Lender payments to mortgage brokers where mortgage brokers initially fund the loan and then sell the loan after settlement are outside the coverage of this statement as exempt from RESPA under the secondary market exemption.

### D. RESPA and Its Legislative History

In enacting RESPA, Congress sought to protect the American home-buying public from unreasonably and unnecessarily inflated prices in the home purchasing process (S. Rep. No. 93-866 (1974) reprinted in 1974

U.S.C.A.N. 6548). Section 2 of the Act provides:

"significant reforms in the real estate settlement process are needed to insure that consumers throughout the Nation are provided with greater and more timely information on the nature and costs of the settlement process and are protected from unnecessarily high settlement charges caused by certain abusive practices that have developed in some areas of the country.

\* \* \* It is the purpose of this act to effect certain changes in the settlement process for residential real estate that will result— in more effective advance disclosure to home buyers and sellers of settlement costs: [and]

(2) In the elimination of kickbacks or referral fees that tend to increase unnecessarily the costs of certain settlement services. \* \* \* 12 U.S.C. 2601.

Section 4(a) of RESPA requires the Secretary to create a uniform settlement statement which "shall conspicuously and clearly itemize all charges imposed upon the borrower and all charges imposed upon the seller in connection with the settlement" (12 U.S.C. 2603(a)).

Section 5(c) of RESPA requires the provision of a "good faith estimate of the amount or range of charges for specific settlement services the borrower is likely to incur in connection with the settlement as prescribed by the Secretary" (12 U.S.C. 2604(c)).

Section 8(a) of RESPA prohibits any person from giving and any person from accepting any fee, kickback, or other thing of value pursuant to any agreement or understanding that business shall be referred to any person. (See 12 U.S.C. 2607(a).) Section 8(b) also prohibits anyone from giving or accepting any portion, split, or percentage of any charge made or received for the rendering of a settlement service other than for services actually performed. (12 U.S.C. 2607(b).) Section 8(c) of RESPA provides, however, that nothing in Section 8 shall be construed as prohibiting the payment to any person of a *bona fide* salary or compensation or other payment for goods or facilities actually furnished or services actually performed. (12 U.S.C. 2607(c)(2).)

Under Section 19 of RESPA, HUD is authorized to issue rules, establish exemptions, and make such interpretations as is necessary to implement the law. (12 U.S.C. 2618(a).)

RESPA's legislative history refers to HUD-VA Reports and subsequent hearings by the Housing Subcommittee as defining "major problem areas that [had to] be dealt with if settlement costs are to be kept within reasonable bounds." (S. Rep. No. 93-866, at 6547.) One "major problem area" identified was the "[a]busive and unreasonable

practices within the real estate settlement process that increase settlement costs to home buyers without providing any real benefits to them." Another major concern was "[t]he lack of understanding on the part of most home buyers about the settlement process and its costs, which lack of understanding makes it difficult for a free market for settlement services to function at maximum efficiency."

The legislative history reveals that Congress intended RESPA to guard against these unreasonable and excessive settlement costs in two ways. Under Section 4, Congress sought to "mak[e] information on the settlement process available to home buyers in advance of settlement and requir[e] advance disclosures of settlement charges." (S. Rep. 93-866, at 6548.) The Senate Report explained that "home buyers who would otherwise shop around for settlement services, and thereby reduce their overall settlement costs, are prevented from doing so because frequently they are not apprised of the costs of these services until the settlement date or are not aware of the nature of the settlement services that will be provided."

Under Section 8, Congress sought to eliminate what it termed "abusive practices"—kickbacks, referral fees, and unearned fees. In enacting these prohibitions, Congress intended that "the costs to the American home buying public will not be unreasonably or unnecessarily inflated." (S. Rep. 93-866 at 6548.) In describing the Section 8 provisions, the Senate Report explained that RESPA "is intended to prohibit all \* \* \* referral fee arrangements whereby any payment is made or 'thing of value' is provided for the referral of real estate settlement business." (S. Rep. 93-866, at 6551.)

The legislative history adds that "[t]o the extent the payment is in excess of the reasonable value of the goods provided or services performed, the excess may be considered a kickback or referral fee proscribed by Section [8]." (S. Rep. 93-866, at 6551.) The Senate Report states that "reasonable payments in return for services actually performed or goods actually furnished" were not intended to be prohibited (Id).<sup>3</sup> It also provided that "[t]hose persons and companies that provide settlement

<sup>3</sup> One of the examples of abusive activities listed in the legislative history that RESPA was intended to remedy is "a title insurance company [that] may give 10% or more of the title insurance premium to an attorney who may perform no services for the title insurance company other than placing a telephone call to the company or filling out a simple application." (S. Rep. 93-866, at 6551.) Accordingly, where insufficient services are provided, RESPA is intended to prohibit payment.

services should therefore take measures to ensure that any payments they make or commissions they give are not out of line with the reasonable value of the services received." (Id.)

The Department has consistently held that the prohibitions under Section 8 of RESPA cover the activities of mortgage brokers, because RESPA applies to the origination, processing, and funding of a federally related mortgage loan. This became an issue when, in 1984, the 6th Circuit Court of Appeals held that in applying Section 8 as a criminal statute, the definition of settlement services did not clearly extend to the making of a mortgage loan. (*U.S. versus Graham Mortgage Corp.*, 740 F.2d 414 (6th Cir. 1984).) In 1992, Congress responded by amending RESPA to remove any doubt that, for purposes of RESPA, a settlement service includes the origination and making of a mortgage loan. (Section 908 of the Housing and Community Development Act of 1992 (Pub. L. 102-550, approved October 28, 1992; 104 Stat. 4413).) At the same time, Congress also specifically made RESPA applicable to second mortgages and refinancings. (Id.)

#### E. HUD's RESPA Rules

On November 2, 1992 (57 FR 49600), the Department issued a major revision of Regulation X, the rule interpreting RESPA. The rule defined the term "mortgage broker" for the first time. Under the rule, mortgage brokers are required to disclose direct and indirect payments on the Good Faith Estimate (GFE) no later than 3 days after loan application. (See 24 CFR 3500.7(a) and (c).) Such disclosure must also be provided to consumers, as a final figure, at closing on the settlement statement. (24 CFR 3500.8; 24 CFR part 3500, Appendix A (Instructions for Filling Out the HUD-1 and HUD-1A).) On the GFE and the settlement statement, lender-paid mortgage broker fees must be shown as "Paid Outside of Closing" (P.O.C.), and not computed in arriving at totals. (See 24 CFR 3500.7(a)(2) and 24 CFR part 3500, Appendix A.) The 1992 rule treats mortgage brokers as settlement service providers whose fees are disbursed at or before settlement, akin to title agents, attorneys, appraisers, etc., whose fees are subject to disclosure and otherwise subject to RESPA, including Section 8.

The 1992 rule did not explicitly take a position on whether yield spread premiums or any other named class of back-funded or indirect fees paid by lenders to brokers are *per se* legal or illegal. By illustration, codified as Illustrations of Requirements of RESPA, Fact Situations 5 and 12 in Appendix B

to 24 CFR part 3500, the 1992 rule specifically listed "servicing release premiums" and "yield spread premiums" as fees required to be itemized on the settlement statement. Although the 1992 rule specifically acknowledged the existence of such fees and provided illustrations of how they were to be denominated on HUD disclosure forms, this requirement was intended to ensure their disclosure, but not to create a presumption of *per se* legality or illegality.

The anti-kickback, anti-referral fee and unearned fee provisions of RESPA are implemented by 24 CFR 3500.14. Regulation X repeats the Section 8 prohibitions against compensation for the referral of settlement service business and for the giving or accepting of any portion, split or percentage of any charge other than for services actually rendered. (24 CFR 3500.14(c).) Regulation X provides that a charge by a person for which no or nominal services are performed or for which duplicative fees are charged is an unearned fee and violates the unearned fee prohibition. (See 24 CFR 3500.14(c).) Moreover, 24 CFR 3500.14(g)(1)(iv) clarifies that Section 8 of RESPA permits "[a] payment to any person of a *bona fide* salary or compensation or other payment for goods or facilities actually furnished or for services actually performed."

The Department's regulations provide, under 24 CFR 3500.14(g)(2), that:

The Department may investigate high prices to see if they are the result of a referral fee or a split of a fee. *If the payment of a thing of value bears no reasonable relationship to the market value of the goods or services provided, then the excess is not for services or goods actually performed or provided.* These facts may be used as evidence of a violation of section 8 and may serve as a basis for a RESPA investigation. High prices standing alone are not proof of a RESPA violation. The value of a referral (i.e., the value of any additional business obtained thereby) is not to be taken into account in determining whether the payment exceeds the reasonable value of such goods, facilities or services. \* \* \* (emphasis supplied).

In addition, Regulation X clarifies that "[w]hen a person in a position to refer settlement service business \* \* \* receives a payment for providing additional settlement services as part of a real estate transaction, such payment must be for services that are actual, necessary and distinct from the primary services provided by such person." (24 CFR 3500.14(g)(3).)

Since 1992, HUD has provided various interpretations and other issuances under these rules stating the Department's position that the legality

of a payment to a mortgage broker is not premised on the name of the particular fee. Rather, HUD has consistently advised that the issue under RESPA is whether the compensation to a mortgage broker in covered transactions is reasonably related to the value of the goods or facilities actually furnished or services actually performed. If the compensation, or a portion thereof, is not reasonably related to the goods or facilities actually furnished or the services actually performed, there is a compensated referral or an unearned fee in violation of Section 8(a) or 8(b) of RESPA, whether the compensation is a direct or indirect payment or a combination thereof.

#### F. Recent HUD Rulemaking Efforts

The Department received comments on the 1992 rule's requirement that mortgage brokers disclose indirect payments from lenders on the GFE and the settlement statement. In response, the Department reviewed whether the disclosure of indirect or back-funded fees is necessary or in the borrower's interest and whether additional rulemaking was needed to clarify the legality of fees to mortgage brokers. Brokers had alleged that these disclosures were confusing to consumers and disadvantaged brokers as compared to other originators who were within the secondary market exemption and were not required to disclose their compensation for the subsequent sale of the loan. Consumer representatives said that consumers needed to understand the existence of indirect fees and whether brokers represented consumers in shopping for loans. On September 13, 1995, the Department issued a proposed rule (60 FR 47650) and in December 1995 through May 1996, embarked on a negotiated rulemaking on these subjects.

Although the negotiated rulemaking did not result in consensus, on October 16, 1997, HUD published a proposed rule (62 FR 53912) that was shaped by views from both industry and consumer representatives provided during the negotiated rulemaking (as well as by comments received from the September 13, 1995, proposed rule (60 FR 47650)). The 1997 proposed rule proposed a qualified "safe harbor" for payments to mortgage brokers under Section 8. Under the proposal, if a broker enters into a contract with consumers explaining the broker's functions (whether or not it represented the consumer) and the total compensation the broker would receive in the transaction, before the consumer applied for a loan, HUD would presume the broker fees, both direct and indirect,

to be legal. The 1997 proposal also provided, however, that this qualified safe harbor would only be available to those payments that did not exceed a test, to be established in the rulemaking, to preclude unreasonable fees. This proposal was intended, among other things, to establish that yield spread premiums paid to brokers meeting the rule's requirements were presumed legal when brokers provided consumers with prescribed information concerning the functions and compensation of mortgage brokers. The Department has received over 9,000 comments in response to this proposed rule.

#### G. Litigation

During the last several years, more than 150 lawsuits have been brought seeking class action certification based in whole or in part on the theory that the making of indirect payments from lenders to mortgage brokers violates Section 8 of RESPA. In various cases, plaintiffs have argued that yield spread premiums or other denominated indirect payments to brokers, regardless of their amount, constitute prohibited referral fees under Section 8(a). These plaintiffs generally argue that yield spread premiums are payments based upon the broker's ability to deliver a loan that is above the par rate. Some lawsuits have alleged that such yield spread premiums or other indirect payments are a split of fees between the lender and the broker, or are simply unearned fees and, therefore, also violate Section 8(b) of RESPA. Other challenges rely, in part, on the alleged unreasonableness of brokers' fees. These complaints assert that under the RESPA regulations, payments must bear a reasonable relationship to the market value of the good or the service provided and that payments in excess of such amounts must be regarded as forbidden referral fees.

Many of the lawsuits involve allegations that consumers were not informed by mortgage brokers concerning the mortgage brokers' role and compensation. A common element in many allegations is that borrowers were not informed about the existence or the amount of the yield spread premiums paid to the mortgage broker, and the relationship of the yield spread premium to the direct fees that the borrower paid. The facts in these cases suggest generally that even where there were proper disclosures on the GFE and the settlement statement, borrowers allege that they were unaware of, or did not understand, that a yield spread premium was tied to the interest rate they agreed to pay, and that they could have reduced this charge or their direct



payment to the broker either by further negotiation or by engaging in additional shopping among mortgage loan providers.

Courts have been split in their decisions on these cases. Some of the decisions have concluded that yield spread premiums may be prohibited referral fees or duplicative fees in contravention of Section 8 of RESPA under the specific facts of the case. Some have held that the permissibility of yield spread premiums must be based on an analysis of whether the premiums constitute a reasonable payment, either alone or in combination with any direct fee paid by the borrower, for either the goods, services or facilities actually furnished. Because some courts have found that this necessitates an individual analysis of the facts of each transaction, some courts have denied plaintiffs' requests for class action certification. Some courts have certified a class without reaching a conclusion on the RESPA issues. Others have held that yield spread premiums constitute valid consideration to the mortgage broker in exchange for the origination of the loan and the sale of the loan to the lender. These courts have found that the payment of yield spread premiums is one method among many of compensating the broker for the origination services rendered.

#### H. Reform

In July 1998, the Department and the Federal Reserve Board delivered a report to Congress recommending significant improvements to streamline and simplify current RESPA and Truth In Lending Act requirements. The Report proposed that along with a tighter and more enforceable scheme for providing consumers with estimated costs for settlements, an exemption from Section 8's prohibitions should be established for those entities that offer a package of settlement services and a mortgage loan at a guaranteed price, rate and points for the package early in the consumer's process of shopping for a loan. Such an approach, which also includes other additional consumer protection recommendations, would largely resolve these issues for any mortgage broker who chooses to abide by the requirements of this exemption. The Report's consumer protection recommendations included, among other items, that Congress consider establishment of an unfair and deceptive acts and practices remedy.

Under the "packaging" proposal set forth in the Report, settlement costs would be controlled more effectively by market forces. Consumers would be better able to comparison-shop, thereby

encouraging creditors and others to operate efficiently and pass along discounts and lower prices. In addition, the Report's recommendations would greatly simplify compliance for the industry and clarify legal uncertainties that create liability risks.

#### I. This Policy Statement

This policy statement provides HUD's views of the legality of fees to mortgage brokers from lenders under existing law. In accordance with the Conference Report, in developing this policy statement, HUD met with representatives of government agencies, as well as a broad range of consumer and industry groups, including the Office of Thrift Supervision, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the National Association of Mortgage Brokers, the Mortgage Bankers Association of America, the American Bankers Association, the Consumer Mortgage Coalition, America's Community Bankers, the Consumer Bankers Association, the Independent Bankers Association of America, AARP, the National Consumer Law Center, Consumers Union, and the National Association of Consumer Advocates.

#### II. RESPA Policy Statement 1999-1

##### A. Introduction

The Department hereby states its position on the legality of payments by lenders to mortgage brokers under the Real Estate Settlement Procedures Act (12 U.S.C. 2601 *et seq.*) (RESPA) and its implementing regulations at 24 CFR part 3500 (Regulation X). This Statement of Policy is issued pursuant to Section 19(a) of RESPA (12 U.S.C. 2617(a)) and 24 CFR 3500.4(a)(1)(ii). HUD is cognizant of the Conferees' statement in the Conference Report on the FY 1999 HUD Appropriations Act that "Congress never intended payments by lenders to mortgage brokers for goods or facilities actually furnished or for services actually performed to be violations of [Sections 8](a) or (b) (12 U.S.C. Sec. 2607) in its enactment of RESPA." (H. Rep. 105-769, at 260.) The Department is also cognizant of the congressional intent in enacting RESPA of protecting consumers from unnecessarily high settlement charges caused by abusive practices. (12 U.S.C. 2601.)

In transactions where lenders make payments to mortgage brokers, HUD does not consider such payments (i.e., yield spread premiums or any other class of named payments), to be illegal *per se*. HUD does not view the name of the payment as the appropriate issue

under RESPA. HUD's position that lender payments to mortgage brokers are not illegal *per se* does not imply, however, that yield spread premiums are legal in individual cases or classes of transactions. The fees in cases or classes of transactions are illegal if they violate the prohibitions of Section 8 of RESPA.

In determining whether a payment from a lender to a mortgage broker is permissible under Section 8 of RESPA, the first question is whether goods or facilities were actually furnished or services were actually performed for the compensation paid. The fact that goods or facilities have been actually furnished or that services have been actually performed by the mortgage broker does not by itself make the payment legal. The second question is whether the payments are reasonably related to the value of the goods or facilities that were actually furnished or services that were actually performed.

In applying this test, HUD believes that total compensation should be scrutinized to assure that it is reasonably related to goods, facilities, or services furnished or performed to determine whether it is legal under RESPA. Total compensation to a broker includes direct origination and other fees paid by the borrower, indirect fees, including those that are derived from the interest rate paid by the borrower, or a combination of some or all. The Department considers that higher interest rates alone cannot justify higher total fees to mortgage brokers. All fees will be scrutinized as part of total compensation to determine that total compensation is reasonably related to the goods or facilities actually furnished or services actually performed. HUD believes that total compensation should be carefully considered in relation to price structures and practices in similar transactions and in similar markets.

##### B. Scope

In light of 24 CFR § 3500.5(b)(7), which exempts from RESPA coverage *bona fide* transfers of loan obligations in the secondary market, this policy statement encompasses only transactions where mortgage brokers are not the real source of funds (i.e., table-funded transactions or transactions involving "intermediary" brokers). In table-funded transactions, the mortgage broker originates, processes and closes the loan in the broker's own name and, at or about the time of settlement, there is a simultaneous advance of the loan funds by the lender and an assignment of the loan to that lender. (See 24 CFR 3500.2 (Definition of "table funding").) Likewise, in transactions where

mortgage brokers are intermediaries, the broker provides loan origination services and the loan funds are provided by the lender; the loan, however, is closed in the lender's name.

**C. Payments Must Be for Goods, Facilities or Services**

In the determination of whether payments from lenders to mortgage brokers are permissible under Section 8 of RESPA, the threshold question is whether there were goods or facilities actually furnished or services actually performed for the total compensation paid to the mortgage broker. In making the determination of whether compensable services are performed, HUD's letter to the Independent Bankers Association of America, dated February 14, 1995 (IBAA letter) may be useful. In that letter, HUD identified the following services normally performed in the origination of a loan:

- (a) Taking information from the borrower and filling out the application;<sup>4</sup>
- (b) Analyzing the prospective borrower's income and debt and pre-qualifying the prospective borrower to determine the maximum mortgage that the prospective borrower can afford;
- (c) Educating the prospective borrower in the home buying and financing process, advising the borrower about the different types of loan products available, and demonstrating how closing costs and monthly payments could vary under each product;
- (d) Collecting financial information (tax returns, bank statements) and other related documents that are part of the application process;
- (e) Initiating/ordering VOsEs (verifications of employment) and VODs (verifications of deposit);
- (f) Initiating/ordering requests for mortgage and other loan verifications;
- (g) Initiating/ordering appraisals;
- (h) Initiating/ordering inspections or engineering reports;
- (i) Providing disclosures (truth in lending, good faith estimate, others) to the borrower;
- (j) Assisting the borrower in understanding and clearing credit problems;
- (k) Maintaining regular contact with the borrower, realtors, lender, between application and closing to appraise them of the status of the application and gather any additional information as needed;

<sup>4</sup> In a subsequent informal interpretation, dated June 20, 1995, HUD stated that the filling out of a mortgage loan application could be substituted by a comparable activity, such as the filling out of a borrower's worksheet.

- (l) Ordering legal documents;
- (m) Determining whether the property was located in a flood zone or ordering such service; and
- (n) Participating in the loan closing.

While this list does not exhaust all possible settlement services, and while the advent of computer technology has, in some cases, changed how a broker's settlement services are performed, HUD believes that the letter still represents a generally accurate description of the mortgage origination process. For other services to be acknowledged as compensable under RESPA, they should be identifiable and meaningful services akin to those identified in the IBAA letter including, for example, the operation of a computer loan origination system (CLO) or an automated underwriting system (AUS).

The IBAA letter provided guidance on whether HUD would take an enforcement action under RESPA. In the context of the letter's particular facts and subject to the reasonableness test which is discussed below, HUD articulated that it generally would be satisfied that sufficient origination work was performed to justify compensation if it found that:

- The lender's agent or contractor took the application information (under item (a)); and
- The lender's agent or contractor performed at least five additional items on the list above.

In the letter and in the context of its facts, HUD also pointed out that it is concerned that a fee for steering a customer to a particular lender could be disguised as compensation for "counseling-type" activities. Therefore, the letter states that if an agent or contractor is relying on taking the application and performing only "counseling type" services—(b), (c), (d), (j), and (k) on the list above—to justify its fee, HUD would also look to see that meaningful counseling—not steering—is provided. In analyzing transactions addressed in the IBAA letter, HUD said it would be satisfied that no steering occurred if it found that:

- Counseling gave the borrower the opportunity to consider products from at least three different lenders;
- The entity performing the counseling would receive the same compensation regardless of which lender's products were ultimately selected; and
- Any payment made for the "counseling-type" services is reasonably related to the services performed and not based on the amount of loan business referred to a particular lender.

In examining services provided by mortgage brokers and payments to

mortgage brokers, HUD will look at the types of origination services listed in the IBAA letter to help determine whether compensable services are performed.<sup>5</sup> However, the IBAA letter responded to a program where a relatively small fee was to be provided for limited services by lenders that were brokering loans.<sup>6</sup>

Accordingly, the formulation in the IBAA letter of the number of origination services which may be required to be performed for compensation is not dispositive in analyzing more costly mortgage broker transactions where more comprehensive services are provided. The determinative test under RESPA is the relationship of the services, goods or facilities furnished to the total compensation received by the broker (discussed below). In addition to services, mortgage brokers may furnish goods or facilities to the lender. For example, appraisals, credit reports, and other documents required for a complete loan file may be regarded as goods, and a reasonable portion of the broker's retail or "store-front" operation may generally be regarded as a facility for which a lender may compensate a broker. However, while a broker may be compensated for goods or facilities actually furnished or services actually performed, the loan itself, which is arranged by the mortgage broker, cannot be regarded as a "good" that the broker may sell to the lender and that the lender may pay for based upon the loan's yield's relation to market value, reasonable or otherwise. In other words, in the context of a non-secondary market mortgage broker transaction, under HUD's rules, it is not proper to argue that a loan is a "good," in the sense of an instrument bearing a particular yield, thus justifying any yield spread premium to the mortgage broker, however great, on the grounds that such yield spread premium is the "market value" of the good.

**D. Compensation Must Be Reasonably Related to Value of Goods, Facilities or Services**

The fact that goods or facilities have been actually furnished or that services have been actually performed by the mortgage broker, as described in the IBAA letter, does not by itself make a payment by a lender to a mortgage

<sup>5</sup> In the June 20, 1995 letter, the Department clarified that the counseling test in the IBAA letter would not apply if an entity performed only non-counseling services (a, e, f, g, h, i, l, m, n) or a mix of counseling and non-counseling services (but did not rely only on the five counseling services (b, c, d, j, and k)).

<sup>6</sup> In the particular program reviewed by HUD in the IBAA letter, the average total compensation for performing six of the origination services listed above was below \$200.

broker legal. The next inquiry is whether the payment is reasonably related to the value of the goods or facilities that were actually furnished or services that were actually performed. Although RESPA is not a rate-making statute, HUD is authorized to ensure that payments from lenders to mortgage brokers are reasonably related to the value of the goods or facilities actually furnished or services actually performed, and are not compensation for the referrals of business, splits of fees or unearned fees.

In analyzing whether a particular payment or fee bears a reasonable relationship to the value of the goods or facilities actually furnished or services actually performed, HUD believes that payments must be commensurate with that amount normally charged for similar services, goods or facilities. This analysis requires careful consideration of fees paid in relation to price structures and practices in similar transactions and in similar markets.<sup>7</sup> If the payment or a portion thereof bears no reasonable relationship to the market value of the goods, facilities or services provided, the excess over the market rate may be used as evidence of a compensated referral or an unearned fee in violation of Section 8(a) or (b) of RESPA. (See 24 CFR 3500.14(g)(2).) Moreover, HUD also believes that the market price used to determine whether a particular payment meets the reasonableness test may not include a referral fee or unearned fee, because such fees are prohibited by RESPA. Congress was clear that for payments to be legal under Section 8, they must bear a reasonable relationship to the value received by the person or company making the payment. (S. Rep. 93-866, at 6551.)

The Department recognizes that some of the goods or facilities actually furnished or services actually performed by the broker in originating a loan are "for" the lender and other goods or facilities actually furnished or services actually performed are "for" the borrower. HUD does not believe that it is necessary or even feasible to identify or allocate which facilities, goods or services are performed or provided for the lender, for the consumer, or as a function of State or Federal law. All services, goods and facilities inure to the benefit of both the borrower and the lender in the sense that they make the loan transaction possible (e.g., an appraisal is necessary to assure that the

<sup>7</sup> HUD recognizes that settlement costs may vary in different markets. The cost of a specific service in Omaha, Nebraska, for example, may bear little resemblance to the cost of a similar service in Los Angeles, California.

lender has adequate security, as well as to advise the borrower of the value of the property and to complete the borrower's loan).

The consumer is ultimately purchasing the total loan and is ultimately paying for all the services needed to create the loan. All compensation to the broker either is paid by the borrower in the form of fees or points, directly or by addition to principal, or is derived from the interest rate of the loan paid by the borrower. Accordingly, in analyzing whether lender payments to mortgage brokers comport with the requirements of Section 8 of RESPA, HUD believes that the totality of the compensation to the mortgage broker for the loan must be examined. For example, if the lender pays the mortgage broker \$600 and the borrower pays the mortgage broker \$500, the total compensation of \$1,100 would be examined to determine whether it is reasonably related to the goods or facilities actually furnished or services actually performed by the broker.

Therefore, in applying this test, HUD believes that total compensation should be scrutinized to assure that it is reasonably related to goods, facilities, or services furnished or performed to determine whether total compensation is legal under RESPA. Total compensation to a broker includes direct origination and other fees paid by the borrower, indirect fees, including those that are derived from the interest rate paid by the borrower, or a combination of some or all. All payments, including payments based upon a percentage of the loan amount, are subject to the reasonableness test defined above. In applying this test, the Department considers that higher interest rates alone cannot justify higher total fees to mortgage brokers. All fees will be scrutinized as part of total compensation to determine that total compensation is reasonably related to the goods or facilities actually furnished or services actually performed.

In so-called "no-cost" loans, borrowers accept a higher interest rate in order to reduce direct fees, and the absence of direct payments to the mortgage broker is made up by higher indirect fees (e.g., yield spread premiums). Higher indirect fees in such arrangements are legal if, and only if, the total compensation is reasonably related to the goods or facilities actually furnished or services actually performed.

In determining whether the compensation paid to a mortgage broker is reasonably related to the goods or facilities actually furnished or services

actually performed, HUD will consider all compensation, including any volume based compensation. In this analysis, there may be no payments merely for referrals of business under Section 8 of RESPA. (See 24 CFR 3500.14.)<sup>8</sup>

Under HUD's rules, when a person in a position to refer settlement service business receives a payment for providing additional settlement services as part of the transaction, such payment must be for services that are actual, necessary and distinct from the primary services provided by the person. (24 CFR 3500.14(g)(3).) While mortgage brokers may receive part of their compensation from a lender, where the lender payment duplicates direct compensation paid by the borrower for goods or facilities actually furnished or services actually performed, Section 8 is violated. In light of the fact that the borrower and the lender may both contribute to some items, HUD believes that it is best to evaluate seemingly duplicative fees by analyzing total compensation under the reasonableness test described above.

#### E. Information Provided to Borrower

Under current RESPA rules mortgage brokers are required to disclose estimated direct and indirect fees on the Good Faith Estimate (GFE) no later than 3 days after loan application. (See 24 CFR 3500.7(a) and (b).) Such disclosure must also be provided to consumers, as a final exact figure, at closing on the settlement statement. (24 CFR 3500.8; 24 CFR part 3500, Appendix A.) On the GFE and the settlement statement, lender payments to mortgage brokers must be shown as "Paid Outside of Closing" (P.O.C.), and are not computed in arriving at totals. (24 CFR 3500.7(a)(2).) The requirement that all fees be disclosed on the GFE is intended to assure that consumers are shown the full amount of compensation to brokers and others early in the transaction.

The Department has always indicated that any fees charged in settlement transactions should be clearly disclosed so that the consumer can understand the nature and recipient of the payment. Code-like abbreviations like "YSP to DBG, POC", for instance, have been noted.<sup>9</sup> Also, the Department has seen

<sup>8</sup> The Department generally has held that when the payment is based on the volume or value of business transacted, it is evidence of an agreement for the referral of business (unless, for example, it is shown that payments are for legitimate business reasons unrelated to the value of the referrals). (See 24 CFR 3500.14(e).)

<sup>9</sup> This is an example only. HUD recognizes that current practices may leave borrowers confused. However, the use of any particular terms, including abbreviations, may not, by itself, violate RESPA. Nevertheless, going forward, HUD recommends that

examples on the GFE and/or the settlement statement where the identity and/or purpose of the fees are not clearly disclosed.

The Department considers unclear and confusing disclosures to be contrary to the statute's and the regulation's purposes of making RESPA-covered transactions understandable to the consumer. At a minimum, all fees to the mortgage broker are to be clearly labeled and properly estimated on the GFE. On the settlement statement, the name of the recipient of the fee (in this case, the mortgage broker) is to be clearly labeled and listed, and the fee received from a lender is to be clearly labeled and listed in the interest of clarity. For example, a fee would be appropriately disclosed as "Mortgage broker fee from lender to XYZ Corporation (P.O.C.)." In the interest of clarity, other fees or payments from the borrower to the mortgage broker should identify that they are mortgage broker fees from the borrower.<sup>10</sup>

There is no requirement under existing law that consumers be fully informed of the broker's services and compensation prior to the GFE. Nevertheless, HUD believes that the broker should provide the consumer with information about the broker's services and compensation, and agreement by the consumer to the arrangement should occur as early as possible in the process. Mortgage brokers and lenders can improve their ability to demonstrate the reasonableness of their fees if the broker discloses the nature of the broker's services and the various methods of compensation at the time the consumer first discusses the possibility of a loan with the broker.

The legislative history makes clear that RESPA was not intended to be a rate-setting statute and that Congress instead favored a market-based approach. (S. Rep. No. 93-866 at 6546 (1974).) In making the determination of whether a payment is *bona fide* compensation for goods or facilities actually furnished or services actually performed, HUD has, in the past, indicated that it would examine whether the price paid for the goods,

the disclosures on the GFE and the settlement statement be as described in the text. HUD recognizes that system changes may require time for lenders and brokers to implement.

<sup>10</sup>HUD recognizes that current software may not currently accommodate these additional disclosures. Both industry and consumers would be better served if these additional disclosures were included in future forms.

facilities or services is truly a market price; that is, if in an arm's length transaction a purchaser would buy the services at or near the amount charged. If the fee the consumer pays is disclosed and agreed to, along with its relationship to the interest rate and points for the loan and any lender-paid fees to the broker, a market price for the services, goods or facilities could be attained. HUD believes that for the market to work effectively, borrowers should be afforded a meaningful opportunity to select the most appropriate product and determine what price they are willing to pay for the loan based on disclosures which provide clear and understandable information.

The Department reiterates its long-standing view that disclosure alone does not make illegal fees legal under RESPA. On the other hand, while under current law, pre-application disclosure to the consumer is not required, HUD believes that fuller information provided at the earliest possible moment in the shopping process would increase consumer satisfaction and reduce the possibility of misunderstanding.

HUD commends the National Association of Mortgage Brokers and the Mortgage Bankers Association of America for strongly suggesting that their members furnish consumers with a form describing the function of mortgage brokers and stating that a mortgage broker may receive a fee in the transaction from a lender.

Although this statement of policy does not mandate disclosures beyond those currently required by RESPA and Regulation X, the most effective approach to disclosure would allow a prospective borrower to properly evaluate the nature of the services and all costs for a broker transaction, and to agree to such services and costs before applying for a loan. Under such an approach, the broker would make the borrower aware of whether the broker is or is not serving as the consumer's agent to shop for a loan, and the total compensation to be paid to the mortgage broker, including the amounts of each of the fees making up that compensation. If indirect fees are paid, the consumer would be made aware of the amount of these fees and their relationship to direct fees and an increased interest rate. If the consumer may reduce the interest rate through increased fees or points, this option also would be explained. HUD recognizes that in many cases, the industry has not been using

this approach because it has not been required. Moreover, new methods may require time to implement. HUD encourages these efforts going forward and believes that if these desirable disclosure practices were adhered to by all industry participants, the need for more prescriptive regulatory or legislative actions concerning this specific problem could be tempered or even made unnecessary.

While the Department is issuing this statement of policy to comply with a Congressional directive that HUD clarify its position on the legality of lender payments to mortgage brokers, HUD agrees with segments of the mortgage lending and settlement service industries and consumer representatives that legislation to improve RESPA is needed. HUD believes that broad legislative reform along the lines specified in the HUD/Federal Reserve Board Report remains the most effective way to resolve the difficulties and legal uncertainties under RESPA and TILA for industry and consumers alike. Statutory changes like those recommended in the Report would, if adopted, provide the most balanced approach to resolving these contentious issues by providing consumers with better and firmer information about the costs associated with home-secured credit transactions and providing creditors and mortgage brokers with clearer rules.

### III. Executive Order 12866, Regulatory Planning and Review

The Office of Management and Budget (OMB) reviewed this Statement of Policy under Executive Order 12866, *Regulatory Planning and Review*. OMB determined that this Statement of Policy is a "significant regulatory action," as defined in section 3(f) of the Order (although not economically significant, as provided in section 3(f)(1) of the Order). Any changes made to the Statement of Policy subsequent to its submission to OMB are identified in the docket file, which is available for public inspection in the office of the Department's Rules Docket Clerk, Room 10276, 451 Seventh Street, SW, Washington, DC 20410-0500.

Dated: February 22, 1999.

William C. Appgar,

*Assistant Secretary for Housing-Federal Housing Commissioner.*

[FR Doc. 99-4921 Filed 2-26-99; 8:45 am]

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**Harmonizing Truth in  
Lending (Regulation Z) and  
RESPA**



## Harmonizing Regulation Z and RESPA

### Overview

Almost all consumer-purpose real estate secured transactions are covered by the requirements of both the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (Regulation Z). There are certain aspects of the requirements that need to be harmonized in order to ensure a good compliance position. Some of the predominate ones are discussed below.

- I. Business Loan Exemption
  - A. Business-Purposes Loans are Exempt – RESPA and Regulation Z
    1. RESPA now harmonizes with Regulation Z in this regard
- II. Home Equity Loan Exemption
  - A. Home Equity Lines of Credit (HELOC)
    1. No RESPA required
    2. Regulation Z program disclosures and booklet must be provided
- III. Early Truth in Lending Disclosure
  - A. “Residential Mortgage Transaction” under Regulation Z
  - B. Covered by RESPA
  - C. Disclosure Required When A and B Apply
- IV. Itemization of Amount Financed
  - A. Required by Regulation Z
  - B. HUD-1 Satisfies Requirement



## Harmonizing Regulation Z and RESPA

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1. HUD-1 must identify prepaids

### V. Payment Schedule Disclosures

#### A. Regulation Z Commentary Revision

1. Addresses new PMI rules

#### B. Automatic Termination Date

1. Payment schedule should reflect PMI payments through this date

**FEDERAL RESERVE SYSTEM****12 CFR Part 226****[Regulation Z; Docket No. R-1029]****Truth in Lending****AGENCY:** Board of Governors of the Federal Reserve System.**ACTION:** Final rule; official staff interpretation.

**SUMMARY:** The Board is publishing revisions to the official staff commentary to Regulation Z (Truth in Lending). The commentary applies and interprets the requirements of the regulation. The update addresses the prohibition against the issuance of unsolicited credit cards. It provides guidance on calculating payment schedules involving private mortgage insurance. In addition, the update discusses credit sale transactions where downpayments include cash and property used as a trade-in, and adopts several technical amendments.

**DATES:** This rule is effective March 31, 1999. Compliance is optional until March 31, 2000.

**FOR FURTHER INFORMATION CONTACT:** James H. Mann or Obrea O. Poindexter (open-end credit), or Michael E. Hentrel or Kathleen C. Ryan (closed-end credit), Staff Attorneys; Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, at (202) 452-3667 or 452-2412; for users of Telecommunications Device for the Deaf (TDD) only, Diane Jenkins at (202) 452-3544.

**SUPPLEMENTARY INFORMATION:****I. Background**

The purpose of the Truth in Lending Act (TILA; 15 U.S.C. 1601 *et seq.*) is to promote the informed use of consumer credit by providing for disclosures about its terms and cost. The act requires creditors to disclose the cost of credit as a dollar amount (the finance charge) and as an annual percentage rate (APR). Uniformity in creditors' disclosures is intended to assist consumers in comparison shopping. TILA requires additional disclosures for loans secured by a consumer's home and permits consumers to rescind certain transactions that involve their principal dwelling. In addition, the act regulates

certain practices of creditors. The act is implemented by the Board's Regulation Z (12 CFR Part 226). The Board's official staff commentary (12 CFR Part 226 (Supp. I)) interprets the regulation, and provides guidance to creditors in applying the regulation to specific transactions. The commentary is a substitute for individual staff interpretations; it is updated periodically to address significant questions that arise.

In December, the Board published proposed amendments to the commentary to Regulation Z (63 FR 67436, December 7, 1998). The Board received about 50 comments. Most of the comments were from financial institutions and other creditors; state attorneys general and consumer representatives also submitted comments. Overall, commenters generally supported the proposed amendments. Views were mixed on comments concerning multifunction cards that are or may be used as credit cards and credit sale transactions where downpayments involve cash payments and property used as a trade-in.

Except as discussed below, the commentary is being adopted as proposed; some technical suggestions or concerns raised by commenters are addressed. In response to concerns about the uncertainty of computer readiness for the Year 2000 date change, the effective date for mandatory compliance with the commentary update is March 31, 2000.

**II. Commentary Revisions****Subpart A—General****Section 226.2—Definitions and Rules of Construction****2(a) Definitions****2(a)(15) Credit Card**

Section 226.2(a)(15) defines a credit card to include any card or credit device that may be used from time to time to obtain credit. Comment 2(a)(15)-2 provides examples of cards and devices that are and are not credit cards. The comment is revised to include a new example of cards or devices that are credit cards, addressing recent programs where cards are marketed from the outset with both credit and non-credit features. (Two additional examples were proposed. Some commenters suggested technical changes to ensure consistency in the new examples; the changes were made by merging them.)

**2(a)(18) Downpayment**

Comment 2(a)(18)-3 provides guidance on how a creditor discloses the downpayment if a trade-in is

involved in a credit sale transaction and if the amount of an existing lien exceeds the value of the trade-in. Under Regulation Z, the term "downpayment" refers to an amount, including the value of any property used as a trade-in, paid to a seller to reduce the "cash price." If the amount of an existing lien exceeds the value of the property being used as a trade-in and no cash payment is involved, creditors must disclose zero as the downpayment and not a negative number. The proposed comment also added an example where the consumer makes a cash payment. In that example, creditors would apply the cash payment to the excess lien amount rather than reduce the price of the purchased item. In response to commenters' concerns, the comment has been revised to provide flexibility. At their option, creditors may first apply the cash payment to reduce the price of the purchased item.

Many commenters opposed the proposal. Some believed that applying the cash payment to the excess lien amount would be confusing to consumers because the creditor's treatment of the cash payments might not be readily apparent. They argued that the comment should comport with consumers' general expectations—that cash payments would be disclosed as downpayments that reduce the cash price.

Moreover, commenters stated that, where cash payments are made in credit sales involving a trade-in and a lien on the property that exceeds the value of the trade-in, many creditors currently apply the cash payment to any excess lien amount. These creditors disclose the cash payment as a downpayment. Many of these creditors, along with consumer advocates and state Attorneys General commenting on the issue, believe disclosing a downpayment equal to the cash payment is more helpful to consumers. They express concern about the potential for confusion under the proposal when, for example, a cash payment of \$500 is applied to an excess lien amount of \$2,000 and the downpayment is disclosed as \$0, even if the cash payment is disclosed elsewhere in the itemization of the amount financed. (See § 226.18(c).) Some commenters also believed the proposal potentially conflicts with some state laws regarding the disclosure of downpayments.

In response to comments received and upon further analysis, the proposed example has been revised. In disclosing a downpayment where cash payments are made in credit sales involving a trade-in and a lien on the property that exceeds the value of the trade-in,

creditors may, but need not, apply the cash payment first to any excess lien amount.

#### Subpart B—Open-end Credit

##### Section 226.12—Special Credit Card Provisions

##### 12(a) Issuance of Credit Cards

###### 12(a)(1)

Section 226.12(a) prohibits creditors from issuing credit cards except in response to a consumer's request or application for the card or as a renewal of, or substitute for, a previously accepted credit card. The prohibition, which parallels the statute, addresses various concerns including the potential for theft and fraud and the consumer inconvenience of refuting claims of liability. The law does not prohibit creditors from issuing unsolicited cards that have a non-credit purpose—such as check-guarantee or purchase-price discount cards—so long as they cannot also be used to obtain credit. Consumers may later be able to convert these cards to credit cards if the issuer makes a credit feature available and the consumer requests the credit.

Comment 12(a)(1)-7 provides guidance regarding a card that is issued to and accepted by the consumer as a non-credit device and that subsequently is converted for use as a credit device at the consumer's request. The revisions clarify the comment's applicability to recent programs where unsolicited cards are marketed from the outset as both stored-value cards and credit cards. The Board proposed revisions to the comment to reflect more clearly its intended purpose.

Views were mixed on the proposal. Commenters that opposed the revisions cited a variety of reasons for their position. Some believed the concerns associated with the prohibition—theft, fraud, and the inconvenience of refuting claims of liability—were outdated, due to advances in technology and industry practice regarding fraud prevention, and TILA's \$50 maximum potential loss for consumers. Others believed the proposal would inappropriately deter the development of multifunction cards. They discussed the convenience of such cards and urged that any rule be crafted narrowly so as to not affect the continuing development of multifunction cards. The prohibition is, however, statutory.

Comment 12(a)(1)-7 is revised in accord with the proposal, with some changes to address commenters' concerns. The fundamental import of the comment remains unchanged: Multifunction cards connected with

credit plans when they are issued are credit cards, and they may not be sent without the consumer's prior request or application. New examples have been added to provide further guidance. The comment makes clear that card issuers do not violate the prohibition merely by sending a card imprinted with information that identifies the consumer, so long as the issuer does not propose to connect the card to a credit plan at the time the card is issued.

To the extent that the interpretation of the TILA rule previously may have been unclear, the Board believes that liability should not attach to a card issuer's prior reliance on comment 12(a)(1)-7 in issuing multifunction cards that included a credit feature.

##### Section 226.14—Determination of Annual Percentage Rate

##### 14(c) Annual Percentage Rate for Periodic Statements

Comment 14(c)-10 addresses finance charges that are imposed during the current billing cycle but that relate to account activity that occurred during a prior billing cycle. The comment is revised to refer expressly to current-cycle or prior-cycle debits and current-cycle or prior-cycle credits.

#### Subpart C—Closed-end Credit

##### Section 226.18—Content of Disclosures

##### 18(g) Payment Schedule

The Homeowners Protection Act of 1998 limits the amount of private mortgage insurance (PMI) consumers can be required to purchase. Borrowers may request cancellation of PMI under some circumstances and lenders must terminate PMI automatically when certain conditions are met.

Comment 18(g)-5 is added in response to creditors' requests for guidance on how the new statutory requirements affect TILA disclosures. PMI premiums are finance charges and are figured into disclosures such as the APR and payment schedule. TILA disclosures are based on the legal obligation between the parties, and the comment provides that the payment schedule disclosure should reflect all components of the finance charge, including PMI for the time period there is a legal obligation to maintain the insurance.

Commenters generally supported the proposed guidance, although a few believed the guidance was unnecessary and others believed the guidance was not detailed enough. In response to comments received, the comment is revised to clarify that creditors may rely on assumptions used for variable-rate transactions and discounted and

premium variable-rate transactions in calculating payment schedules that involve PMI.

18(j) Total Sale Price

Comment 18(j)-2 provides the formula for calculating the total sale price in a credit sale transaction; it is the sum of the cash price, certain other amounts financed, and the finance charge. In response to requests for guidance, the commentary is revised to address how the total sale price may be affected by downpayments involving both cash and property used as a trade-in with a lien exceeding the value of the trade-in. This guidance is provided in a new comment 18(j)-3.

Under the proposal, creditors were to calculate the downpayment by applying cash payments first to reduce excess lien amounts. In response to commenters' concerns about the Board's proposed approach to disclosing the downpayment, the guidance has been revised. See comment 2(a)(18)-3.

The flexibility provided to creditors in disclosing a downpayment may result in disclosures of a total sale price that may differ among creditors. However, key disclosures such as the amount financed, finance charge, and APR remain uniform and will not be affected by the creditor's approach in disclosing the downpayment and total sale price.

Subpart E—Special Rules for Certain Home Mortgage Transactions

Section 226.32—Requirements for Certain Closed-end Home Mortgages

32(a) Coverage

32(a)(1)(ii)

Creditors must follow the rules in § 226.32 if the total points and fees payable by the consumer at or before loan closing exceed the greater of \$400 or 8 percent of the total loan amount. The Board is required to adjust the \$400 amount each year. The adjusted amount for 1999 (\$441), published on December 8, 1998 (63 FR 67575) is added to comment 32(a)(1)(ii)-2.

List of Subjects in 12 CFR Part 226

Advertising, Banks, banking, Consumer protection, Credit, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Truth in lending.

For the reasons set forth in the preamble, the Board amends 12 CFR part 226 as follows:

PART 226—TRUTH IN LENDING (REGULATION Z)

1. The authority citation for part 226 continues to read as follows:

Authority: 12 U.S.C. 3806; 15 U.S.C. 1604 and 1637(c)(5).

2. In Supplement I to Part 226, under Section 226.2—Definitions and Rules of Construction, the following amendments are made:

- a. Under Paragraph 2(a)(15) Credit card., paragraph 2. is revised; and
b. Under Paragraph 2(a)(18) Downpayment., paragraph 3. is revised.
The revisions read as follows:

Supplement I to Part 226—Official Staff Interpretations

Subpart A—General

Section 226.2—Definitions and Rules of Construction

2(a) Definitions.

2(a)(15) Credit card.

2. Examples. i. Examples of credit cards include:

- A. A card that guarantees checks or similar instruments, if the asset account is also tied to an overdraft line or if the instrument directly accesses a line of credit.
B. A card that accesses both a credit and an asset account (that is, a debit-credit card).
C. An identification card that permits the consumer to defer payment on a purchase.
D. An identification card indicating loan approval that is presented to a merchant or to a lender, whether or not the consumer signs a separate promissory note for each credit extension.
E. A card or device that can be activated upon receipt to access credit, even if the card has a substantive use other than credit, such as a purchase-price discount card. Such a card or device is a credit card notwithstanding the fact that the recipient must first contact the card issuer to access or activate the credit feature.

ii. In contrast, a credit card does not include, for example:
A. A check-guarantee or debit card with no credit feature or agreement, even if the creditor occasionally honors an inadvertent overdraft.
B. Any card, key, plate, or other device that is used in order to obtain petroleum products for business purposes from a wholesale distribution facility or to gain access to that facility, and that is required to be used without regard to payment terms.

2(a)(18) Downpayment.

3. Effect of existing liens. i. No cash payment. In a credit sale, the "downpayment" may only be used to reduce the cash price. For example, when a trade-in is used as the downpayment and the existing lien on an automobile is to be traded in exceeds the value of the automobile, creditors must disclose a zero on the downpayment line rather than a negative number. To illustrate, assume a consumer owes \$10,000 on an existing automobile loan and that the trade-in value of the automobile is only \$8,000, leaving a \$2,000 deficit. The creditor should disclose a downpayment of \$0, not -\$2,000.

ii. Cash payment. If the consumer makes a cash payment, creditors may, at their option, disclose the entire cash payment as the downpayment, or apply the cash payment first to any excess lien amount and disclose any remaining cash as the downpayment. In the above example:

- A. If the downpayment disclosed is equal to the cash payment, the \$2,000 deficit must be reflected as an additional amount financed under § 226.18(b)(2).
B. If the consumer provides \$1,500 in cash (which does not extinguish the \$2,000 deficit), the creditor may disclose a downpayment of \$1,500 or of \$0.
C. If the consumer provides \$3,000 in cash, the creditor may disclose a downpayment of \$3,000 or of \$1,000.

3. In Supplement I to Part 226, under Section 226.12—Special Credit Card Provisions, under Paragraph 12(a)(1), paragraph 7. is revised to read as follows:

Subpart B—Open-end Credit

Section 226.12—Special Credit Card Provisions

12(a) Issuance of credit cards. Paragraph 12(a)(1)

7. Issuance of non-credit cards. i. General. Under § 226.12(a)(1), a credit card cannot be issued except in response to a request or an application. (See comment 2(a)(15)-2 for examples of cards or devices that are and are not credit cards.) A non-credit card may be sent on an unsolicited basis by an issuer that does not propose to connect the card to any credit plan; a credit feature

may be added to a previously issued non-credit card only upon the consumer's specific request.

ii. *Examples.* A purchase-price discount card may be sent on an unsolicited basis by an issuer that does not propose to connect the card to any credit plan. An issuer demonstrates that it proposes to connect the card to a credit plan by, for example, including promotional materials about credit features or account agreements and disclosures required by § 226.6. The issuer will violate the rule against unsolicited issuance if, for example, at the time the card is sent a credit plan can be accessed by the card or the recipient of the unsolicited card has been preapproved for credit that the recipient can access by contacting the issuer and activating the card.

4. In Supplement I to Part 226, Section 226.14—*Determination of Annual Percentage Rate*, under Paragraph 14(c) *Annual percentage rate for periodic statements*, paragraph 10.ii. is republished and paragraph 10.ii.B. is revised to read as follows:

Section 226.14—Determination of Annual Percentage Rate

14(c) Annual percentage rate for periodic statements.

10. Prior-cycle adjustments.

ii. Finance charges relating to activity in prior cycles should be reflected on the periodic statement as follows:

B. If a finance charge that is posted to the account relates to activity for which a finance charge was debited or credited to the account in a previous billing cycle (for example, if the finance charge relates to an adjustment such as the resolution of a billing error dispute, or an unintentional posting error, or a payment by check that was later returned unpaid for insufficient funds or other reasons), the creditor shall at its option:

- 1. Calculate the annual percentage rate in accord with ii.A. of this paragraph, or
- 2. Disclose the finance charge adjustment on the periodic statement and calculate the annual percentage rate for the current billing cycle without including the finance charge adjustment in the numerator and balances associated with the finance charge adjustment in the denominator.

5. In Supplement I to Part 226, under Section 226.18—*Content of Disclosures*, the following amendments are made:

- a. Under 18(g) *Payment schedule*, a new paragraph 5. is added; and
- b. Under 18(j) *Total sale price*, a new paragraph 3. is added.

The additions read as follows:

Subpart C—Closed-end Credit

Section 226.18—Content of Disclosures

18(g) Payment schedule.

5. *Mortgage insurance.* The payment schedule should reflect the consumer's mortgage insurance payments until the date on which the creditor must automatically terminate coverage under applicable law, even though the consumer may have a right to request that the insurance be cancelled earlier. (For assumptions in calculating a payment schedule that includes mortgage insurance that must be automatically terminated, see comments 17(c)(1)-8 and 17(c)(1)-10.)

18(j) Total sale price.

3. *Effect of existing liens.* When a credit sale transaction involves property that is being used as a trade-in (an automobile, for example) and that has a lien exceeding the value of the trade-in, the total sale price is affected by the amount of any cash provided. (See comment 2(a)(18)-3.) To illustrate, assume a consumer finances the purchase of an automobile with a cash price of \$20,000. Another vehicle used as a trade-in has a value of \$8,000 but has an existing lien of \$10,000, leaving a \$2,000 deficit that the consumer must finance.

i. If the consumer pays \$1,500 in cash, the creditor may apply the cash first to the lien, leaving a \$500 deficit, and reflect a downpayment of \$0. The total sale price would include the \$20,000 cash price, an additional \$500 financed under § 226.18(b)(2), and the amount of the finance charge. Alternatively, the creditor may reflect a downpayment of \$1,500 and finance the \$2,000 deficit. In that case, the total sale price would include the sum of the \$20,000 cash price, the \$2,000 lien payoff amount as an additional amount financed, and the amount of the finance charge.

ii. If the consumer pays \$3,000 in cash, the creditor may apply the cash first to extinguish the lien and reflect the remainder as a downpayment of \$1,000. The total sale price would

reflect the \$20,000 cash price and the amount of the finance charge. (The cash payment extinguishes the trade-in deficit and no charges are added under § 226.18(b)(2).) Alternatively, the creditor may elect to reflect a downpayment of \$3,000 and finance the \$2,000 deficit. In that case, the total sale price would include the sum of the \$20,000 cash price, the \$2,000 lien payoff amount as an additional amount financed, and the amount of the finance charge.

6. In Supplement I to Part 226, Section 226.32—*Requirements for Certain Closed-end Home Mortgages*, under Paragraph 32(a)(1)(ii), paragraph 2.iv. is added to read as follows:

Subpart E—Special Rules For Certain Home Mortgage Transactions

Section 226.32—Requirements for Certain Closed-end Home Mortgages

32(a) Coverage.

Paragraph 32(a)(1)(ii).

2. *Annual adjustment of \$400 amount.*

iv. For 1999, \$441, reflecting a 1.4 percent increase in the CPI-U from June 1997 to June 1998, rounded to the nearest whole dollar.

By order of the Board of Governors of the Federal Reserve System, acting through the Secretary of the Board under delegated authority, March 31, 1999.

Robert deV. Frierson,  
Associate Secretary of the Board.

[FR Doc. 99-8413 Filed 4-5-99; 8:45 am]

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**ETHICAL ISSUES  
IN  
DRAFTING OPINION LETTERS**

**James H. Newberry, Jr.  
Wyatt, Tarrant & Combs  
Lexington, Kentucky**

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**SECTION D**



# ETHICAL ISSUES IN DRAFTING OPINION LETTERS

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## ETHICAL ISSUES IN DRAFTING OPINION LETTERS

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### I. INTRODUCTION

- A. **Purpose** - Sensitize attorneys to some of the ethical dilemmas which arise in the course of rendering legal opinions to third parties.
- B. **Approach**
1. Review selected rules from the Kentucky Rules of Professional Conduct (KRPC) and selected portions of the Commentary from the KRPC which relate to the issuance of opinion letters. All citations to the KRPC and the Commentary are from the 1999 Kentucky Rules of Court - State. The issues of professional responsibility can be analyzed much as any other legal problem because there are some analogous tools available for use.
    - a. The KRPC serves as the code or statutory material.
    - b. The Commentary serves somewhat like regulations which expand our understanding of the statutory materials.
    - c. There is a small, but growing body of case law which can be used to develop a better understanding of the both the KRPC and the Commentary.
  2. Discuss the application of these rules in the context of rendering legal opinions to third parties in commercial transactions.

### II. THIRD PARTY OPINIONS

- A. **KRPC 2.3** - The KRPC provides specific guidance when attorneys are asked to provide third parties with opinions about matters involving clients. Rule 2.3 states:
- "(a) A lawyer may undertake an evaluation of a matter affecting a client for the use of someone other than the client if:
- (1) The lawyer reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client; and
  - (2) The client consents after consultation.

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<sup>1</sup>The author gratefully acknowledges the assistance of Rick G. Alsip, Esq. in the preparation of this outline.

- (b) Except as disclosure is required in connection with a report of an evaluation, information relating to the evaluation is otherwise protected by Rule 1.6."

**B. Selected Comments to KRPC 2.3**

1. Definition - "...The question is whether the lawyer is retained by the person whose affairs are being examined. When the lawyer is retained by that person, the general rules concerning loyalty to client and preservation of confidences apply, which is not the case if the lawyer is retained by someone else. *For this reason, it is essential to identify the person by whom the lawyer is retained. This should be made clear not only to the person under examination, but also to others to whom the results are to be made available.*" (Comment 3 to KRPC 2.3; emphasis added.)
2. Duty to Third Person - "When the evaluation is intended for the information or use of a third person, a legal duty to that person may or may not arise. That legal question is beyond the scope of this Rule. However, since such an evaluation involves a departure from the normal client-lawyer relationship, careful analysis of the situation is required. *The lawyer must be satisfied as a matter of professional judgment that making the evaluation is compatible with other functions undertaken in behalf of the client. . . . [T]he lawyer should advise the client of the implications of the evaluation, particularly the lawyer's responsibilities to third persons and the duty to disseminate the findings.*" (Comment 4 to KRPC 2.3; emphasis added.)
3. Access to and Disclosure of Information - "The quality of an evaluation depends on the freedom and extent of the investigation upon which it is based. Ordinarily, a lawyer should have whatever latitude of investigation seems necessary as a matter of professional judgment. Under some circumstances, however, the terms of the evaluation may be limited. For example, certain issues or sources may be categorically excluded, or the scope of search may be limited by time constraints or the non-cooperation of persons having relevant information. *Any such limitations which are material to the evaluation should be described in the report.* If after a lawyer has commenced an evaluation, the client refuses to comply with the terms upon which it was understood the evaluation was to have been made, the lawyer's obligations are determined by law, having reference to the terms of the client's agreement and the surrounding circumstances." (Comment 5 to KRPC 2.3; emphasis added.)

**C. Analysis**

1. Legal duties to intended recipient of opinion beyond the scope of KRPC 2.3. (Comment 4 to KRPC 2.3.)
2. An attorney must make his or her own *reasonable* determination, independent of consent given by client, that giving the opinion is otherwise compatible with the attorney's relationship with the client.

- a. KRPC defines "reasonable", when used to describe the conduct of a lawyer, as "the conduct of a reasonably prudent and competent lawyer." (KRPC Terminology Section (7).)
  - b. An attorney should consider whether the duty of loyalty to the client conflicts with the attorney's own professional interests. For example, a client's desire to close a transaction and have his attorney give the opposing party any opinion the opposing party wants conflicts with attorney's self-interest in limiting the scope of the opinion so as to limit the attorney's own exposure.
3. Client's informed consent is necessary.
- a. KRPC 1.4(b) - "A lawyer should explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."
  - b. Generally, the purpose and scope of the opinion and its consequences should be discussed with the client in order that client's consent be informed. (Comment 4 to KRPC 3.1.)
  - c. Consent may be given in the form of the client's signature to the acquisition agreement or letter of intent that requires the opinion or may be implied from past experiences with the client.
  - d. Level of consultation with client regarding the opinion varies with sophistication and experience of client. (See discussion of KRPC 2.1, below.)
  - e. Clients should be informed if the opinion will require the assistance or perhaps even the opinion of special or local counsel.
4. An attorney's duties to client, including confidentiality, still apply when rendering legal opinions to third parties.
- a. KRPC 2.3(b) recognizes information that would otherwise be privileged by KRPC 1.6 might have to be disclosed to third party in the opinion.
  - b. An attorney should discuss the necessity and consequences of disclosing in the opinion information otherwise privileged in order for consent from the client to be meaningful.
5. The opinion should state the name of the client. Such a disclosure makes it clear to all concerned that the issuer has an attorney/client relationship with the client, not with the recipient. It also makes it clear to the recipient of the opinion that no attorney/client relationship exists between the recipient and the attorney rendering the opinion.

6. Disclose in the opinion any material limitations on access to or disclosure of information.
7. Set forth all limitations on the opinion so as to minimize the extent of liability to third parties. Generally, opinions set forth numerous qualifications designed to clarify and limit the scope of what opinion. Attorneys also often rely on certificates from client as to the existence of certain facts and assumptions. Common limitations found in opinions rendered in commercial transactions include the following:
  - a. Issues Limitation (Sample Language) - "This opinion relates solely to the question(s) of law set out above and does not address, and should not be construed to address, other questions of law which may be presented by the facts specified above."
  - b. Reliance Limitation (Sample Language) - "This opinion is furnished to you solely for your benefit in connection with [describe the reason for giving the opinion] and may not be relied upon in any other context or by any other person without our prior written consent."
  - c. Practice Limitation (Sample Language) - "This opinion is limited to the laws of the State of X and the federal laws of the United States of America, and we do not express any opinion concerning any other law."
  - d. Subsequent Events Limitation (Sample Language) - "We expressly disclaim any responsibility for advising you of any change occurring hereafter in circumstances concerning the matters which are the subject of this opinion, including any changes in the law or in factual matters occurring after the date of this opinion."

### III. FALSE STATEMENTS

- A. **KRPC 4.1** - "In the course of representing a client a lawyer shall not knowingly make a false statement of material fact or law to a third person."
- B. **Selected Comments to KRPC 4.1**
  1. "A lawyer is required to be truthful when dealing with others on a client's behalf, but generally has no affirmative duty to inform an opposing party of relevant facts. *A misrepresentation can occur if the lawyer incorporates or affirms a statement of another person that the lawyer knows is false.* Misrepresentations can also occur by failure to act." (Comment 1 to KRPC 4.1; emphasis added.)
  2. "This Rule refers to statements of fact. Whether a particular statement should be regarded as one of fact can depend on the circumstances. Under generally accepted conventions in negotiations, certain types of statements ordinarily are not taken as statements of material fact. . . ." (Comment 2 to KRPC 4.1.)

**C. Analysis**

1. If a lawyer knows that a portion of the materials upon which an opinion is based is not true, it is a violation of KRPC 4.1 to blindly rely upon those materials.
2. KRPC states that "'knowingly' . . . denotes actual knowledge of the fact in question. A person's knowledge may be inferred from circumstances." (KRPC Terminology Section (5).)
3. Reliance upon and references to an officer's certificate as to factual assumptions an attorney knows to be false would violate KRPC 4.1.
4. Reliance upon and references to an opinion of local counsel that an attorney knows to be false or to be based on false assumptions would violate KRPC 4.1.
5. Negotiations provide a setting where attorneys have more flexibility with their statements, but other exceptions will be rare.

**IV. CRIMINAL OR FRAUDULENT CONDUCT**

**A. KRPC 1.2(d) - "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent. . . ."**

**B. Selected Comments to KRPC 1.2(d)**

1. "A lawyer is required to give an honest opinion about the actual consequences that appear likely to result from a client's conduct. The fact that a client uses advice in a course of action that is criminal or fraudulent does not, of itself, make a lawyer a party to the course of action. However, a lawyer may not knowingly assist a client in criminal or fraudulent conduct. . . ." (Comment 6 to KRPC 1.2.)
2. "When the client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate. The lawyer is not permitted to reveal the client's wrongdoing, except where permitted by Rule 1.6. However, the lawyer is required to avoid furthering the purpose. . . . A lawyer may not continue assisting a client in conduct that the lawyer originally supposes is legally proper but then discovers is criminal or fraudulent. Withdrawal from the representation may therefore be required." (Comment 7 to KRPC 1.2.)

**C. Analysis**

1. Ordinarily, one would not think it necessary to include such a basic tenet of professional responsibility in a discussion of opinion letters. However, in 1998, a loss prevention specialist cited "the representation of crooks" as one of the two most prominent areas of losses for attorneys issuing opinion letters. Freivogel, "The Ethics and Lawyer Liability Issues Raised by Third-Party Opinion Letters," 1054 PLI/Corp 227.

2. To avoid potential liability, know your clients well, either as a result of extensive prior representation or as the result of an appropriate due diligence investigation prior to the issuance of an opinion letter on behalf of the client.
3. Within firms, a policy mandating the use of multiple lawyers to oversee the preparation of opinion letters for new clients would provide another line of defense against a firm being accused of violating KRPC 1.2(d).

## V. CONFIDENTIALITY

- A. **KRPC 1.6** - Although attorneys and many clients know that client communications are confidential, a review of the rule reveals that there are limits on attorney-client confidences. The rule states:

- “(a) A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraph (b).
- (b) A lawyer may reveal such information to the extent the lawyer reasonably believes necessary:
- (1) To prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm;
  - (2) To establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer’s representation of the client; or
  - (3) To comply with other law or a court order.”

### B. Selected Comments to KRPC 1.6

1. "The observance of the ethical obligation of a lawyer to hold inviolate confidential information of the client not only facilitates the full development of facts essential to proper representation of the client but also encourages people to seek early legal assistance." (Comment 2 to KRPC 1.6.)
2. "A fundamental principle in the client-lawyer relationship is that the lawyer maintain confidentiality of information relating to the representation. The client is thereby encouraged to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter." (Comment 4 to KRPC 1.6.)
3. "The Rules of Professional Conduct in various circumstances permit or require a lawyer to disclose information relating to the representation. See Rules 2.2, 2.3, 3.3 and 4.1. In addition to these provisions, a lawyer may be obligated or permitted by other provisions of law to give information about a client. *Whether another*

*provision of law supercedes Rule 1.6 is a matter of interpretation beyond the scope of these Rules, but a presumption should exist against a supersession."* (Comment 21 to KRPC 1.6; emphasis added.)

**C. Analysis**

1. Unlike the Rules of Professional Conduct of some other jurisdictions, KRPC 1.6 does not permit a lawyer to disclose privileged information of a client in order to prevent the client from perpetrating a fraud on a third party. KRPC therefore would not permit the attorney to "whistle-blow" in the ordinary context of providing legal opinions.
2. Both Comment 21 to KRPC 1.6 and KRPC 2.3 make it clear that confidential information *may* be disclosed, but in light of Comment 21's presumption against disclosure, attorneys are wise to have clear client authorization to disclose any information which might be deemed confidential.

**VI. CONFLICTS**

**A. Three Provisions of the KRPC Governing Conflicts**

1. KRPC Rule 1.7 - "(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:
  - (1) The lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and
  - (2) Each client consents after consultation.""(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:
  - (1) The lawyer reasonably believes the representation will not be adversely affected; and
  - (2) The client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved."
2. KRPC Rule 1.8 - "(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:
  - (1) The transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client;
  - (2) The client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
  - (3) The client consents in writing thereto."



"(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents after consultation."

\* \* \*

"(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:

- (1) Such compensation is in accordance with an agreement between the client and the third party or the client consents after consultation;
- (2) There is no interference with the lawyer's independence of professional judgment or with the client/lawyer relationship; and
- (3) Information relating to the representation of a client is protected as required by Rule 1.6."

\* \* \*

"(h) A lawyer shall not make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless permitted by law and the client is independently represented in make the agreement. . . ."

3. KRPC Rule 1.9 - "A lawyer who has formerly represented a client in a matter shall not thereafter:

- (a) Represent another person in the same or substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client consents after consultation; or
- (b) Use information relating to the representation to the disadvantage of the former client except as Rule 1.6 would permit with respect to a client or when the information has become generally known."

## **B. Selected Comments Relating to Conflicts**

1. Selected Comments to KRPC Rule 1.7

a. Loyalty to a Client

- (1) "Loyalty is an essential element in the lawyer's relationship to a client. . . ." (Comment 1 to KRPC 1.7.)
- (2) "As a general proposition, loyalty to a client prohibits undertaking representation directly adverse to that client without that client's consent. Paragraph (a) [of Rule 1.7] expresses that general rule. Thus, a lawyer ordinarily may not act as advocate against a person the lawyer represents in some other matter, even if it is wholly unrelated. On the other hand, simultaneous representation in

unrelated matters of clients whose interests are only generally adverse, such as competing economic enterprises, does not require consent of the respective clients. Paragraph (a) [of Rule 1.7] applies only when the representation of one client would be directly adverse to the other." (Comment 2 to KRPC 1.7.)

(3) "Loyalty to a client is also impaired when a lawyer cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests. The conflict in effect forecloses alternatives that would otherwise be available to the client. . . . The critical questions are the likelihood that a conflict will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives. . . ." (Comment 3 to KRPC 1.7.)

b. **Lawyer's Interests** - ". . . A lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed interest." (Comment 4 to KRPC 1.7.)

## 2. Selected Comments to KRPC Rule 1.8

a. **Person Paying for Lawyer's Services** - "Paragraph (f) requires disclosure of the fact that the lawyer's services are being paid for by a third party unless such payment is provided for in an agreement between the client and the third party. Such an arrangement must also conform to the requirements of Rule 1.6 concerning confidentiality and Rule 1.7 concerning conflict of interest. . . ." (Comment 4 to KRPC 1.8.)

b. **Limiting Liability** - "Paragraph (h) is not intended to apply to customary qualifications and limitations in legal opinions and memoranda." (Comment 5 to KRPC 1.8.)

## 3. Selected Comments to KRPC Rule 1.9

a. "After termination of a client/lawyer relationship, a lawyer may not represent another client except in conformity with [Rule 1.9]. . . ." (Comment 1 to KRPC 1.9.)

b. "The scope of a 'matter' for purposes of paragraph (a) [of Rule 1.9] may depend on the facts of a particular situation or transaction. The lawyer's involvement in a matter can also be a question of degree. When a lawyer has been directly involved in a specific transaction, subsequent representation of other clients with materially adverse interests clearly is prohibited. On the other hand, a lawyer who recurrently handled a type of problem for a former client is not precluded from later representing another client in a wholly distinct problem of that type even though the subsequent representation involves a position adverse to the prior client. . . . The

underlying question is whether the lawyer was so involved in the matter that the subsequent representation can be justly regarded as a changing of sides in the matter in question." (Comment 2 to KRPC 1.9.)

### C. Representative Cases

1. Use of a screening devise ("Chinese wall") may be built around an incoming attorney so that the attorney's representation of a client by his/her former firm is not imputed to the remainder of the new firm. Such a screen will not work to segregate members within a firm working for adverse clients. Westinghouse v. Kerr-McGee Corp., 580 F.2d 1311, 1321 (7th Cir. 1981), cert. denied, 439 U.S. 955 (1978).
2. In reviewing motions for disqualification on the basis of a conflict in interest, one court established a three-part test:
  - a. Is there a substantial relationship between the matter at issue and the matter of the former firm's prior representation?
  - b. If there is a substantial relationship between these matters, is the presumption of shared confidences within the former firm rebutted by evidence that the attorney had no personal contact with or knowledge of the related matter?
  - c. If the attorney did have personal contact with or knowledge of the related matter, did the new law firm erect adequate and timely screens to rebut a presumption of shared confidences with the new firm so as to avoid imputed disqualification?

Kala v. Aluminum Smelting & Refining Company, Inc., 688 N.E.2d 258 (Ohio 1998). This case arose in a litigation context, but it provides useful guidance for transactional lawyers who are trying to evaluate their own situations.

### D. Analysis

1. Conflicts of interest are one of the leading causes of legal malpractice losses. If a deal goes bad and a plaintiff can succeed in showing a conflict of interest, the lawyer who wrote an opinion letter and the lawyer's firm become prime targets, regardless of whether the letter had anything to do with the loss. Freivogel, Id.
2. A clear conflict would exist when the attorney issuing the opinion on behalf of a borrower has a longstanding attorney-client relationship with the lending institution, and such a representation can only be undertaken in accord with KRPC 1.7(a).
3. However, less certain conflicts can impact the attorney-client relationship.
  - a. For instance, if the attorney issuing the opinion has not represented the lending institution but hopes to refer enough clients to the lender so as to generate legal work later, a potential conflict may arise in violation of KRPC 1.8(a).

- b. Another potential violation of KRPC 1.8(a) could arise if the borrower's attorney is directing the borrower toward a lender in which the attorney owns stock. See also KRPC 1.7(b) and Comment 4 to KRPC 1.7.

In each of the two instances, KRPC 1.8(a) requires disclosure, the opportunity to seek independent counsel, and written consent.

4. Comment 3 to KRPC 1.7 clearly imposes a duty on attorneys to not undertake work when the attorney cannot carry out an appropriate course of action because of other responsibilities or interests. This broad statement can impact attorneys who because of workload considerations or because of positions taken in other representations are unable to meet their client's needs.
5. KRPC 1.8(f) and Comment 4 can also impact transactions since attorneys for lending institutions are often paid by the borrowers. To avoid potential problems, the lender's attorney should request payment directly from the lender, and have the borrower pay the lender for the cost of legal services surrounding the transaction. However, some lenders prefer for the borrower to pay the fees directly to the lender's counsel, and in those cases, the attorney must make a determination as to whether KRPC 1.8(f) can be satisfied.

## VII. ATTORNEYS AS ADVISORS

- A. **KRPC Rule 2.1** - "In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation."

- B. **Selected Comments to KRPC 2.1**

1. "A client is entitled to straightforward advice expressing the lawyer's honest assessment. Legal advice often involves unpleasant facts and alternatives that a client may be disinclined to confront. . . ." (Comment 1 to KRPC 2.1.)
2. "Advice couched in narrowly legal terms may be of little value to a client, especially where practical considerations, such as cost or effects on other people, are predominant. Purely technical legal advice, therefore, can sometimes be inadequate. It is proper for a lawyer to refer to relevant moral and ethical considerations in giving advice. Although a lawyer is not a moral advisor as such, moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied." (Comment 2 to KRPC 2.1.)
3. "A client may expressly or impliedly ask the lawyer for purely technical advice. When such a request is made by a client experienced in legal matters, the lawyer may accept it at face value. When such a request is made by a client inexperienced in legal matters, however, the lawyer's responsibility as advisor may include indicating that more may be involved than strictly legal considerations." (Comment 3 to KRPC 2.1.)

4. "Matters that go beyond strictly legal questions may also be in the domain of another profession. . . . Where consultation with a professional in another field is itself something a competent lawyer would recommend, the lawyer should make such a recommendation. At the same time, a lawyer's advice at its best often consists of recommending a course of action in the face of conflicting recommendations of experts." (Comment 4 to KRPC 2.1.)

**C. Analysis**

1. The Impact of Client Sophistication - Comment 3 and KRPC 2.1 make it clear that the attorney's responsibility as counselor may vary depending on the level of the client's sophistication. However, a single individual's level of sophistication can vary depending on the light in which it is evaluated. Thus, to determine the nature of the attorney's obligation to the client, an attorney must carefully evaluate each client's sophistication level relative to the advice sought.
2. The Lawyer's Position as Moral and Ethical Advisor to the Client - Comment 2 to KRPC 2.1 clearly authorizes attorneys to refer their clients to moral and ethical considerations in giving advice, and it notes that moral and ethical considerations impinge on most legal questions. When should attorneys refrain from referring to moral and ethical considerations when legal advice is rendered? On the other and, when should attorneys seize the opportunity to expand their advice beyond strict legal parameters?

**VIII. ETHICAL ISSUES INVOLVED IN RENDERING ROUTINE OPINIONS**

**A. Due Organization Opinion**

1. Sample Language - "X is a corporation duly organized and validly existing under the laws of the State of Y."
2. Purpose of the Due Organization Opinion
  - a. To confirm that X is a *corporation*, which in turn requires the attorney to verify that:
    - (1) X complied with all the then-applicable requirements for incorporation when it incorporated;
    - (2) X's incorporation documents were filed by the secretary of state; and
    - (3) X has not subsequently ceased to exist.
  - b. To confirm that X is *duly organized*, which in turn requires the attorney to review the then-applicable law to verify that:
    - (1) X's articles of incorporation were filed;

- (2) X's officers and directors were elected, bylaws were adopted and minimum payment of capital, if any, was made; and
  - (3) X's board of directors authorized initial issuance of stock.
- c. To confirm that X is *validly existing*, which in turn requires the attorney to verify that X has not ceased to exist or not engaged in a merger, consolidation or other transaction which it did not survive.
3. Potential Ethical Issue - Since clients usually do not prepare corporate documents, the attorney's investigation of the incorporation process might uncover mistakes the attorney made which must be corrected in order for the attorney to render the due organization opinion without violating KRPC 4.1. Such a dilemma creates a professionally embarrassing moment, but the professional embarrassment pales in comparison to a potential disciplinary proceeding.

**B. Corporate Power Opinion**

1. Sample Language - "X has the corporate power to own its properties, to conduct its businesses, and to execute and deliver the Transaction Documents and to perform its obligations under the Transaction Documents."
2. Purpose of the Corporate Power Opinion
  - a. To confirm X has the capacity to act under applicable corporate law and its articles and bylaws.
  - b. To confirm X has the capacity to perform each of the contractual obligations which it is undertaking to perform.
3. Potential Ethical Issues
  - a. To avoid making a false statement in violation of KRPC 4.1, it may be necessary for an attorney to investigate and review the applicable law if X is in a heavily regulated industry or is a special corporation (e.g., a national bank) whose existence is derived from a unique set of statutes which might limit or otherwise vary its corporate powers from those of typical corporations.
  - b. Similarly, the issuing attorney will need to review the borrowing entity's organizational documents and the contracts in order to ensure that the statements made are true.

**C. Qualification Opinion**

1. Sample Language - "Based solely upon certificates provided by agencies of the states of \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_, X is qualified as of the respective dates of those certificates to transact business as a foreign corporation

in those states. X is not required to be qualified as a foreign corporation in any other state."

2. Purpose of Qualification Opinion

- a. To confirm that X is qualified to do business in each state in which the conduct of its business or its ownership of property would require it to qualify to do business in that state.
- b. To address the opinion recipient's concerns about any adverse consequences from the failure of X to qualify to do business in a particular jurisdiction, such as its inability to maintain suits in that jurisdiction.

3. Potential Ethical Issue - KRPC 2.3 requires the client to consent to the attorney rendering an opinion to a third party. To the extent a lender demands a qualification opinion that would require extensive research and analysis of the applicable laws of several states and the business conducted or property owned by the client in those states, the client should be informed of the potentially considerable expense in order to give meaningful consent.

**D. Authorized Stock Opinion**

1. Sample Language - "The authorized shares of X consist of \_\_\_\_\_ common shares, of which \_\_\_\_\_ common shares are outstanding. The outstanding shares have been duly authorized and validly issued and are fully paid and nonassessable."

2. Purpose of the Authorized Stock Opinion

- a. To confirm the number of authorized and the number of issued shares.
- b. To confirm the outstanding shares have been duly authorized by virtue of having requisite attributes permitted by law and X's articles.
- c. To confirm the outstanding shares were validly issued.
  - (1) Sale or transfer complies with applicable corporate and securities law.
  - (2) Sale or transfer complies with any applicable charter provisions.
  - (3) Issuance approved by directors/shareholders as required.
  - (4) Issuance complies with any requirements imposed in authorizing resolutions.
- d. To confirm that all issued shares are fully paid and nonassessable under applicable state corporate law.

3. **Potential Ethical Issues**

- a. **Avoiding False Statements -** The issuing attorney must review stock transfer records, articles, and resolutions, as well as then- applicable law to determine the above requirements were met. In addition, filings with state and/or federal securities regulators may also have to be reviewed to determine compliance with all applicable securities laws.
  
- b. **Confidentiality -** If securities law problems are detected, the prior sales of the corporation's shares could be subjected to orders of rescission, and those orders could have devastating consequences for the corporate entity.
  - (1) The attorney is unable to disclose the violation without the client's consent since Kentucky has not adopted the "whistle-blower" exception to KRPC 1.6.
  
  - (2) Without such a disclosure, the attorney cannot issue the requested opinion because the limitations of KRPC 4.1 prohibiting false statements.





**NEW REPORTING REQUIREMENTS  
FOR OVERDRAFTS  
IN  
CLIENT ESCROW AND TRUST ACCOUNTS**

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**SECTION E**



## BAR COUNSEL'S PAGE

Benjamin Cowgill, Jr.  
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### "Dear Bank Officer..."

*A Suggested Letter to Your Escrow and Trust Account Depository*

*If you have been wondering how to comply with the new overdraft reporting rule in Kentucky Rules of Professional Conduct (KRPC) 1.15, here is an example to follow in discussing the matter with your banker.*

Dear Bank Officer;

I am writing to inform you of a new ethics rule which I am required to follow as a member of the Kentucky Bar. I need your assistance and cooperation to comply with this rule, because it relates to one or more accounts at your bank.

The new rule requires that I obtain an agreement from your bank to notify the Kentucky Bar Association if and when any overdraft occurs in any escrow or trust account established by me or my firm. I will identify the particular accounts to which the rule applies.

This overdraft reporting requirement is designed to help the KBA fulfill its mission of protecting the public by maintaining a proper discipline among members of the Bar.<sup>1</sup> Experience in other states has shown that overdraft reporting rules are an effective means of identifying and correcting shortcomings in the management and application of client funds by practicing attorneys. The corollary benefit to the bank is that such problems are promptly resolved.

The rule recognizes that an overdraft is not always the lawyer's fault. A report of overdraft does *not* constitute a complaint or allegation of misconduct by the bank against the attorney. It is merely an informational report which permits the Bar to investigate the circumstances and determine whether any action is necessary with respect to the attorney's management of the account.

The new requirement appears in Rule 1.15 of the Kentucky Rules of Professional Conduct (SCR 3.130-1.15). Rule 1.15 has long required that I hold any funds of clients or third persons in one or more escrow or trust accounts separate from my personal and business accounts. The new requirement was added through an amendment to the Rule, effective October 1, 1998, to which the Supreme Court of Kentucky added the follow-

ing sentence:

*The separate account...shall be maintained in a bank which has agreed to notify the Kentucky Bar Association in the event that any overdraft occurs in the account.*

A number of banks in Kentucky are already providing their attorney customers with letters confirming their



Ben Cowgill

agreement to notify the KBA of any overdraft in the escrow or trust accounts maintained by those attorneys. If your bank is unable to make such an agreement, it will be my ethical obligation to move my escrow and trust accounts to another bank that does report. I am therefore eager to provide you with the infor-

mation you need to understand the new requirement and assist me in bringing my accounts at your bank into compliance with the rules of the Kentucky Supreme Court that govern my professional conduct.

In order to comply with the new requirement, I need to obtain a letter from your bank confirming your agreement to notify the Kentucky Bar Association if and when any overdraft occurs in any account to which the Rule applies. I am presently maintaining the following accounts at your bank which are subject to the new requirement:

*[Identify all escrow accounts, trust accounts, real estate closing accounts and other "clearing" accounts which contain funds of clients or third persons.]<sup>2</sup>*

I will be responsible for updating this information when any escrow or trust account is opened or closed.

Your confirmation letter should identify each of these accounts by name and number, to avoid any misunderstanding as to which accounts will be "flagged" for overdraft reporting to the KBA.

The only other essential component of your letter is the confirmation that your bank agrees to report any overdraft in the specified account(s). It is sufficient for your letter to read as follows:

*Dear Attorney:*

*Re: [List each account by name and number]*

*You have advised us that your firm maintains the above-referenced account(s) at our Bank, and that such account(s) contain (or may at times contain) funds of clients or third persons. You have further advised us that Rule 1.15 of the Kentucky Rules of Professional Conduct requires you to maintain any such account at a financial institution which agrees to notify the Kentucky Bar Association in the event that any overdraft occurs in the account.*

*Our Bank agrees to comply with the overdraft reporting requirement with respect to the above-referenced account(s). Accordingly, this will confirm that we will immediately notify the Office of Bar Counsel at the Kentucky Bar Association, 514 West Main Street, Frankfort, Kentucky 40601, if and when any properly payable instrument is presented for payment against an account identified above which contains insufficient funds to pay the instrument in full, whether or not the instrument is actually dishonored.*

*s/ \_\_\_\_\_  
Bank Officer*

I will maintain your letter in my files as evidence of my compliance with the new requirement. I ask that you also send a copy of your letter directly to the KBA Office of Bar Counsel at the address indicated. This will provide the KBA with the name of the appropriate contact person at your bank in the event any question arises.

For purposes of the reporting requirement, an overdraft occurs whenever a properly payable instrument is presented against an account which contains insufficient funds to pay the instrument in full. It does not matter whether the instrument is actually dishonored or paid.

When an overdraft occurs, it *must* be reported to the KBA. The bank does not need to concern itself with the circumstances of the overdraft or the reason it occurred, because the KBA will investigate to determine whether any further action is necessary.

The notice to the KBA must be in writing, sent to the attention of the Office of Bar Counsel at the KBA as indicated in the sample confirmation letter. The notice must provide the KBA with enough basic information about the overdraft to initiate an inquiry — i.e., the name of the attorney (or firm), the account name and number, and the date and amount of the overdraft. Otherwise, the notice does not need to follow any particular form; it can simply be a duplicate copy of the overdraft notice sent to the attorney customer, so long as it is issued when there is any overdraft as defined above.

If you have any further questions regarding the new requirement, please contact Barbara S. Rea, Chief Bar Counsel, or Benjamin Cowgill, Jr., Chief Deputy Bar Counsel, at 502-564-3795. Otherwise, I look forward to receiving your letter

confirming that you will notify the KBA of any overdraft in the accounts mentioned above. Please remember to send a copy of your letter to the Office of Bar Counsel.

Sincerely yours,  
Member of the Kentucky Bar

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#### ENDNOTES

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1. SCR 3.025.
2. The Rule applies to all client escrow and trust accounts, whether or not they are part of the Kentucky IOLTA program ("interest on lawyers' trust accounts). Under IOLTA, the interest on pooled accounts is paid into the IOLTA Fund which in turn grants the funds to law-related charitable organizations. The overdraft reporting requirement is separate and distinct from participation in the IOLTA program.

**SCR 3.130(1.15) SAFEKEEPING PROPERTY**

(a) A lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from a lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. The separate account referred to in the preceding sentence shall be maintained in a bank which has agreed to notify the Kentucky Bar Association in the event that any overdraft occurs in the account. Other property shall be identified as such and appropriately safeguarded. Complete records of such account funds and other property shall be kept by the lawyer and shall be preserved for a period of five years after termination of the representation.

(b) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this rule or otherwise permitted by law or by agreement with the client, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.

(c) When in the course of representation a lawyer is in possession of property in which both the lawyer and another person claim interests, the property shall be kept separate by the lawyer until there is an accounting and severance of their interests. If a dispute arises concerning their respective interests, the portion in dispute shall be kept separate by the lawyer until the dispute is resolved.

(d) A lawyer may deposit funds in an account for the limited purpose of minimizing bank charges. A lawyer may also participate in an IOLTA program authorized by law or court rule.

[Amended by Order 98-1, eff. 10-1-98; adopted by Order 89-1, eff. 1-1-90]

## COMMENTARY

### Supreme Court

**1989:** [1] A lawyer should hold property of others with the care required of a professional fiduciary. Securities should be kept in a safe deposit box, except when some other form of safekeeping is warranted by special circumstances. All property which is the property of clients or third persons should be kept separate from the lawyer's business and personal property and, if monies, in one or more trust accounts. Separate trust accounts may be warranted when administering estate monies or acting in similar fiduciary capacities.

[2] Lawyers often receive funds from third parties from which the lawyer's fee will be paid. If there is risk that the client may divert the funds without paying the fee, the lawyer is not required to remit the portion from which the fee is to be paid. However, a lawyer may not hold funds to coerce a client into accepting the lawyer's contention. The disputed portion of the funds should be kept in trust and the lawyer should suggest means for prompt resolution of the dispute, such as arbitration. The undisputed portion of the funds shall be promptly distributed.

[3] Third parties, such as a client's creditors, may have just claims against funds or other property in a lawyer's custody. A lawyer may have a duty under applicable law to protect such third-party claims against wrongful interference by the client, and accordingly may refuse to surrender the property to the client. However, a lawyer should not unilaterally assume to arbitrate a dispute between the client and the third party.

[4] The obligations of a lawyer under this Rule are independent of those arising from activity other than rendering legal services. For example, a lawyer who serves as an escrow agent is governed by the applicable law relating to fiduciaries even though the lawyer does not render legal services in the transaction.

[5] A "clients' security fund" provides a means through the collective efforts of the bar to reimburse persons who have lost money or property as a result of dishonest conduct of a lawyer. Where such a fund has been established, a lawyer should participate.

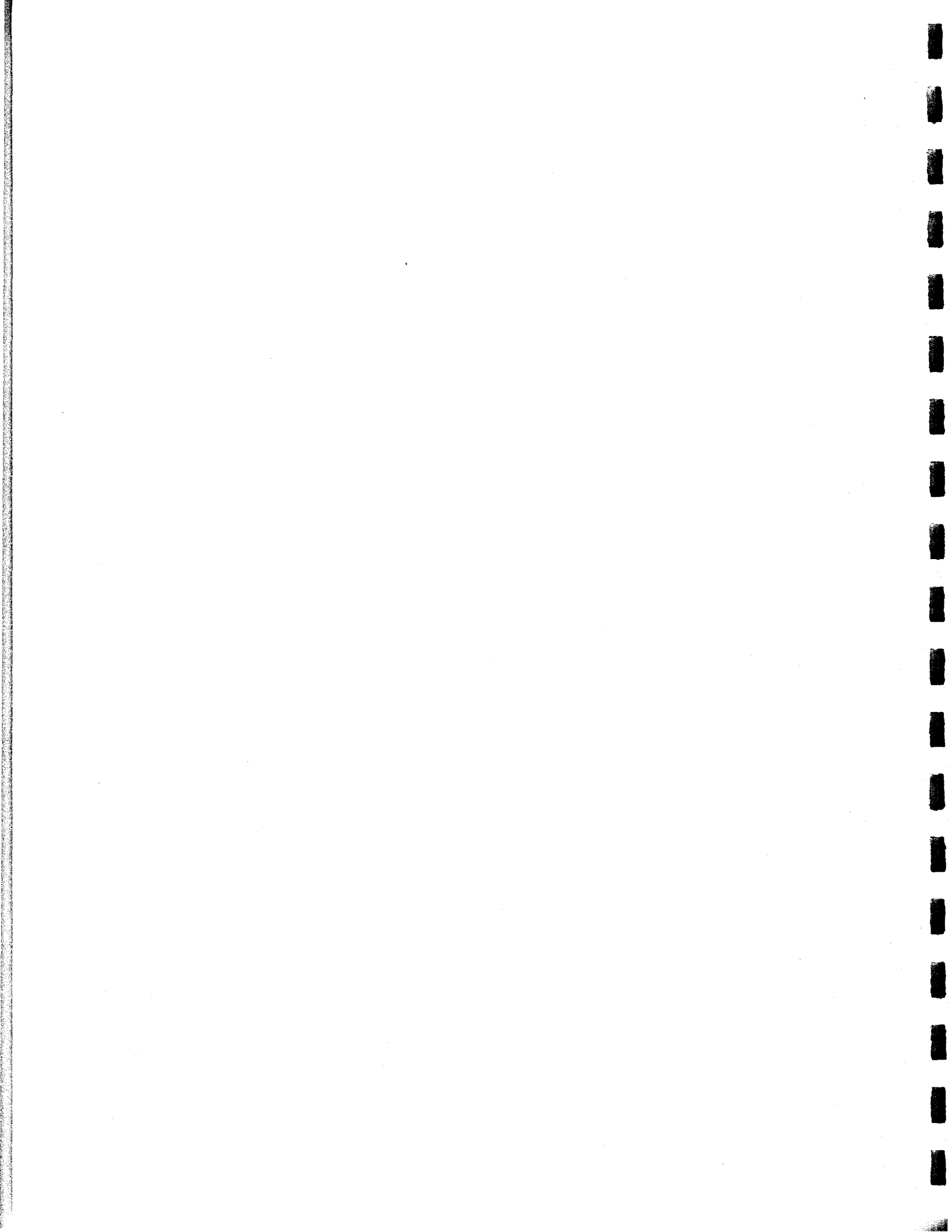
# **LENDER LIABILITY ISSUES**

**R. Gregg Hovious  
and  
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**SECTION F**

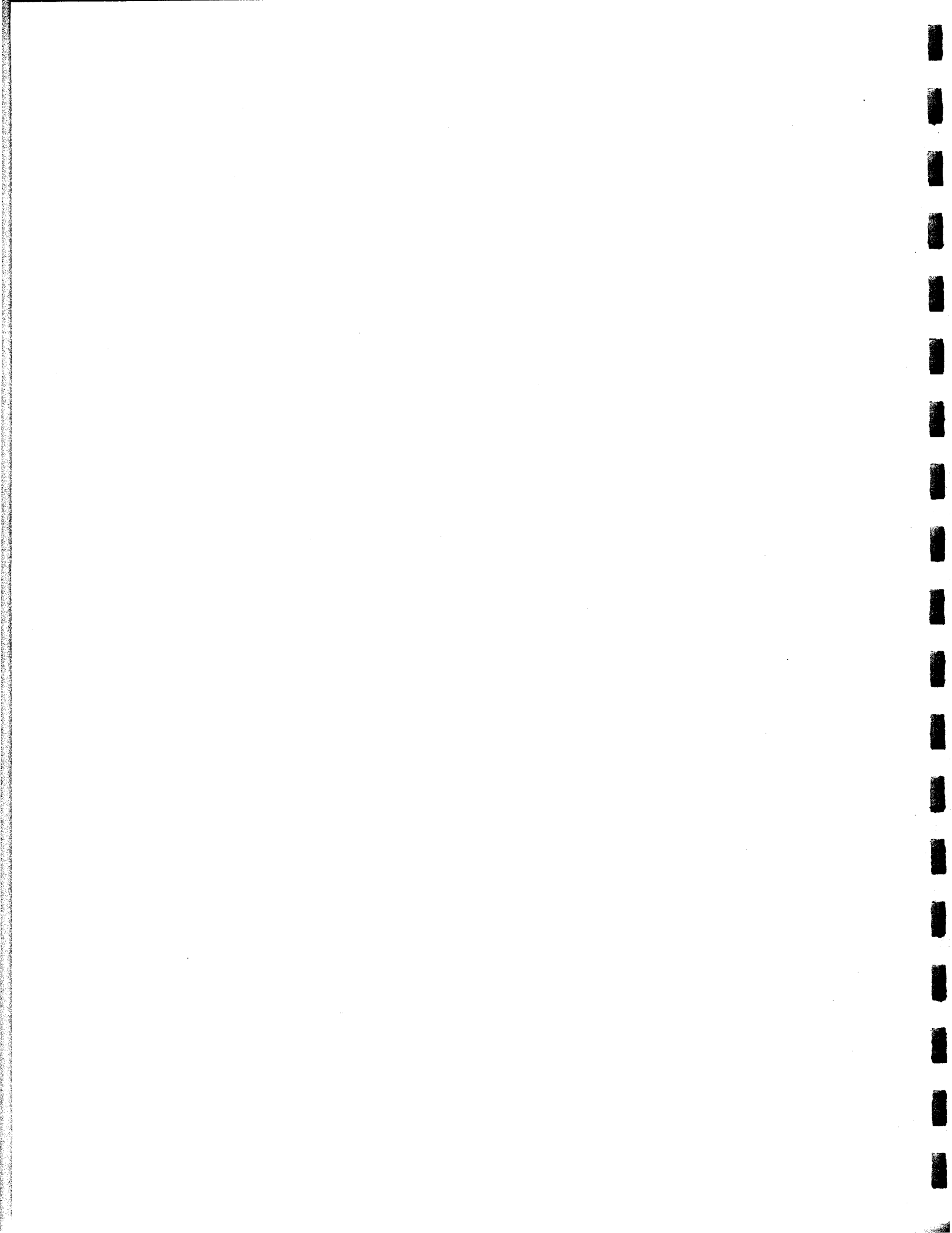




# LENDER LIABILITY ISSUES

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## I. OVERVIEW

A. Definition of Lender Liability: “Lender liability” is a broad and loosely defined clarification for a number of more specifically designed actions, usually torts, alleged against banks in defense of collection efforts. We define it as:

1. Action taken by a debtor or debtors, usually in connection with a bank’s efforts to collect a debt, for the purpose of:
  - (a) Avoiding the debt;
  - (b) Making an otherwise unprofitable business profitable.

B. Causes –

1. Sloppy paperwork;
2. Lack of attention to detail;
3. Loose lips;
4. Overreaching, sometimes after overreacting;
5. Inaccurate statements, whether intentional, reckless or negligent.

C. Effects:

1. Bad loans and damage verdicts;
2. Significant attorneys’ fees;
3. Loss of reputation;
4. Lost jobs.

## II. THEORIES OF RECOVERY

A. Interference with corporate management – the aegis of modern lender liability.

1. State Nat’l Bank v. Farah Manufacturing Company, Tx.App., 678 S.W.2d 661 (1984). First significant damage award against a bank and the impetus for debtor’s lawyers to explore, and expand, lender liability theories. Mr. Farah, the majority shareholder and CEO, finds his Company in financial difficulty. Upon notification, the bank decides that “it would be in the best interest of the Company” (actually the best interest of the bank) to install its own officers and directors to manage the Company. The Company continues to suffer precipitous declines and the bank moves to protect its collateral. Farah counterclaims, alleging that the bank had no

business running the business. Jury finds that the bank's officers and directors ran the Company into financial difficulty and that it must pay lost profits.

2. Moral. Do not take control of the Company's business. This includes implicit control as well as the overt control illustrated by Farah.

B. Contract - Prior course of dealing/Waiver.

1. Seems to be fairly common in Kentucky.
2. Example: Bank has permitted Mr. Debtor to:
  - (a) pay late; or
  - (b) intermingle accounts.
3. Suddenly, and without warning, bank stops credit line based upon the same acts. Debtor loses customer or suppliers and goes out of business. Debtor will assert lender liability action when bank attempts to protect collateral.

C. Breach of Duty of Good Faith. See Ranier v. Mt. Sterling Nat'l Bank, Ky., 812 SW.2d 154 (1990).

1. As a whole, the Uniform Commercial Code provides significant protection to banks.
2. Exception: The exception relates to ambiguous duty of good faith which includes "honesty in fact" and "reasonable expectations of the trade." The banks' attorneys will have a very difficult time persuading a Court, as a matter of law, that the case should be dismissed due to the ambiguity of the law. Accordingly, case may go to the jury.
3. Best defense - Solid paperwork will protect the bank by confirming representations made to the debtor. File memoranda and letters to the debtor from years before will serve to contradict any "new testimony" provided by the debtor.

D. Fraud and Misrepresentation. See Hanson v. American Nat'l Bank and Trust Co., 812 S.W.2d 154 (1991).

1. Fraud means an intentional misrepresentation, deceit or concealment of material fact known to the defendant and made with the intention of causing injury to the plaintiff.
2. The primary danger from this theory arises from the debtor alleging that the bank failed to advise him of certain facts (concealment of material fact). For example, debtor may state that bank failed to advise her that it had ability to repossess the collateral. Or, debtor may allege that banks stated that it would not repossess the collateral. In either event, bank repossesses collateral and plaintiff counter-sues.

3. Best Defense:

- (a) Plain and simple language;
- (b) Encourage debtor to obtain counsel in connection with the loan and use clause in contract that states that the debtor "had an opportunity to consult counsel";
- (c) Debtor acknowledges in contract that no representations have been made to her which are not contained in the contract.

E. Breach of Fiduciary Duty. See Steelvest v. Scansteel Service Center, Inc., Ky., 807 S.W.2d 476 (1991).

1. Standard - Debtor vested trust and confidence in the bank.
2. Best Defense. Always maintain arms-length business relationship with the debtor.
3. The new dilemma - Lending to competing businesses. See United Parcel Service v. Rickert, 1999 Ky. LEXIS 58.

F. Promissory Estoppel - Almost a contract? But see KRS 371.010(9).

1. Debtor will allege promissory estoppel where there have been discussions concerning a loan but no loan agreement reached.
2. Example - Debtor alleges that bank promised to loan money, debtor relied upon the promise by entering into contracts with suppliers in the amount of \$500,000 and then the bank did not loan the money. When the supplier came to collect, the debtor sues the bank on this theory. The primary danger seems to arise from letters of intent.
3. Best Defense. - Paperwork - Letters of Intent must clearly state that the bank has not yet agreed to loan money. Back-up memoranda will support the statements.

G. Oral Representations Constitute Contract.

1. Bank advises customer that loan will contain terms X, Y and Z. Contract documents are then prepared containing terms X, Y and A. Debtor seeks to impose oral representation against the bank.
2. Best defenses:
  - (a) Letter to the debtor which states that on March 2, 1993 we discussed possible contract terms which included X, Y and Z. We have not yet entered into a contract.
3. Merger Agreements.

H. Interference with Contractual Relations. See NCAA v. Hornung, Ky., 754 S.W.2d 855 (1988).

1. Mr. Seller considers allowing Mr. Debtor to purchase goods on credit. Mr. Seller discusses Mr. Debtor's credit with Mr. Banker at happy hour. Mr. Banker suggests to Mr. Seller that Mr. Debtor is a deadbeat. Mr. Seller decides not to extend credit to Mr. Debtor. Mr. Debtor cannot buy goods, then cannot sell goods, then goes broke. Mr. Debtor comes looking for at least Mr. Banker and perhaps the bank. In due course, Mr. Banker is thankful for Mr. President's extension of unemployment benefits.
2. The Hornung case and the Restatement set forth affirmative defenses.

I. Duress.

1. Bank threatens an act which it has no legal right to do.
2. For example - bank threatens to sell the house if the business debts are not paid. The debtor caused to take steps which were not ordinarily taken, such as entering into new agreement with bank. The new agreement will not be enforceable.
3. Remember, however, that threatening to do that which a party has a legal right to do cannot form the basis of a claim duress by business compulsion.

J. Violation of Policy or Statute – See Lillard v. Farm Credit Services of Mid-America, Ky.App., 831 S.W.2d 626 (1991).

1. Bank's violation of its own policies or statute may evidence lack of good faith or negligence.

K. Bank's violation of its own policies or statute may evidence lack of good faith or negligence.

L. Agreement to Agree. See Walker v. Keith, Ky., 382 s.w.2d 198 (1964).

M. Securities -- Trust Department.

N. Government Involvement - SBA Loans.

O. ERISA.

III. DAMAGES

A. Actual losses.

1. Difference in the rate of interest.

2. Incidental expenses incurred in obtaining loans, such as architectural fees and engineering fees.
3. Lost profits.
4. Lost equity.
5. Loss of business opportunity.

B. Punitive Damages.

1. Fraud.
2. Breach of fiduciary duty.
3. Intentional interference with business relationship.

C. Rescission.

D. Damage to Reputation.

IV. THE KENTUCKY CASES

A. Steelvest v. Scansteel

1. Breach of fiduciary duty and aiding and abetting breach of fiduciary duty.
2. Loan to each of two competitors.
3. A very difficult summary judgment standard.

B. Ranier v. Mount Sterling National Bank

1. Implied covenant of good faith and fair dealing apply to third party who executed subordination agreement.
2. Damages-loss of superior position.
3. Application of proceeds to unsecured line found wrongful.

C. Hanson v. American National Bank

1. Debtor alleges that the bank's pre-contract representations were different from the contract.
2. Debtor further alleges that bank would not permit him to consult attorney in connection with loan documentation.



3. Bank stops line of credit and debtor goes out of business.
4. Bank pays \$9,000,000 which includes \$5,000,000 in punitive damages and \$3,000,000 in interest.

D. United Parcel Service Company v. Rickert, 1999 Ky. LEXIS 58

1. No need to identify a corporate representative who makes a fraudulent statement.
2. "Fraud may be established by evidence which is wholly circumstantial."
3. The reviewing court must accept the evidence as true, draw all reasonable inferences from it in favor of the claimant, refrain from questioning the credibility of the witnesses of the claimant and refrain from assessing the weight that should be given to any particular item of evidence.
4. Dangerous damage language regarding the "benefit of the bargain."

V. LEGAL DEFENSES

A. Contract Terms.

1. Merger Agreements.

Entire Agreement - This Agreement constitutes and contains the complete and final agreement between the parties. No agreement or promise of any kind whatsoever which is not expressed herein has been made to, or amongst, the parties to this Settlement Agreement.

2. Jury Waivers.

Waiver of Jury Trial - Debtor and Creditor acknowledge and agree that any controversy which may arise under this Settlement Agreement, or any relationship they may have in connection with Creditor's business activities, will be based upon difficult and complicated issues. Therefore, the parties agree that any lawsuit growing out of such controversy will be tried in a Kentucky court by a judge sitting without a jury. The parties further agree that this clause shall not be admissible as evidence in any trial arising between the parties.

3. Ability to hire counsel.

Advice of Counsel - "Debtor and Creditor" hereby represent and warrant that they execute this Note having had the opportunity to seek advice from counsel. This Agreement has been jointly negotiated and drafted, and shall not be construed more strongly in favor of or against any party.

4. No Modification or Waiver of terms.

(a) Amendments - No agreements or other understandings in any way purporting to modify the terms and conditions set forth herein shall be binding upon the parties

unless the same shall be in writing and duly executed by all of the parties on or subsequent to the date of this Agreement.

(b) Waiver of Breach - The waiver by any party of a breach of any provision of this Agreement by any other shall not operate or be construed as a waiver of any subsequent breach of the same or different provisions by such other party.

- B. Failure to mitigate damages.
- C. Debtor fraud - Document debtor's representations.
- D. Release - The workout agreement.

## VI. DEFENSE LITIGATION STRATEGY

- A. Discourage Frivolous Suits.
  - 1. Discourage future lender liability actions by aggressively defending all such actions.
  - 2. Discourage debtor's counsel who hope to reap a 33% contingency fee for a small amount of work.
  - 3. Protect the bank's reputation.
- B. Protect your documents.
  - 1. Regulatory protection for OTS and SEC documentation.
- C. Bank takes the first deposition, the second deposition and the third deposition, quickly.
  - 1. The Bank deposes CEO, accountant and primary employees to quickly end the case.
  - 2. Avoid multiple bank employee depositions on the same day.

## VII. Email and Spoliation.

- A. E-Mail – A treasure trove of documents
  - 1. Written Discovery Request: Please produce all email containing communications between John Doe and X, Y, and Z employers regarding debtor
  - 2. Computer experts
- B. Spoliation.
  - 1. "It has always been understood – the inference indeed is one of the simplest in human experience – that a party's falsehood or other fraud in the preparation and

presentation of his cause, his fabrication or suppression of evidence by bribery or spoliation, is receivable against him as an indication of his consciousness that his case is a weak or unfounded one; and from that consciousness may be inferred the fact itself of the cause's lack of truth and merit. 2 Wigmore @278(2) (Chadbourne Rev. 1979)... It is of no significance that this is a criminal case and McQueeney was a civil case, for KRE 404(b) applies to both civil and criminal cases." Tamme v. Commonwealth, Ky., 973 S.W.2d 13 (1998).

2. The "missing evidence instruction" advises the jury that the destruction of evidence creates a favorable inference for the other party. Sanborn v. Commonwealth, Ky., 754 S.W. 2d 534 (1988).
3. No separate cause of action for spoliation. Monsanto v. Reed, Ky., 950 S.W.2d 811 (1997).

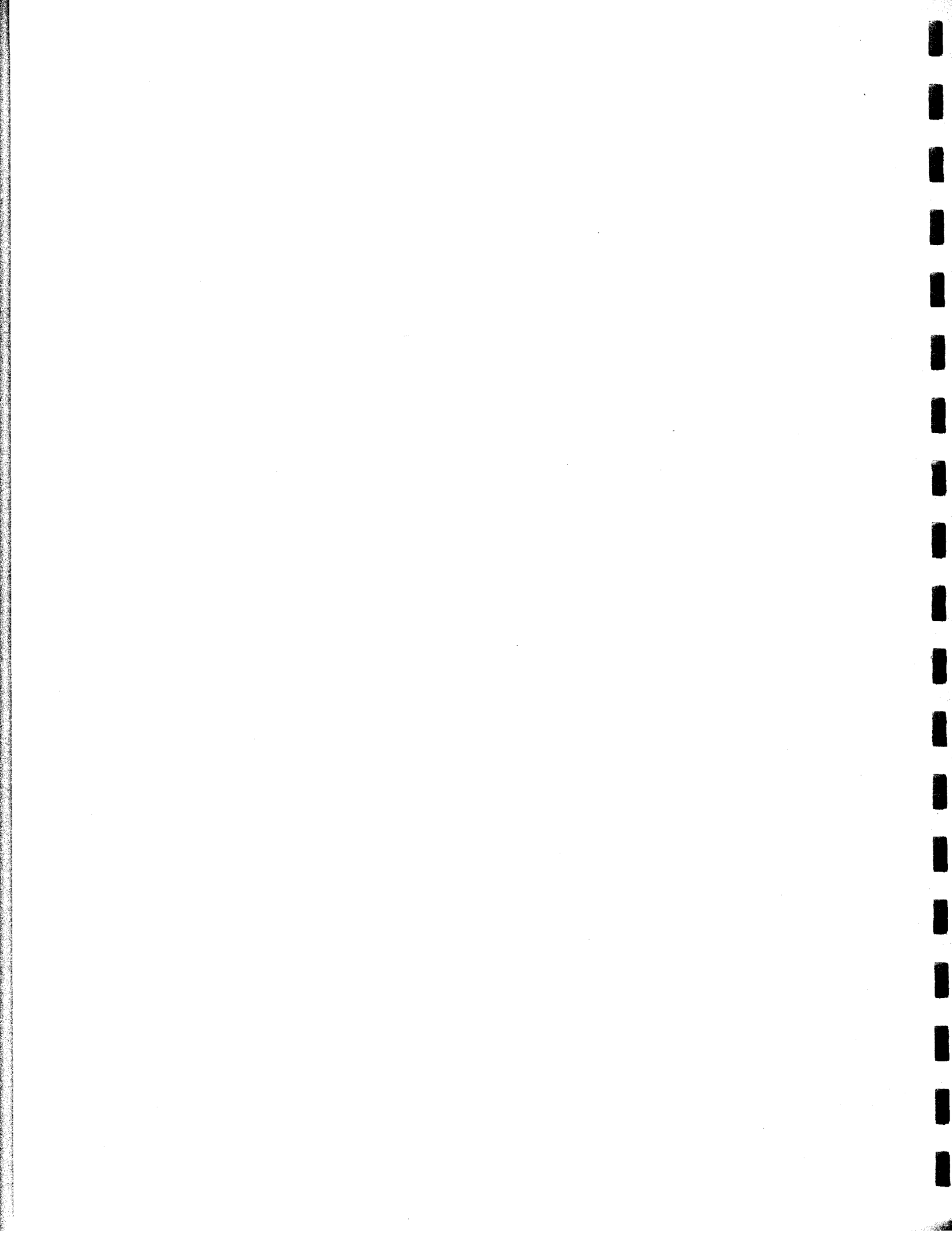
**YEAR 2000  
CUSTOMER AND SHAREHOLDER COMMUNICATIONS**

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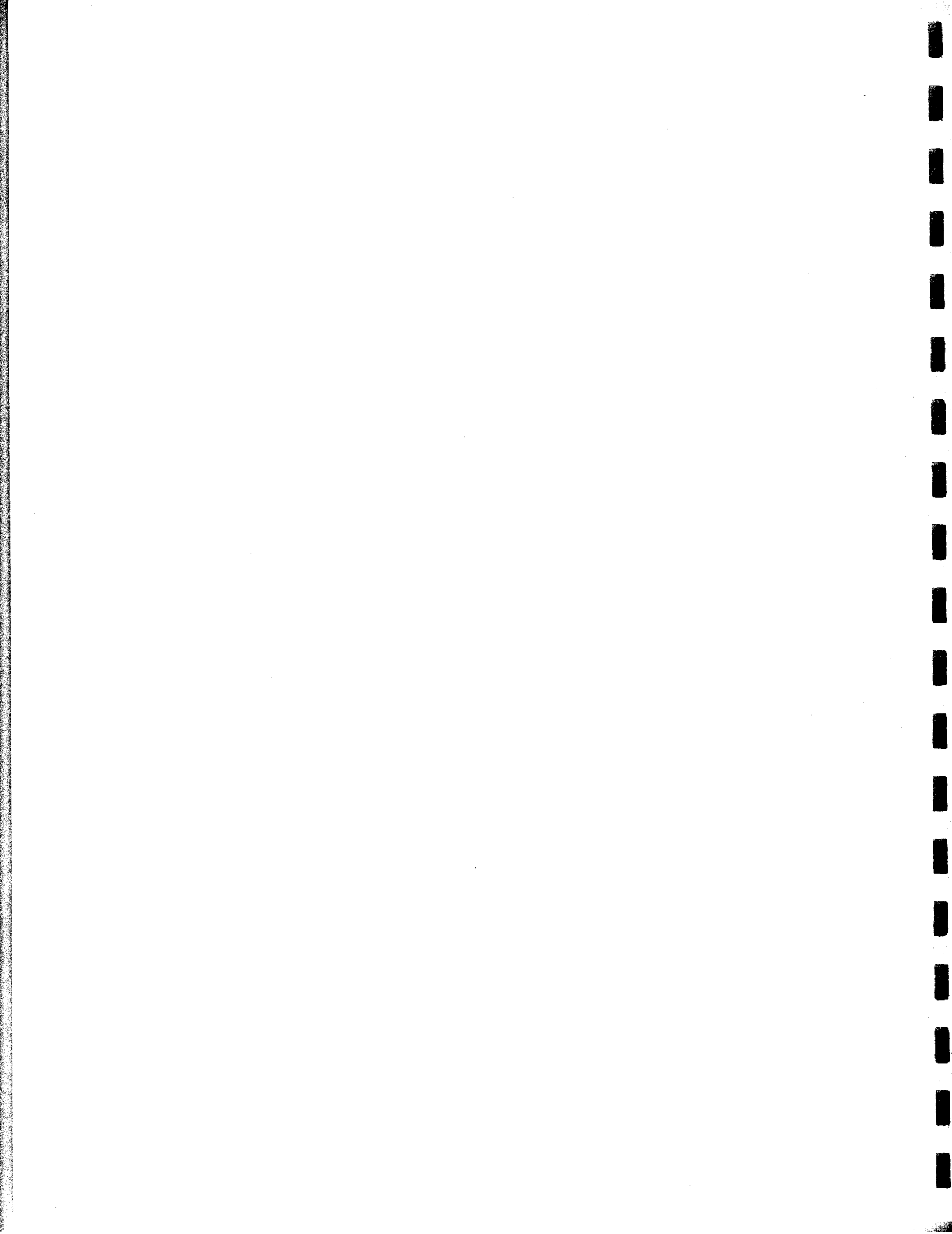
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## FDIC INTERPRETATION CONCERNING YEAR 2000 COMMUNICATIONS

### I. Background

- A. Intense interest in Year 2000 Issues
- B. SEC not satisfied with current disclosure
- C. FDIC encourages use of SEC model

### II. Duty to Disclose

#### A. Two-Part Materiality Test:

- 1. If assessment of Year 2000 issues is not complete or
- 2. If consequences of Year 2000 issues would have a material effect using a  
worst case analysis

- B. Deadlines being met
- C. May not disclose status ranking

### III. Duty to Update Disclosure

- A. "In almost all cases, companies will have material events and changes requiring updated Year 2000 disclosure in each quarterly and annual report filed with us."

### IV. Prescribed Elements of Disclosure

- A. The Company's state of readiness
- B. Costs



- C. Risks
  - D. Contingency Plans
- V. State of Readiness
- A. Cover both IT and non-IT systems
  - B. Disclose progress, stage by stage
  - C. Discuss Year 2000 issues relating to significant third parties
- VI. Costs
- A. Historical costs
  - B. Estimated future costs
- VII. Risks
- A. Describe "most reasonably likely worst case Year 2000 scenarios"
  - B. Discuss uncertainties
- VIII. Contingent Plans
- A. Describe existing contingency plans
  - B. Discuss if there are no contingency plans
  - C. State whether a contingency plan will be developed and the related timetable
- IX. Specific Disclosures If Applicable
- A. Historical and estimated costs adjusted quarterly

- B. Sources of funds for costs; % of IT budget
- C. IT projects deferred because of Year 2000 efforts
- D. Description of independent verification processes
- E. Possible chart
- F. Breakdown of costs

X. Other Possible Disclosure Areas

- A. Description of Business
- B. Material Contracts
- C. Current Report on Form 8-K
- D. Financial Statements

XI. Safe Harbor Protection

- A. SEC examples of Year 2000 forward-looking statements for purposes of safe harbors
  - 1. Estimated costs of remediation and testing
  - 2. Future costs of business disruption
  - 3. Timetables
  - 4. Contingency plans



## Federal Financial Institutions Examination Council

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Board of Governors of the Federal Reserve System  
Office of the Comptroller of the Currency  
Federal Deposit Insurance Corporation  
Office of Thrift Supervision  
National Credit Union Administration

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### Interagency Statement

May 13, 1998 statement

Y2K

#### Guidance on Year 2000 Customer Awareness Programs

To: The Board of Directors and Chief Executive Officer of all federally supervised financial institutions, service providers, software vendors, senior management of each FFIEC agency, and all examining personnel.

#### Background

The Federal Financial Institutions Examination Council (FFIEC) has issued several statements on the Year 2000 problem. These interagency statements address project management phases, specific responsibilities of the board of directors and senior management with respect to business risks, due diligence with respect to service providers and software vendors, risks associated with financial institution customers, and testing for Year 2000 readiness.

On December 17, 1997 the FFIEC issued business risk guidelines which required institutions to develop strategies for responding to inquiries from customers and business partners regarding the institution's Year 2000 readiness. Financial institutions have a responsibility to provide forthright and honest responses to questions and concerns that customers and business partners may have concerning their financial institution's Year 2000 readiness. The scope of this guidance is customer awareness (in contrast to business partner) policies. Institutions should consider including the components described below in their customer awareness programs, as appropriate.

#### Purpose

Customers of financial institutions will look to institutions for assurances that the institution is taking appropriate steps in preparation for the century date change. This statement provides suggestions for developing a customer awareness program and identifies issues that financial institutions should be prepared to discuss with customers.

#### Awareness Program for Customers

The regulators expect financial institutions to develop a customer awareness program which responds to questions and communicates with customers on Year 2000 matters. During on-site Year 2000 examinations, examiners will be reviewing the adequacy of an institution's customer awareness strategy. Effectively responding to customer inquiries also is in the best interests of the financial institution. It can serve to disclose to customers the institution's Year 2000 efforts and to provide information on how products and services used by those customers may be affected by the institution's readiness efforts. Ultimately, achieving Year 2000 readiness and ensuring that customers and business partners receive adequate information about an institution's efforts is and must be the responsibility of a financial institution's directors and officers. Management is in the best position to know how the Year 2000 date change will affect an institution's operations, strategies, resources

and exposures, and how and when it would be best to respond to the specific concerns of its customers.

The FFIEC agencies are encouraging customers with questions and concerns about Year 2000 readiness to contact their financial institutions directly. Financial institutions are of different sizes, offer different ranges of products, and vary in the complexity of information systems. This guidance recognizes these differences and provides the following suggestions that can be used to develop a program to respond to customer inquiries about the Year 2000 problem.

In developing a customer awareness strategy, financial institutions should identify those customers who should be proactively informed of efforts to address business risks arising from the Year 2000 problem. Customers may include depositors, borrowers, fiduciary clients, or others who engage in transactions with the institution. Next, financial institutions should consider the most effective ways of communicating with various types of customers about the status of the financial institution's Year 2000 readiness. Depending upon the institution's size and business environment, possible methods include:

- Providing informational brochures or other written disclosures in monthly or quarterly statements;
- Establishing toll-free hotlines for customer inquiries;
- Holding seminars to discuss the Year 2000 problem and efforts the financial institution is taking to prepare for the century date change; and
- Developing Internet sites-or perhaps an exclusive portion of their existing site-to inform customers of their Year 2000 preparedness efforts.

It is recommended that financial institutions consult with legal counsel before issuing information describing the status of Year 2000 readiness efforts.

The customer awareness program should ensure that personnel who regularly interact with customers are trained to respond appropriately to inquiries by referring customers to appropriate explanatory materials or expert financial institution staff. Institutions also may consider including interested external parties (such as the news media and community organizations in the financial institution's service area) in the communication program, as appropriate.

In developing customer awareness programs, financial institutions should consider some of the issues customers may be interested in discussing and effectively communicate with them about what could happen and what they should do if problems do arise. Some potential customer inquiries include concerns about:

- The safety of the money in their accounts.
- Access to their funds, such as access through ATMs, debit cards, telephone lines or the Internet, and the arrangements the financial institution will make to ensure alternative means of access to funds if disruptions occur.
- Whether they should withdraw some cash from their accounts prior to December 31, 1999.
- Availability of information on or summaries of the financial institution's Year 2000 project management and contingency plans.
- Whether direct deposit, direct debit and other automatic electronic payments will be made on a timely basis and credited or debited accurately to the proper accounts, and what arrangements the institution will make to deal with such transactions should disruptions occur.
- How the financial institution will assist any customers who may be affected by incorrect automatic transactions such as direct deposit and direct debit initiated by the institution or by third parties.
- Whether customers might not receive proper credit for loan payments.

- The financial institution's record keeping practices.
- The types of records customers should maintain prior to and after January 1, 2000.

The FFIEC is developing a consumer brochure that provides information to consumers about the Year 2000 challenge. The brochure will explain the steps financial institutions and the federal financial institution regulators are taking to address the century date change and emphasizes that the Year 2000 date change will not affect deposit insurance coverage. Financial institutions may wish to use the brochure as part of their communications with customers. The brochure will be available by June 1998. The federal financial institution regulatory agencies will supply each institution with one copy of the brochure along with instructions for ordering multiple copies, should institutions wish to provide them to their customers.

Depository institutions are reminded that they may not disclose publicly the contents of federal supervisory agency examination reports or reviews of the institution or any service provider or software vendor, including the confidential Year 2000 summary ratings contained therein. Thus, in designing their Year 2000 public awareness plans and efforts, institutions should be careful not to violate this prohibition. Moreover, they should avoid any statements that indicate or imply that the institution's readiness has been approved or certified by a supervising agency with regard to its Year 2000 plan.

### **Conclusion**

Financial institutions should develop a pragmatic strategy for responding to customer inquiries about their institution's Year 2000 readiness. The guidance in this interagency statement is designed to assist financial institutions in developing their programs. Each institution may choose to tailor its customer awareness program based on its own business environment, but ultimately, it is essential that each institution develop a program to address customer questions and concerns about the status of Year 2000 readiness.

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May 13, 1998 Press Release | Y2K

Maintained by FFIEC. All suggestions regarding this site may be forwarded via e-mail.  
Last Updated: May 14, 1998

FIL-111-98  
October 8, 1998

**YEAR 2000 DISCLOSURE OBLIGATIONS**

TO: CHIEF EXECUTIVE OFFICER  
SUBJECT: *Disclosures Involving Year 2000 Issues*

The Securities and Exchange Commission (SEC) on July 29, 1998, issued the attached "Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers." The statement, which took effect August 4, 1998, supersedes disclosure guidance provided in SEC Staff Legal Bulletin No. 5 (see FIL-24-98, issued February 27, 1998).

The statement requires a public company to make Year 2000 disclosures in "Management's Discussion and Analysis of Financial Condition and Results of Operations" when:

- its assessment of its Year 2000 issues is not complete, or
- management determines that the consequences of the company's Year 2000 issues would have a material effect on the company's business, results of operations or financial condition (assuming the company performs no remediation).

If disclosure is required, it must include, at a minimum:

- the company's current state of Year 2000 readiness and expected completion dates of each remediation phase;
- material historical and estimated costs of remediation;
- risks of the company's Year 2000 issues, i.e., a description of its most likely worst-case Year 2000 scenarios and the effect on operations, liquidity and financial condition; and
- the company's contingency plans for the most likely worst-case scenarios if it is not Year 2000-ready. If the company does not have a contingency plan, it should disclose if and when it will create one.

Among other things, in assessing its own readiness, a public company should determine the Year 2000-readiness of third parties with whom it has material relationships. A company should assume that material third parties will not be Year 2000-ready unless it receives written assurances from the third parties that they expect to be Year 2000-ready.

This summary of the attached statement is not intended to be comprehensive or a definitive statement of the Year 2000 disclosure obligations of public companies. Detailed guidelines and recommendations are contained in the statement.

A public company must make Year 2000 disclosures in its Forms 10-K and 10-Q (disclosures in Form 10-Q must be made beginning no later than the quarter ending after August 4, 1998). FDIC-supervised institutions registered under the Securities Exchange Act of 1934, as implemented by 12 C.F.R. Part 335, or institutions selling securities under an offering circular should prepare their disclosures of Year 2000 obligations in public filings so that such disclosures are consistent with the attached statement.

The FDIC strongly encourages other insured depository institutions to use the statement as the basis for appropriate disclosure concerning Year 2000 issues in publicly available

documents that report on the institution's financial results. The FDIC recommends that disclosure of Year 2000 readiness be included in one or more of the following:

- the annual disclosure statement prepared by each FDIC-supervised institution under 12 C.F.R. Part 350;
- for an insured depository institution with \$500 million or more in total assets, its annual report prepared under 12 C.F.R. Part 363; or
- its publicly available annual report to shareholders.

For further information, please contact your Division of Supervision regional office. Additional information on the Year 2000 issue is available from the Internet at: <http://www.fdic.gov/about/y2k/> , <http://www.ffiec.gov> or <http://www.sec.gov/news/home2000.htm>.

Nicholas J. Ketcha Jr.  
Director, Division of Supervision

Attachment: August 4, 1998, Federal Register, pages 41394-41404.

Distribution: FDIC-Supervised Banks (Commercial and Savings)

NOTE: Paper copies of FDIC financial institution letters may be obtained through the FDIC's Public Information Center, 801 17th Street, NW, Room 100, Washington, DC 20434 (800-276-6003 or 202-416-6940).





Interpretation:

## **Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers**

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### **SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 231, 241, 271, 276**

**(Release Nos. 33-7558; 34-40277; IA-1738; IC-23366; International Series Release No. 1149 )**

### **STATEMENT OF THE COMMISSION REGARDING DISCLOSURE OF YEAR 2000 ISSUES AND CONSEQUENCES BY PUBLIC COMPANIES, INVESTMENT ADVISERS, INVESTMENT COMPANIES, AND MUNICIPAL SECURITIES ISSUERS**

**AGENCY:** Securities and Exchange Commission

**ACTION:** Interpretation

**SUMMARY:** The Securities and Exchange Commission ("we" or "the Commission") is publishing guidance for public companies, investment advisers, investment companies, and municipal securities issuers regarding their disclosure obligations about Year 2000 issues. This release provides guidance to public companies so they can determine whether their Year 2000 issues are known material events, trends, or uncertainties that should be disclosed in the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") section of their disclosure documents. This release also sets forth our guidance regarding specific matters for companies to address in their MD&A Year 2000 disclosure. In addition, we address the need for companies to consider the Year 2000 issue in connection with other rules and regulations and when they prepare financial statements. Finally, we remind municipal securities issuers, as well as public companies, investment advisers, and investment companies, that the anti-fraud provisions of the federal securities laws apply to disclosure about the Year 2000 issue. This guidance supersedes the current staff guidance in revised Staff Legal Bulletin No. 5 ("Staff Legal Bulletin").

**EFFECTIVE DATE:** August 4, 1998. For information regarding the first periodic reports filed by public companies that should follow this release's guidance, see Section I.A.

**FOR FURTHER INFORMATION CONTACT:** Broc Romanek or Joseph Babits, Office of Chief Counsel, Division of Corporation Finance at 202-942-2900 (with respect to public companies), Anthony Vertuno, Division of Investment Management, at 202-942-0591 (with respect to investment companies); Arthur Laby, Division of Investment Management, at 202-942-0716 (with respect to investment advisers), and Mary Simpkins, Office of Municipal Securities, at 202-942-7300 (with respect to municipal securities).

## **Supplementary Information**

### **I. Executive Summary**

The "Year 2000 problem" arose because many existing computer programs use only the last two digits to refer to a year. Therefore, these computer programs do not properly recognize a year that begins with "20" instead of the familiar "19." If not corrected, many computer applications could fail or create erroneous results. The extent of the potential impact of the Year 2000 problem is not yet known, and if

not timely corrected, it could affect the global economy.

### A. Public Companies <sup>1</sup>

Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 to provide for full and fair disclosure to investors. <sup>2</sup> Our disclosure framework requires companies to disclose material information that enables investors to make informed investment decisions. For public companies, our authority basically is directed towards eliciting disclosure.

Under this disclosure framework, all companies must provide specific categories of information. Companies have the flexibility, however, to tailor disclosure to their particular circumstances. In almost every case, we rely on this general framework and rarely provide specific guidance on any particular issue. Companies already disclose in their MD&A their assessment of known trends, demands, commitments, events or uncertainties that are likely to have a material impact. <sup>3</sup> MD&A is designed to allow investors to see the company through the eyes of management. Investors deserve no less with respect to management's assessment of their company's Year 2000 problems. To help companies with their disclosure obligations, we are providing specific guidance on what public companies should consider when disclosing information about their Year 2000 readiness. <sup>4</sup>

This follows similar actions taken by our staff. During the past year, the staff of the Divisions of Corporation Finance and Investment Management issued and then revised the Staff Legal Bulletin to provide specific guidance regarding Year 2000 disclosure obligations. <sup>5</sup> Both of the Divisions created task forces to determine the effectiveness of the guidance.

While the number of companies disclosing Year 2000 issues has increased dramatically, the task force surveys show that many companies are not providing the quality of disclosure that we believe investors expect. In response to continuing concerns regarding this important issue, we are providing more extensive guidance in this formal Commission interpretive release. This release supersedes the revised Staff Legal Bulletin.

Public companies should apply this interpretive guidance immediately after August 4, 1998. Companies with June 30th or July 31st fiscal year ends need to follow this guidance when they file their annual reports. Companies with quarter ends after the effective date of this release also need to follow this guidance. We encourage companies with quarters that end on June 30th or July 31st to consider this guidance in their quarterly reports.

This release provides our guidance based on the current requirements of the federal securities laws. It briefly addresses a number of disclosure requirements, but focuses on MD&A. We address two important issues under MD&A -- whether companies are required to provide Year 2000 disclosure and the type of Year 2000 disclosure that is required. As discussed in Section III.A below, we believe a company must provide Year 2000 disclosure if:

- (1) its assessment of its Year 2000 issues is not complete, or
- (2) management determines that the consequences of its Year 2000 issues would have a material effect on the company's business, results of operations, or financial condition, without taking into account the company's efforts to avoid those consequences.

We expect that for the vast majority of companies Year 2000 issues are likely to be material, and therefore disclosure would be required. When a company has a Year 2000 disclosure obligation, we believe that full and fair disclosure includes:

- (1) the company's state of readiness;
- (2) the costs to address the company's Year 2000 issues;

(3) the risks of the company's Year 2000 issues; and

(4) the company's contingency plans.

Each company also must consider if its own Year 2000 circumstances require MD&A disclosure of additional information. This release provides suggestions to help companies meet their disclosure obligations. In addition to MD&A, this release reminds companies that Year 2000 disclosure may be required in their financial statements and under other rules and regulations, as discussed in Sections III.B and C below.

### **B. Investment Advisers and Investment Companies**

Because of the key role that investment advisers and the investment companies they manage play in the financial markets, we believe it is important for us to monitor the progress of these entities in preparing for the Year 2000, regardless of the materiality of any individual entity's Year 2000 issues. We believe that the best approach to monitoring the readiness of investment advisers and investment companies is to require that registered investment advisers provide detailed reports to us. In June 1998, we proposed a rule to implement this approach, as discussed in Section III.D below. Under the proposal, investment advisers would describe their Year 2000 preparedness, and that of any investment companies that they advise, in publicly available reports.

Investment advisers and investment companies that conclude that the Year 2000 issue is material to their operating results and/or financial condition would need not only to report to us but also to include disclosure in their public filings. Investment advisers and investment companies are reminded of their obligations under the anti-fraud provisions of the federal securities laws. These entities should follow the guidance provided in Section III.D.

### **C. Municipal Issuers**

Municipal issuers also have disclosure obligations. Our regulatory authority over disclosure by issuers of municipal securities is not as broad as our authority over disclosure by public and investment companies. Generally, municipal securities offerings are, by statute, exempt from registration and municipal securities issuers are exempt from the reporting provisions of the federal securities laws, including line-item disclosure rules.

Municipal securities issuers, and persons participating in the preparation of municipal securities issuers' disclosure, however, are subject to the anti-fraud provisions of the federal securities laws.<sup>6</sup>

Approximately 50,000 state and local governments have over \$1.3 trillion in municipal securities outstanding.<sup>7</sup> Municipal securities issuers, like other organizations, have Year 2000 issues. Year 2000 problems may affect their operations, creditworthiness, and ability to make timely payment on their indebtedness. We encourage municipal securities issuers and persons who assist in preparing their disclosure documents to consider whether Year 2000 issues may be material to investors. If material, the disclosure documents used by municipal issuers should contain a discussion of Year 2000 issues to avoid misleading statements or omissions that could violate the anti-fraud provisions. In Section III.E, we provide guidance to municipal issuers, and persons assisting in the preparation of their disclosures, regarding Year 2000 disclosure.

## **II. Background**

### **A. Significance of the Year 2000 Issue**

As the end of this century nears, there is worldwide concern that Year 2000 technology problems may wreak havoc on global economies. No country, government, business, or person is immune from the potential far-reaching effects of Year 2000 problems. President Clinton recently stated that "all told, the worldwide cost will run into the tens, perhaps the hundreds of billions of dollars, and that's the cost of

fixing the problem, not the cost if something actually goes wrong." <sup>8</sup> Some estimates that include not only software and hardware costs, but also costs related to business interruptions, litigation, and liability, run in the hundreds of billions of dollars. <sup>2</sup>

Only one thing is certain about the impact of the Year 2000 -- it is difficult to predict with certainty what truly will happen after December 31, 1999. <sup>10</sup> To reduce the impact of this potentially serious, widespread problem, many public officials and private commentators have spoken out about the need to plan properly now. <sup>11</sup>

We intend to intensify our efforts to elicit meaningful disclosure from companies about their Year 2000 issues. Only through that disclosure can investors make informed investment decisions. We believe that companies have sufficient incentive to provide meaningful disclosure to investors and meet their Year 2000 disclosure obligations. These incentives include business reasons, investor relations concerns, and possible referrals to our Division of Enforcement.

### **B. Staff Efforts Regarding Year 2000 Disclosure: Divisions of Corporation Finance and Investment Management**

The Year 2000 issues faced by the securities industry and ourselves are very serious. Every Division and Office within the Commission has participated in special initiatives to promote Year 2000 readiness in the securities industry, the capital markets, and their underlying industries. <sup>12</sup> Our staff has been providing reminders and guidance to companies for over a year regarding their Year 2000 disclosure obligations. To educate investors, the Office of Investor Education has posted on our web site a series of questions that investors can use. <sup>13</sup>

In May 1997, the Division of Corporation Finance updated its Current Issues and Rulemaking Projects outline to discuss the need for public companies to disclose the effect of Year 2000 technology problems. <sup>14</sup> On October 8, 1997, the Divisions of Corporation Finance and Investment Management issued a joint Staff Legal Bulletin reminding entities with disclosure obligations that our rules and regulations apply to Year 2000 issues, just like any other significant issue. <sup>15</sup> On January 12, 1998, the Divisions revised the Staff Legal Bulletin to provide more specific guidance under existing rules and regulations. <sup>16</sup>

After the Staff Legal Bulletin was revised, the Division of Corporation Finance created a Year 2000 task force to determine how many public companies are addressing the Year 2000 issue and to assess whether the disclosure being provided is meaningful. The task force found that only 10% of the annual reports filed by public companies during the first four months of 1997 contain the phrase "Year 2000." For the quarterly reports filed after the staff published the Staff Legal Bulletin, this percentage increased to 25%. After the staff revised the Staff Legal Bulletin in January 1998, 70% of the annual reports contained the phrase "Year 2000."

To evaluate the quality of the Year 2000 disclosure, the task force read the Year 2000 disclosure in the filings of 1,023 public companies selected from 12 major industries, including 66 small business issuers. The task force believed that this sampling of filings fairly represented a cross-section of public companies. The task force also surveyed the most recent annual or quarterly reports filed by the Fortune 100 companies that file periodic reports with us. <sup>17</sup>

Based on the specific guidance provided in the revised Staff Legal Bulletin, the task force looked for eight categories of information. The task force discovered that companies were providing a wide variety of Year 2000 disclosures. While the number of companies disclosing Year 2000 issues has increased dramatically, the task force survey shows that many companies are not providing the quality of detailed disclosure that we believe that investors would expect. <sup>18</sup>

In its review of Year 2000 disclosures made by investment companies, the Division of Investment Management found that twenty-four of the twenty-five largest investment company complexes have

made Year 2000 disclosure to their fund shareholders. In addition, the Division surveyed 740 registration statements of investment companies filed since January 1, 1998, and found that 81% of these contained Year 2000 disclosure.<sup>19</sup> Typically, investment companies' Year 2000 disclosure was generic and included acknowledgment of the Year 2000 issue, that the issues are being addressed and will be resolved, and that they cannot guarantee that its remediation efforts will prevent all consequences.

The generic nature of an investment company's Year 2000 disclosure may be related to its Year 2000 compliance reliance on entities whose Year 2000 readiness efforts it does not control. Investment companies rely heavily on external service providers (e.g., investment advisers, transfer agents, brokers, and custodians) that may have represented to the investment companies that they anticipate being Year 2000 compliant.

### **C. The Statutory Safe Harbors for Forward-Looking Information**

We recognize that companies face difficult disclosure challenges due to the forward-looking nature of Year 2000 issues. In drafting disclosure documents, companies necessarily have to address uncertainties and describe future events relating to their Year 2000 issues. To help companies in this task, we provide the following interpretive guidance regarding the application of the two statutory safe harbors for forward-looking information provided by the Private Securities Litigation Reform Act of 1995.<sup>20</sup>

The statutory safe harbors apply to forward-looking statements<sup>21</sup> provided by eligible companies.<sup>22</sup> Almost all of the required MD&A disclosures concerning Year 2000 problems contain forward-looking statements. For example, in our view, a projection of capital expenditures or other financial items -- such as the estimated costs of remediation and testing -- is a forward-looking statement because it anticipates how remediation and testing will proceed in the future.<sup>23</sup>

A company's statement regarding the estimated future costs due to business disruption caused by vendors, suppliers, customers, or even the possible loss of electric power or phone service, typically would be a statement of future economic performance, as well as a projection of a financial item. Much of the description of a company's Year 2000 problems would be part of a forward-looking statement because the statement contains assumptions concerning estimated costs or plans for future operations. Contingency plans that assess which scenarios are most likely (such an assessment is typically necessary in deciding which scenarios to spend time and money preparing for) would be forward-looking statements of plans and objectives of management for future operations.

Some matters that are simply statements of historical fact are not forward-looking. For example, historical costs are not forward-looking. Similarly, whether a company has a contingency plan at all would be a matter of fact. Whether a company actually has performed an assessment would be a fact, as would its inventory of hardware, software, and embedded chips. However, a description of the problems that the company anticipates, which form the basis of its assessment, is sufficiently forward-looking to constitute either a forward-looking statement or an assumption relating to a forward-looking statement. Similarly, statements identifying the remediation phase that a company currently is in would be a matter of fact, but timetables for implementation of future phases, including estimates of how long the internal and third-party testing phases will take, would be forward-looking statements, at least until the phases are completed.

For the statutory safe harbors to apply, material forward-looking statements must be accompanied by "meaningful cautionary statements."<sup>24</sup> The meaningful cautionary statements cannot be boilerplate language.<sup>25</sup> The safe harbors do not apply if the statement was knowingly false when made. Furthermore, the statutory safe harbors were meant to apply only to private actions in federal court.<sup>26</sup>

### **III. Our Specific Disclosure Guidance**

As the end of the century draws near, the Year 2000 technical and legal issues become increasingly material to investors. We are concerned that some companies may not be meeting their Year 2000 disclosure obligations. With each passing month, the extent of the Year 2000 risks become more evident

and companies' obligations to disclose their Year 2000 issues becomes clearer. Investors need to know how companies are addressing these issues.

The federal securities laws are dynamic and responsive to changing circumstances. As companies remediate their Year 2000 issues, their circumstances change as they discover new issues. Companies need to adjust their disclosure accordingly. In almost all cases, companies will have material events and changes requiring updated Year 2000 disclosure in each quarterly and annual report filed with us.<sup>27</sup>

#### **A. Specific Guidance for Year 2000 Disclosure under MD&A**

The following specific guidance sets forth the type of Year 2000 disclosure that companies should provide under MD&A and other rules and regulations.

##### ***1. Basic MD&A Analysis***

MD&A is intended to give investors the opportunity to look at a company through the eyes of management by providing both a short and long-term analysis of the company's business -- with particular emphasis on the company's prospects for the future. MD&A requires a discussion of liquidity, capital resources, results of operations, and other information necessary to an understanding of a company's financial condition, changes in financial condition, and results of operations. The language of the MD&A requirement is intentionally general. This reflects our view that a flexible approach best elicits meaningful disclosure and avoids boilerplate discussions.

One of the challenges that a company faces when drafting its MD&A is discussing forward-looking information. One of the few regulations that require forward-looking disclosure, MD&A contains a variety of formulations calling for this information, including a requirement to disclose known material events, trends or uncertainties.<sup>28</sup>

In the 1989 Release, we gave guidance to companies on various aspects of MD&A disclosure. Under the 1989 Release, companies should apply the following analysis to determine if they should disclose forward-looking information.

Where a trend, demand, commitment, event, or uncertainty is known, management must make two assessments:

- (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
- (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the company's financial condition or results of operations is not reasonably likely to occur.

The determination made by management must be objectively reasonable, viewed as of the time the determination is made.

This test essentially requires companies to disclose forward-looking information based on currently known events, trends or uncertainties that are reasonably likely to have material effects on the company's financial condition or results of operations.<sup>29</sup> Because of the prevalence of computers and embedded technology in virtually all businesses and the potential consequences of not adequately addressing the Year 2000 problem, we believe that almost every company will need to address this issue.

##### ***2. How We Interpret MD&A in the Year 2000 Context***

###### ***a. Whether to Disclose Year 2000 Issues***

The first decision that a company must make is whether it has an obligation to provide any disclosure regarding its Year 2000 issues.<sup>30</sup> By applying the 1989 Release's guidance regarding forward-looking information, we believe that a company must provide Year 2000 disclosure if:

- (1) its assessment of its Year 2000 issues is not complete, *or*
- (2) management determines that the consequences of its Year 2000 issues would have a material effect on the company's business, results of operations, or financial condition, without taking into account the company's efforts to avoid those consequences.

Our two-part test is substantially similar to the revised Staff Legal Bulletin's guidance for whether companies have a Year 2000 disclosure obligation. We believe that a large majority of companies will meet one or both of these tests and therefore will be required to provide Year 2000 disclosure. We expect that significantly more companies will be providing Year 2000 disclosure in future disclosure documents than the 70% found by the task force.

Under the first test, a company's assessment should take into account whether third parties with whom a company has material relationships are Year 2000 compliant. The determination of whether a relationship is material depends on the nature of the relationship.

For vendors and suppliers, the relationship is material if there would be a material effect on the company's business, results of operations, or financial condition if they do not timely become Year 2000 compliant. The same analysis should be made for significant customers whose Year 2000 readiness could cause a loss of business that might be material to the company. The company also should consider its potential liability to third parties if its systems are not Year 2000 compliant, resulting in possible legal actions for breach of contract or other harm.

In our view, a company's Year 2000 assessment is not complete until it considers these third party issues and takes reasonable steps to verify the Year 2000 readiness of any third party that could cause a material impact on the company. We understand that this is often done by analyzing the responses to questionnaires sent to these third parties. In the absence of receiving responses to questionnaires, there may be other means to assess third party readiness.<sup>31</sup>

Under the second test, companies must determine whether they have a Year 2000 disclosure obligation by evaluating their Year 2000 issues on a "gross" basis.<sup>32</sup> In other words, in the absence of clear evidence of readiness, a company must assume that it will not be Year 2000 compliant and weigh the likely results of this unpreparedness.<sup>33</sup> As part of this analysis, the company must assume that material third parties will not be ready either, unless these third parties have delivered written assurances to the company that they expect to be Year 2000 compliant in time. The test is driven by measuring the consequences if the company is not prepared, rather than the amount of money the company spent, or plans to spend, to address this issue.<sup>34</sup>

#### **b. What to Disclose about Year 2000 Issues**

Once a company determines that it has a Year 2000 disclosure obligation, it has to decide what to disclose about its Year 2000 issues. MD&A does not require categories of specific information because each company has to consider its own circumstances in drafting its MD&A. For Year 2000 disclosure to be meaningful, we believe that companies will have to address the following four categories of information in their MD&A, as discussed in more detail below:

- (1) the company's state of readiness;
- (2) the costs to address the company's Year 2000 issues;
- (3) the risks of the company's Year 2000 issues; and

(4) the company's contingency plans.

The disclosure should be specific to each company and quantified to the extent practicable. Some companies may have to provide this information by business segment or subdivision.<sup>35</sup> Companies should avoid generalities and boilerplate disclosure. In addition, each company must consider if its own Year 2000 circumstances require that additional matters be disclosed.

### (1) The Company's State of Readiness

When a company has to provide disclosure regarding a known material event, trend, or uncertainty, it first has to describe that event, trend, or uncertainty.<sup>36</sup> A company should describe its Year 2000 issues in sufficient detail to allow investors to fully understand the challenges that it faces. We suggest that the description be similar to that provided to a company's board of directors -- which typically is non-technical plain English and answers the important questions -- such as "will we be ready?" and "how far along are we?" So far, most companies have provided only a cursory description of their Year 2000 issues.

A full description of a company's Year 2000 readiness will generally include, at the very least, the following three elements. First, the discussion should address both information technology ("IT") and non-IT systems.<sup>37</sup> Non-IT systems typically include embedded technology such as microcontrollers.<sup>38</sup> These types of systems are more difficult to assess and repair than IT systems. In fact, companies often have to replace non-IT systems since they cannot be repaired. To date, only a few companies have addressed non-IT issues in their disclosure.<sup>39</sup> We are concerned that companies are overlooking non-IT systems when they provide Year 2000 disclosure.<sup>40</sup>

Second, for both their IT and non-IT systems, companies should disclose where they are in the process of becoming ready for the Year 2000.<sup>41</sup> The status of the company's progress, identified by phase, including the estimated timetable for completion of each remaining phase, is vital information to investors and should be disclosed.<sup>42</sup> There are no universal definitions for the phases in a Year 2000 remediation program.<sup>43</sup> However, for the most part, the phases are self-explanatory, and we recommend that companies briefly describe how they define each phase. Another challenge is describing the status of multiple computer systems. Companies should tailor the disclosure and the format for their own particular circumstances.<sup>44</sup>

The third essential component is a description of a company's Year 2000 issues relating to third parties with which they have a material relationship. Due to the interdependence of computer systems today, the Year 2000 problem presents a unique policy issue. For example, if a major telecommunications company discloses that it may have a business interruption, this may require many other companies to disclose that they too may have a business interruption, if material. Thus, each company's Year 2000 issues may affect other companies' disclosure obligations. Companies should disclose the nature and level of importance of these material relationships, as well as the status of assessing these third party risks.<sup>45</sup>

### (2) The Costs to Address the Company's Year 2000 Issues

Companies must disclose material historical and estimated costs of remediation. This includes costs directly related to fixing Year 2000 issues, such as modifying software and hiring Year 2000 solution providers. In most cases, the replacement cost of a non-compliant IT system should be disclosed as an estimated Year 2000 cost. This is so even if the company had planned to replace the system and merely accelerated the replacement date.<sup>46</sup> A company does not need to include the replacement cost as a Year 2000 estimated cost if it did not accelerate the replacement due to Year 2000 issues.

### (3) The Risks of the Company's Year 2000 Issues

Companies must include a reasonable description of their most reasonably likely worst case Year 2000



scenarios. The essence of MD&A is whether the consequences of a known event, trend, or uncertainty are likely to have a material effect on the company's results of operations, liquidity, and financial condition. If a company does not know the answer, this uncertainty must be disclosed, as well as the efforts made to analyze the uncertainty and how the company intends to handle this uncertainty. For example, companies must disclose estimated material lost revenue due to Year 2000 issues, if known.

#### (4) The Company's Contingency Plans

Companies must describe how they are preparing to handle the most reasonably likely worst case scenarios. This information will help investors evaluate the company's Year 2000 exposure by answering the important question -- "what will the company do if it is not ready?" Under this category of information, the company must describe its contingency plans.<sup>47</sup> We recognize that describing contingency plans may be particularly challenging. Many companies have not yet established a contingency plan. In this case, the company should disclose that it does not have a contingency plan, whether it intends to create one, and the timetable for doing so.

#### (5) Suggested Disclosure

We cannot address the virtually unlimited number of differing circumstances relating to Year 2000 issues that may require a company to provide disclosure. For example, the departure of a senior management member who heads the company's Year 2000 project may be material for some companies but not all companies. Some companies face material Year 2000 risks outside the United States.<sup>48</sup> Software and hardware manufacturers must address whether their products will be Year 2000 compliant and may face potentially greater litigation risks than companies in other industries. Companies regulated by other agencies, such as financial institutions, may face formal supervisory or enforcement actions relating to Year 2000 issues that need to be disclosed.<sup>49</sup>

Companies must be aware that providing the minimum level of Year 2000 disclosure set forth in the four categories of information above may not be enough to meet their disclosure obligations. Each company must consider if its own Year 2000 circumstances require disclosure of other matters. The following suggestions are intended to help companies meet their disclosure obligations. While each of the suggestions may not be relevant for each company, all companies should consider them.

1. Disclose historical and estimated costs related to their Year 2000 issues, even if disclosure of the dollar amounts is not required because these amounts are not material.
2. As of the end of each reporting period, disclose how much of the total estimated Year 2000 project costs have already been incurred.
3. Identify the source of funds for Year 2000 costs, including the percentage of the IT budget used for remediation. This allows investors to determine whether Year 2000 funds will be deducted from the company's income.
4. Explain if other IT projects have been deferred due to the Year 2000 efforts, and the effects of this delay on financial condition and results of operations.
5. Describe the use of any independent verification and validation processes to assure the reliability of their risk and cost estimates. The use of independent verification may be particularly important in the testing phase.<sup>50</sup>
6. Use a chart to provide Year 2000 disclosure. The chart may help investors track a company's progress over time, as it is updated, and make peer comparisons based on the same data. In addition, a chart can reduce lengthy Year 2000 disclosure that otherwise may overwhelm other disclosure.
7. Include a breakdown of the costs, such as disclosure of costs to repair software problems, and costs to replace problem systems and equipment.

## B. Year 2000 Financial Statement Considerations

Existing accounting and auditing standards provide guidance concerning the accounting and disclosure issues arising from the Year 2000 problem. Matters that companies and their auditors should consider include the following.

### 1. Accounting and Disclosure in Financial Statements

**Costs of Modifying Software.** A company's need or plan to modify its own software for Year 2000 compliance does not result in a liability that is recognized in financial statements. Instead, the costs of modifying the software are charged to expense as they are incurred.<sup>51</sup>

**Costs of Failure to Be Year 2000 Compliant.** Operating losses expected to result if a company, its suppliers, or customers fail to correct Year 2000 deficiencies are recognized only as they are incurred.

**Disclosure of Year 2000 Related Commitments.** Companies should consider the need to disclose payments to be made pursuant to unfulfilled or executory contracts or commitments with vendors to remediate Year 2000 noncompliance problems.<sup>52</sup> Companies also should consider the need to disclose the potential for acceleration of debt payments due to covenant defaults tied to Year 2000 readiness.

**Revenue and Loss Recognition.** Year 2000 issues may affect the timing of revenue recognition in accordance with AICPA Statement of Position 97-2, *Software Revenue Recognition*. For example, if a vendor licenses a product that is not Year 2000 compliant and commits to deliver a Year 2000 compliant version in the future, the revenue from the transaction should be allocated to the various elements--the software and the upgrade. Entities also should consider FASB Statement No. 48, *Revenue Recognition When the Right of Return Exists*, relating to any product return issues such as for products containing hardware and software, including whether the necessary conditions have been met to recognize revenue in the period of sale, whether that revenue should be deferred, or whether an allowance for sales return should be provided.

**Allowances for Loan Losses.** The credit quality of a loan may be affected by the failure of a borrower's operating or other systems as a consequence of a Year 2000 issue or a borrower's failure to comply with debt covenant terms regarding Year 2000 issues. Creditors' allowances for loan losses, however, should be provided only for losses incurred as of the balance sheet date, and should not be based on the effects of future events.

**Losses from Breach of Contract.** Possible losses from asserted and nonasserted claims of breach of contract or warranty due to Year 2000 noncompliance must be disclosed in notes to the financial statements, and must be recognized as a liability if those losses are probable and reasonably estimable.<sup>53</sup> For example, companies selling products with an express or implied warranty of Year 2000 compliance may have a potential liability that must be evaluated at each balance sheet date. Companies will be required to disclose potential lawsuits when there is at least a reasonable possibility that a loss, or additional loss, may be incurred even if the amount of loss cannot be reasonably estimated.

**Impairment of Assets.** Certain companies may need to consider if a write-down of capitalized software may be required in accordance with the guidance of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed*. Also, Year 2000 compliance issues may indicate impairment of long-lived assets that contain hardware or software and require application of the guidance in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. An adjustment to the estimated useful lives of hardware or internal use software may be appropriate even if the assets are not considered to be impaired. In addition, companies should consider the accounting for costs associated with developing or obtaining computer software for internal use, as discussed in AICPA Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*.

**Disclosure of Risks and Uncertainties.** A company must explain any risk or uncertainty of a reasonably possible change in its estimates in the near term that would be material to the financial statements. Examples of estimates that may be affected by Year 2000 issues include estimates of warranty liability, reserves for product returns and allowances, capitalized software costs, inventory, litigation, and deferred revenue. <sup>54</sup>

Additional guidance concerning accounting and auditing issues related to the Year 2000 issue is included in *The Year 2000 Issue - Current Accounting and Auditing Guidance*, published by the AICPA on October 31, 1997. <sup>55</sup>

## **2. Auditor Responsibilities**

**Conducting the Audit.** Existing generally accepted auditing standards provide guidance that would apply to performing an audit involving Year 2000 issues. The AICPA publication, *The Year 2000 Issue - Current Accounting and Auditing Guidance*, also addresses auditing issues related to the Year 2000 issue. The auditor should consider professional standards concerning matters such as planning and supervision of the audit, auditor responsibilities for disclosures outside the financial statements in filings made with us, processing of transactions by service organizations, and auditor communications with the client, management and audit committee. <sup>56</sup>

Although the term "may" is used throughout the AICPA's guidance, perhaps suggesting that the guidance is discretionary, we believe that the procedures outlined by the AICPA should be considered appropriate practice at this time and we expect companies and their auditors to comply with that guidance. If they do not, they should be prepared to justify why the procedures were not followed. <sup>57</sup>

**"Going Concern" Issues.** An auditor must evaluate whether or not the procedures performed during the course of the audit identify conditions and events that, in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern. Year 2000 issues, either alone or when considered in relation to other conditions and events, may indicate going concern issues about an entity. The going concern issues may affect the disclosures in the financial statements and result in a modification of the auditor's report. <sup>58</sup>

**Resignation of an Independent Auditor.** Item 4 of Form 8-K requires a company to file a Form 8-K within 5 business days if its principal auditor resigns. <sup>59</sup> The company must disclose in the Form 8-K any disagreements on accounting or reportable events that relate to Year 2000 issues. The company must request the auditor to review its disclosures and invite comment on their completeness and accuracy.

## **C. General Guidance for Public Companies' Year 2000 Disclosure under Other Regulations**

Other federal securities rules or regulations may require disclosure related to companies' Year 2000 issues. The following is a list of rules and regulations that companies should consider.

**1. Description of Business.** <sup>60</sup> This item requires a description of the general development of the business of the company, its subsidiaries, and any predecessors during the past five years (or the period the company has been in business, if shorter). Among other things, this item requires a discussion of:

- any material changes in the mode of conducting the business;
- the principal markets for the company's products and services;
- competitive conditions in the business; and
- financial and narrative information about the company's industry segments.

**2. Legal Proceedings.** <sup>61</sup> A company must describe material pending legal proceedings in which the company or any of its subsidiaries is a party, or to which its property is subject. Generally, no

information is required regarding claims for damages unless the amount involved exceeds ten percent of the current assets of the company and its subsidiaries on a consolidated basis. However, it may be necessary to describe routine litigation where the claim differs from the usual type of claim. <sup>62</sup>

**3. Material Contracts.** <sup>63</sup> A company must file as an exhibit certain contracts that are considered material to its business. These contracts include contracts upon which the business is substantially dependent, such as contracts with principal customers and principal suppliers.

**4. Risk Factors.** <sup>64</sup> Registration statements filed under the Securities Act must include under the caption "Risk Factors" a discussion of the factors that make the offering speculative or risky. This discussion must be specific to the particular company and its operations, and should explain how the risk affects the company and/or the securities being offered. Generic or boilerplate discussions do not tell investors how the risk may affect their investment.

**5. Form 8-K.** <sup>65</sup> Year 2000 issues may reach a level of importance that prompts a company to consider filing a Form 8-K under Item 5 of the form. In considering whether to file a Form 8-K, companies should be particularly mindful of the accuracy and completeness of information in registration statements filed under the Securities Act that incorporate by reference Exchange Act reports, including Forms 8-K. <sup>66</sup>

**6. Any Additional Material Information Necessary to Make the Required Disclosure Not Misleading.** In addition to the information that the company is specifically required to disclose, the disclosure rules require disclosure of any additional material information necessary to make the required disclosure not misleading. <sup>67</sup>

#### **D. Guidance for Year 2000 Disclosure for Investment Advisers and Investment Companies**

Because of the key role that investment advisers and the investment companies they manage play in the financial markets, we believe that it is important that investment advisers provide detailed reports on their Year 2000 readiness to the Commission. In June 1998, we published for comment a proposed rule to require investment adviser Year 2000 reports. <sup>68</sup> Since these reports will be publicly available, they will help analysts and the public, as well as the Commission, to evaluate the progress of investment companies and investment advisers in addressing the Year 2000 issue. In addition to these reports, investment companies and investment advisers that conclude that the Year 2000 issue is material to their operating results and/or financial condition are required to provide disclosure in accordance with other statutory provisions.

The anti-fraud provisions of the Investment Advisers Act generally impose on investment advisers an affirmative duty, consistent with their fiduciary obligation, to disclose to clients or prospective clients material facts concerning their advisory or proposed advisory relationships. <sup>69</sup> If the failure to address the Year 2000 issue could materially affect the advisory service provided to clients, an adviser that will not be able to, or is uncertain about, its ability to address Year 2000 issues has an obligation to disclose that information to its clients. The adviser must provide the disclosure in a timely manner so that the clients and prospective clients may take steps to protect their interests. In addition, investment advisers that are public companies have disclosure obligations under the Securities Act and Exchange Act and should follow our interpretive guidance for public company disclosure in Sections III.A, B, and C.

The Investment Company Act provides that it is unlawful for investment companies to omit from registration statements and other public filings "any fact necessary in order to prevent the statements made therein, in light of the circumstances under which they were made, from being misleading." <sup>70</sup> If investment companies determine that their Year 2000 risks are material, they are required to discuss such risks in their registration statements and other public documents and should follow the guidance provided in this section. <sup>71</sup>

Whether Year 2000 issues are material depends upon the particular facts and circumstances for each

investment company. Consideration should be given, for example, to whether Year 2000 issues affect an investment company's own operations, and its ability to obtain and use services provided by third parties, or its portfolio investments. Investment companies could face difficulties, among other things, performing various functions such as calculating net asset value, redeeming shares, delivering account statements and providing other information to shareholders. Because many investment company operations are performed by external service providers, we expect that investment companies would, as a matter of course, discuss Year 2000 issues with their service providers and seek reasonable assurance from these service providers that they will address Year 2000 issues so as to allow the continuation of the provided services without interruption, and consider carefully the responses provided. <sup>72</sup>

Discussion of Year 2000 issues and their effect on an investment company may need to be made in response to specific items of the registration forms for investment companies. For example, open-end investment companies (mutual funds) are required by Item 6 of Form N-1A to describe in their prospectuses the experience of their investment adviser and the services that the adviser provides. In response to this item, investment companies may need to disclose the effect that the Year 2000 issue would have on their advisers' ability to provide services described in their registration statements. Item 7 of that form requires funds to describe their pricing procedures and purchase and redemption procedures. Investment companies should consider the effect of Year 2000 issues on the effectiveness and operation of these procedures. Investment companies also may need to consider the effect of the Year 2000 issue in discussing their investment strategies and risks, and consider whether their investment objectives or policies need to be changed in light of Year 2000 concerns. <sup>73</sup>

Although those provisions are not specifically applicable to investment companies, investment companies seeking further guidance in preparing Year 2000 disclosure may find it helpful to review the provisions of this release applicable to other public companies and their preparation of MD&A disclosure. For example, investment companies may find it appropriate to include disclosure about the costs of remedying their Year 2000 issues, any liabilities associated with these problems, or contingency plans to deal with their disruptions that may occur when Year 2000 issues are encountered.

Investment companies that conclude that the Year 2000 is not material to their financial operating results and/or financial condition may nonetheless choose to include Year 2000 disclosure in periodic reports to shareholders or in special reports to shareholders on Year 2000 matters. We encourage such reporting, and consider that it is particularly appropriate in cases in which an investment company concludes that the materiality of the problem does not trigger a disclosure obligation in a registration statement. Finally, when providing Year 2000 disclosure, investment advisers and investment companies should avoid boilerplate disclosure that may not be meaningful to shareholders.

#### **E. Guidance for Year 2000 Disclosure for Municipal Issuers**

Generally, municipal securities offerings are exempt from registration and municipal securities issuers are exempt from the reporting provisions of the federal securities laws, including line-item disclosure rules. However, they are not exempt from the anti-fraud provisions. Disclosure documents used by municipal issuers are subject to the prohibition against false or misleading statements of material facts, including the omission of material facts necessary to make the statements made, in light of the circumstances in which they are made, not misleading. <sup>74</sup>

Issuers of municipal securities and persons assisting in preparing municipal issuer disclosures are encouraged to consider whether such disclosures should contain a discussion of Year 2000 issues. Persons, including "obligated persons" as defined in Rule 15c2-12, <sup>75</sup> who provide information for use in disclosure documents or in ongoing disclosure to the market, are urged to consider their own Year 2000 issues. Year 2000 issues should be considered in preparing all disclosure documents, whether in the context of an official statement, continuing disclosure provided in compliance with a disclosure covenant, or other information that is reasonably expected to reach investors and the trading markets. <sup>76</sup>

Whether Year 2000 issues are material depends upon the particular facts and circumstances for each municipal issuer. Consideration may be given, for example, to whether Year 2000 issues affect internal

operations of an issuer or affect an issuer's ability to provide services and meet its obligations, including timely payment of its indebtedness.

Because of the varieties of municipal issuers and of municipal securities, the examples provided below may or may not apply to a particular issuer and an issuer may be subject to facts and circumstances requiring disclosure not described below. Issuers and the persons assisting in disclosure preparation should give careful consideration to Year 2000 issues within the context of the facts and circumstances applicable to the disclosing issuer or the securities.

### **Examples of Potential Year 2000 Problems**

For municipal issuers, Year 2000 issues may be divided into three categories: Internal, External and Mechanical. Internal Year 2000 issues may arise from an issuer's own operations and materially affect its creditworthiness and ability to make timely payment of its obligations. External Year 2000 issues may arise from parties, other than an issuer, that provide payments that support the debt service on an issuer's municipal securities. Such payments may include, for example, health care reimbursement payments and payments under housing and student loan programs, as well as payments made by an obligated person under a lease, loan or installment sale agreement in a conduit financing.

Mechanical Year 2000 issues may arise if Year 2000 problems disrupt the actual mechanical process used to send payments to bondholders. For example, many municipal securities pay interest semiannually on January 1 and July 1 of each year, or have periodic sinking fund installments due to an indenture trustee or fiscal agent. Issuers may wish to determine whether Year 2000 issues affect their ability to identify and meet such obligations in a timely manner and to disclose any measures that will be undertaken if an issuer determines it will not be able to meet such obligations.

Issuers of general obligation debt may wish to consider, for example, the adverse effects, if any, Year 2000 issues may pose to their ability to assess and collect *ad valorem* taxes and allocate receipts and disbursements to proper funds in a timely manner to make debt service payments when due. In addition, while Year 2000 issues may not directly affect an issuer's ability to pay debt service, they may affect an issuer's general accounting and payment functions, which may be material to investors.

Revenue bond issuers may wish to consider, for example, any adverse effects Year 2000 issues may have on their ability to collect and administer the revenue stream securing their bonds and their ability to make timely payment of principal and interest on their obligations, as well as adverse effects to general accounting and payment functions, which may be material to investors.

Conduit borrowers, such as hospitals, universities and others, may wish to consider, for example, any adverse effects Year 2000 issues may have on their ability to deliver services, collect revenue and make timely payment on their obligations, including the obligation to pay debt service relating to municipal securities, which may be material to investors.

All issuers and conduit borrowers also may wish to consider the impact of Year 2000 problems facing third parties on their own ability to satisfy their responsibilities.

Other examples of suggested disclosure for consideration include, but are not limited to, the costs associated with fixing an issuer's Year 2000 problems, any loss associated with fixing an issuer's Year 2000 problems, any loss an issuer may incur because of Year 2000 problems, and any liabilities associated with an issuer's Year 2000 problems.

While not binding on issuers of municipal securities, issuers and persons assisting in preparing municipal issuer disclosure seeking further guidance may wish to review Sections III.A, B, and C of this release applicable to public companies. <sup>17</sup> The anti-fraud provisions of the federal securities law prohibit materially false and misleading statements or omissions, including those relating to the Year 2000 issues we have discussed in this release.

### **LIST OF SUBJECTS**

17 CFR Parts 231, 241, and 276

Securities.

17 CFR Part 271

Investment companies, Securities.

#### AMENDMENTS TO THE CODE OF FEDERAL REGULATIONS

For the reasons set forth in the preamble, the Commission is amending title 17, chapter II of the Code of Federal Regulations as follows:

#### PART 231 - INTERPRETATIVE RELEASES RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS THEREUNDER

1. Part 231 is amended by adding Release No. 33-7558 and the release date of July 29, 1998, to the list of interpretative releases.

#### PART 241 - INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

2. Part 241 is amended by adding Release No. 34-40277 and the release date of July 29, 1998, to the list of interpretative releases.

#### PART 271 - INTERPRETATIVE RELEASES RELATING TO THE INVESTMENT COMPANY ACT OF 1940 AND GENERAL RULES AND REGULATIONS THEREUNDER

3. Part 271 is amended by adding Release No. IC-23366 and the release date of July 29, 1998, to the list of interpretative releases.

#### PART 276 - INTERPRETATIVE RELEASES RELATING TO THE INVESTMENT ADVISERS ACT OF 1940 AND GENERAL RULES AND REGULATIONS THEREUNDER

4. Part 276 is amended by adding Release No. IA-1738 and the release date of July 29, 1998, to the list of interpretative releases.

By the Commission.

Jonathan G. Katz

Secretary

Dated: July 29, 1998

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#### FOOTNOTES

[1] As used in this release, "public companies" generally refers to corporate and similar issuers, rather than investment companies and investment advisers, which are addressed separately.

[2] The Securities Act of 1933 ("Securities Act") can be found at 15 U.S.C. 77a et seq. The Securities Exchange Act of 1934 ("Exchange Act") can be found at 15 U.S.C. 78a et seq.

-[3]- Item 303 of Regulations S-K (17 CFR 229.303) and S-B (17 CFR 228.303). The interpretive guidance in this release applies equally to companies that file forms under Regulation S-K and small businesses that file forms under Regulation S-B. Foreign private issuers should follow the guidance in this release, including MD&A disclosure called for by Item 9 of Form 20-F (17 CFR 249.220f).

-[4]- In 1988, we followed a similar approach when we specifically addressed the disclosure issue of illegal or unethical activities relating to government defense contract procurements. See Securities Act Rel. No. 6791 (August 1, 1988), 53 FR 29226 (August 3, 1988).

-[5]- The Staff Legal Bulletin was first issued on October 8, 1997 and revised on January 12, 1998.

-[6]- Section 17(a) of the Securities Act, 15 U.S.C. 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b); and Rule 10b-5 promulgated thereunder, 17 CFR 240.10b-5. See Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others ("Municipal Securities Interpretive Release"), Securities Act Rel. No. 7049 (March 9, 1994), 59 FR 12748 (March 17, 1994).

-[7]- SEC Staff Report on the Municipal Securities Market (The Division of Market Regulation), September 1993, p. 1; The Bond Buyer Securities Data Company 1998 Yearbook, 1998, p. 64.

-[8]- Speech of July 14, 1998 to National Academy of Science.

-[9]- See, e.g., "Year 2000 Time Bomb," U.S. News & World Report, June 8, 1998, page 45; "Experts Say Bug Will Be Costly; So Will The Cure," Chicago Tribune, March 2, 1998, page C1; and "Debunking Year 2000's Computer Disaster," Los Angeles Times, Nov. 3, 1997, page A1.

-[10]- Year 2000 problems have already occurred and will continue to occur before the Year 2000. The Information Technology Association of America recently conducted a survey showing that 44% of responding companies have already experienced Year 2000 disruptions in their business. This survey can be found at <http://www.ita.org/softpr7.htm>.

-[11]- The United Nations recently passed a resolution calling on member states to cooperate on global awareness initiatives and called upon the public and private sectors to share Year 2000 information. See U.N. Passes Year 2000 Appeal (June 26, 1998) [www.news.com/News/Item/0.4.23624.00.html](http://www.news.com/News/Item/0.4.23624.00.html). President Clinton has formed the President's Council on the Year 2000 Conversion, and the Senate has established the Senate Special Committee on the Year 2000 Technology Problem to focus and provide leadership to reduce the impact of this issue. On July 14, 1998, the President held a press conference to stress the importance of assessing and remedying the Year 2000 problem and promised to send proposed legislation to Congress addressing liability issues relevant to the Year 2000. The President's Council's web site can be found at <http://www.y2k.gov>. The Senate Special Committee Chairman, Senator Robert Bennett, has a web site with materials relating to the committee at <http://www.senate.gov/~bennett/y2k.html>. In addition, in November 1997, Senator Bennett introduced legislation, the Year 2000 Computer Remediation and Shareholder Protection Act of 1997 (S.1518), which would require public companies to disclose their Year 2000 issues. Finally, Representatives Dreier and Cox recently introduced legislation to encourage companies to fix their Year 2000 problems, the Y2K Liability and Antitrust Reform Act (H.R. 4240).

-[12]- In June of 1997 and 1998, the staff provided reports to Congress on the Readiness of the Securities Industry and Public Companies to Meet the Information Processing Challenges of the Year 2000 ("Staff Report to Congress on Year 2000"). Both of these reports are on our web site at <http://www.sec.gov/news/studies/yr2000.htm> for the 1997 report and <http://www.sec.gov/news/studies/yr2000-2.htm> for the 1998 report.

-[13]- These questions can be found at <http://www.sec.gov/consumer/y2kaskit.htm>.

-[14]- The update described generally the nature of these issues and the disclosures that public



companies should make. The latest Current Issues Outline can be found at <http://www.sec.gov/rules/othrindx.htm> and scroll to it.

-[15]- The Staff Legal Bulletin contains the staff's specific guidance on good disclosure practices in the Year 2000 context.

-[16]- In the revised Staff Legal Bulletin, the staff's guidance focused on MD&A, but also noted that other rules might require disclosure. The staff stated that a company should disclose, at a minimum: its plans to address the Year 2000 issues that affect its business and operations, including operating systems; material effects if its customers, suppliers, and other constituents are not Year 2000 ready; its timetable for carrying out these plans; and, if material, an estimate of the Year 2000 costs and any material impact it expects these costs to have on its results of operations, liquidity, and capital resources.

-[17]- Seven of the Fortune 100 companies are not required to file periodic reports with us.

-[18]- The task force survey is on our web site at <http://www.sec.gov/news/extra/v2kcfty.htm>.

-[19]- The Division of Investment Management also reviewed the disclosure of all of the public utility holding companies registered with us under the Public Utility Holding Company Act of 1935. While we regulate the corporate and financial structure of registered public utility holding companies under that Act, these companies are subject to the same disclosure obligations as other public companies, including the MD&A requirement. The interpretive guidance provided in this release is therefore specifically applicable to public utility holding companies.

-[20]- There is a statutory safe harbor for both the Securities Act and the Exchange Act. See Section 27A of the Securities Act (15 U.S.C. 77z-2) and Section 21E of the Exchange Act (15 U.S.C. 78u-5). The statutory safe harbors have certain limitations. For example, the safe harbors do not by their terms apply to lawsuits in state court. We note, however, that pending legislation would address class actions brought in state court. The Securities Litigation Uniform Standards Act of 1998, S. 1260, and its companion bill, H.R. 1689, recently have been passed by Congress.

-[21]- "Forward-looking statement" is defined in Section 27A to include: (A) a statement containing a projection of revenues, income, earnings, capital expenditures, or other financial items; (B) a statement of the plans and objectives of management for future operations; (C) a statement of future economic performance; and (D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C). In addition, Securities Act Rule 175 (17 CFR 230.175) and Exchange Act Rule 3b-6 (17 CFR 240.3b-6) provide some protection for similar "forward-looking statements" that may apply to companies that are excluded from the statutory safe harbors.

-[22]- The statutory safe harbors apply to disclosures made by: a company; a person acting on behalf of the company; an outside reviewer retained by the company making a statement on behalf of the company; or an underwriter, with respect to information derived from information provided by the company. See Securities Act Section 27A(a) and Exchange Act Section 21E(a). There are exclusions from the statutory safe harbors for specific types of filings, and companies need to review the safe harbors before relying on them. For example, the safe harbors are not available to initial public offerings or investment companies. See Securities Act Section 27A(b) and Exchange Act Section 21E(b).

-[23]- Statements included in a financial statement prepared in accordance with generally accepted accounting principles are not covered by the statutory safe harbors. See Securities Act Section 27A(b)(2)(A) (15 U.S.C. 77z-2(b)(2)(A)); Exchange Act Section 21E(b)(2)(A) (15 U.S.C. 78u-5(b)(2)(A)). Consequently, statements of estimated costs included in MD&A disclosure outside the financial statements would generally be covered. Inclusion of those costs in the financial statements, or discussion of them in the footnotes to the financial statements, would not be covered.

-[24]- Securities Act Section 27A(c)(1)(A)(i) (15 U.S.C. 77z-2(c)(1)(A)(i)); Exchange Act Section 21E(c)(1)(A)(i) (15 U.S.C. 78u-5(c)(1)(A)(i)). Further, certain courts have adopted the "bespeaks caution" doctrine to afford protection of forward-looking statements that are accompanied by full and

meaningful discussion of their limitations and assumptions. See, e.g., *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3rd Cir. 1993), cert. denied, 114 S.Ct. 1219 (1994).

-[25]- See H.R. Conf. Rep. No. 104-369 (1995).

-[26]- Securities Act Section 27A(c)(1) (15 U.S.C. 77z-2(c)(1)); Exchange Act Section 21E(c)(1) (15 U.S.C. 78u-5(c)(1)). In contrast, Securities Act Rule 175 and Exchange Act Rule 3b-6 also would apply to Commission actions.

-[27]- Item 303(b) of Regulation S-K (17 CFR 229.303(b)) and Item 303(b)(2) of Regulation S-B (17 CFR 229.303(b)(2)) set forth the MD&A requirements for interim reports. In a 1989 interpretive release ("1989 Release"), we noted that companies need to update known trends, demands, commitments, events, and uncertainties for any material change in each subsequent periodic report. Securities Act Rel. No. 6835 (May 18, 1989), 54 FR 22427 (May 24, 1989), text at note 40.

-[28]- A general instruction in MD&A states that companies "shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition." Item 303(a) of Regulation S-K, Instruction 3 (17 CFR 229.303(a)). For small businesses, Item 303(b) of Regulation S-B (17 CFR 228.303(b)) states in part that "discussion should address the past and future financial condition and results of operation of the small business issuer . . ." for each of the last two fiscal years. Item 303(b) of Regulation S-B contains an instruction (Instruction 1) similar to Instruction 3 of Item 303(a).

-[29]- In addition to the analytical guide, the 1989 Release provides several examples of forward-looking disclosure. These may be useful to help companies determine the type of forward-looking information that should be provided when they have triggered the 1989 two-part test.

-[30]- The Year 2000 issue is certainly "known" to all companies. The problems associated with this issue have been widely publicized, and no company can reasonably argue that it does not know about the Year 2000 issue.

-[31]- A company's statement of its own readiness based on third party representations would be forward-looking and fall within the statutory safe harbors. Further, a company's reasonable reliance on the third party statements would be assumptions underlying that statement and also entitled to safe harbor protection.

-[32]- The gross basis determination is similar to the analysis in Staff Accounting Bulletin (SAB) No. 92 (June 8, 1993) relating to accounting and disclosures related to loss contingencies. In SAB No. 92, our staff gave guidance regarding the need to separately disclose environmental liabilities and related potential claims for recovery, unless the recovery was probable. The staff stressed the uncertainties related to potential claims for recovery. We stress in this release the uncertainties related to remediation, third parties, litigation, insurance coverage and other contingencies in the Year 2000 context.

-[33]- If a company has substantially completed its testing and assessment of third party issues, and thus has a reasonable basis to believe that it is Year 2000 ready, it need not make this assumption. Thus, MD&A disclosure may not be required, although we encourage all companies to address the Year 2000 issue and describe their Year 2000 status.

-[34]- In considering whether potential Year 2000 consequences are material, companies may offset quantifiable dollar amounts of those consequences that would be covered by Year 2000-specific insurance policies, provided that the policies have a sufficiently broad coverage to cover all risks.

-[35]- Item 303(a) of Regulation S-K (17 CFR 229.303(a)).

-[36]- For example, Instruction 3 to Item 303(a) of Regulation S-K (17 CFR 229.303(a)) states that the discussion and analysis should include "descriptions and amounts" of matters that would have an impact

on future operations and have not had an impact in the past.

-[37]- Companies in some industries, such as software and hardware manufacturers, also may need to discuss whether their products will be Year 2000 compliant, and related consequences.

-[38]- For example, most equipment and machinery, such as elevators, contain microcontrollers. For more information regarding the Year 2000 risks of embedded technology, see the Institution of Electrical Engineers web site, <http://www.iee.org/2000risk>.

-[39]- Reportedly, some companies only recently became aware that their non-IT systems have Year 2000 issues. See , e.g. , "Industry Wakes Up to Year 2000 Menace," Forbes , April 27, 1998 at 163.

-[40]- A good description of a company's Year 2000 issues would address whether all its hardware and software systems, and all of its embedded systems contained in the company's buildings, plant, equipment and other infrastructure, have been assessed. If this assessment is not complete, the company should disclose the kinds and percentage of hardware and software systems and embedded systems that remain to be assessed.

-[41]- Companies should discuss their progress in a manner that will best inform investors about where the company is on their timetable. For example, some companies may decide that the amount of money spent may be their best indicator of progress, while other companies may decide that labor still required to be undertaken may be a more appropriate indicator.

-[42]- We are particularly concerned about the testing phase. Experts have stated that companies with numerous systems and third party relationships should be planning to conduct testing for at least one year. Serious consideration should be given to disclosing, as of the end of each reporting period: (1) what kinds and percentage of the company's hardware and software systems have been tested and verified as Year 2000 compliant, (2) what kinds and percentage of embedded systems have been tested and verified as Year 2000 compliant, and (3) what testing and verification methodology was used.

-[43]- Public companies and municipal issuers should consider the phases identified by the General Accounting Office in its checklist guide to federal agencies. The guide describes five phases representing a major Year 2000 activity or segment -- awareness, assessment, renovation, validation, and implementation. General Accounting Office, GAO/AIMD-10.1.14, Year 2000 Computing Crisis: An Assessment Guide (1997). The guide is available as a PDF file on the GAO web site at <http://www.gao.gov/v2kr.htm>. Investment advisers and investment companies should consider the phases identified in our Investment Advisers Year 2000 Reports release, cited in note 68 below.

-[44]- Companies may want to disclose the average phase for all of their mission critical systems or may want to use a chart to disclose the status for each mission critical system.

-[45]- Item 101(c)(vii) of Regulation S-K sets forth the circumstances under which identification of material customers is required. 17 CFR 229.101(c)(vii).

-[46]- If a system is replaced, as part of the description of phase progress, a company should disclose the date of replacement and the status of testing for Year 2000 compliance with the new system.

-[47]- For example, a company might disclose that it stands ready to switch vendors, has back-up systems that do not rely on computers, or has stockpiled raw materials in the months before Year 2000. Contingency plans typically include: identification of the companies' systems and third party risks that the plan addresses; an analysis of strategies and available resources to restore operations; and a recovery program that identifies participants, processes, and any significant equipment needed.

-[48]- It is widely reported that some countries, and organizations within those countries, are not intensively acting to remediate their Year 2000 issues. See , e.g. , "Governments Aid Companies in Preparation," Journal of Commerce , Feb. 25, 1998, page A4.

-[49]- In November 1997, the FDIC issued Orders to Cease and Desist against three Georgia banks relating to Year 2000 readiness. See FDIC Press Release, "Orders to Cease and Desist Issued Against Georgia Banks," PR-83-97 (11/17/97), <http://www.fdic.gov/publish/archive/press/97press/pr9783.html>.

-[50]- Companies may retain experts or advisers to evaluate their Year 2000 readiness. The retention of experts and whether an evaluation has been performed would be historical facts. Statements made by the experts about the company's readiness likely would be statements "on behalf of the company" about its future economic performance and therefore entitled to protection under the statutory safe harbors. Similarly, the company's disclosure of the expert's evaluation is likely to be an assumption regarding its own statement of future economic performance and fall within the statutory safe harbor.

-[51]- See Emerging Issues Task Force ("EITF"), Issue No. 96-14, "Accounting for the Costs Associated with Modifying Computer Software for the Year 2000," which notes the remarks of our former Chief Accountant, Michael Sutton, at the July 23-24, 1997 meeting of the EITF that future costs to modify software for Year 2000 problems are not a current liability, and the staff would object to the accrual of such costs.

-[52]- See FASB Statement No. 5, paragraph 18. See also AICPA, Statement of Position 94-6, "Disclosure of Significant Risks and Uncertainties."

-[53]- See FASB Statement No. 5, paragraphs 24-26.

-[54]- See AICPA, Statement of Position 94-6, "Disclosure of Significant Risks and Uncertainties."

-[55]- This publication can be found on the AICPA web site at <http://www.aicpa.org/members/v2000/intro.htm>.

-[56]- See AICPA, Codification of Statements on Auditing Standards, section ("AU Section") 311, "Planning and Supervision."

-[57]- In the 1998 Staff Report to Congress on Year 2000, our Office of Chief Accountant expressed this view on page 49.

-[58]- See AU Section 9341, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern."

-[59]- Form 8-K (17 CFR 249.308).

-[60]- Item 101 of Regulation S-K (17 CFR 229.101). Item 101 of Regulation S-B (17 CFR 228.101) and Item 1 of Form 20-F require similar disclosure. A company may need to address Year 2000 issues related to each reportable segment.

-[61]- Item 103 of Regulations S-K (17 CFR 229.103) and S-B (17 CFR 228.103), and Item 3 of Form 20-F.

-[62]- Instruction 1 to Item 103 of Regulation S-K, and Item 3 of Form 20-F.

-[63]- Item 601(b)(10) of Regulations S-K (17 CFR 229.601(b)(10)) and S-B (17 CFR 228.601(b)(10)), and Item 19 of Form 20-F.

-[64]- Item 503(c) of Regulations S-K and S-B. This item was amended in Securities Act Release No. 7497 (January 28, 1998) to require companies to describe risk factors in plain English. 63 FR 6370 (Feb. 6, 1998). This amendment takes effect October 1, 1998.

-[65]- Item 5 may be used by a company to report on Form 8-K any events, for which information is not otherwise required by the form, that the company deems of importance to securityholders.

-[66]- General Instruction B.4 of Form 8-K.

-[67]- Securities Act Rule 408 (17 CFR 230.408), Exchange Act Rules 12b-20 (17 CFR 240.12b-20) and 14a-9 (17 CFR 240.14a-9). Companies also should consider the anti-fraud provisions of the Securities Act and the Exchange Act. These anti-fraud requirements apply to statements and omissions both in Commission filings and outside of Commission filings. Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5. Companies also should consider potential civil liabilities under Securities Act Sections 11 (15 U.S.C. 77k) and 12(a)(2) (15 U.S.C. 771(a)(2)) and Exchange Act Section 18 (15 U.S.C. 78r).

-[68]- Investment Advisers Year 2000 Reports, Release Nos. IA-1728 and IC-23293 (June 30, 1998), 63 FR 36632 (July 7, 1998). Comments must be received on or before August 10, 1998.

-[69]- Sections 206(1) and (2) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6(1) and (2)). See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

-[70]- Section 34(b) of the Investment Company Act of 1940 (15 U.S.C. 80a-33(b)).

-[71]- In evaluating these risks, investment companies should consider whether Year 2000 issues present material risks for their investment portfolios as well as for investment company operations. See, e.g., Item 4 of Form N-1A (17 CFR 274.11A), and Item 8 of Form N-2 (17 CFR 274.11a-1).

-[72]- When assessing the Year 2000 readiness of an external service provider that is a registered broker-dealer or transfer agent, the Year 2000 reports that are required to be submitted to us by most broker-dealers and transfer agents are one source of information.

-[73]- See e.g., Item 4 of Form N-1A (17 CFR 274.11A), Item 8 of Form N-2 (17 CFR 274.11a-1).

-[74]- See Municipal Securities Interpretive Release, cited at note 6 above.

-[75]- Exchange Act Rule 15c2-12 (17 CFR 240.15c2-12).

-[76]- See Municipal Securities Interpretive Release.

-[77]- See also Proposed Governmental Accounting Standards Board Technical Bulletin No. 98-a, "Disclosures about Year 2000 Resources Committed," July 24, 1998. It can be found at <http://www.rutgers.edu/accounting/raw/gasb/gasbhome.html>.

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*<http://www.sec.gov/rules/concept/33-7558.htm>  
Last update: 08/05/98*

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## FINANCIAL INSTITUTION LETTERS

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FIL-137-98  
December 30, 1998

### CUSTOMER AWARENESS AND THE YEAR 2000

TO: CHIEF EXECUTIVE OFFICER  
SUBJECT: *Two New FDIC Publications for Consumers on the Year 2000 Problem*

On May 13, 1998, the Federal Financial Institutions Examination Council (FFIEC) issued guidance requiring all FDIC-insured financial institutions to establish Year 2000 customer awareness programs (see FIL-52-98). This guidance requires insured institutions to make an effort to inform their customers of the Year 2000 issue and the steps they are taking to minimize the risk that customers may be affected by Year 2000-related computer problems. As part of the FDIC's efforts to help educate consumers about the Year 2000, the agency in June sent all insured institutions an FDIC brochure, *The Year 2000 Date Change*, together with camera-ready art that institutions may use to reproduce the brochure for their customers (see FIL-67-98). Now, the FDIC has published two new products that insured institutions may wish to use in their customer awareness programs:

- A special report -- *The Year 2000, Your Bank and You* -- that was published in the Fall 1998 edition of the FDIC's quarterly FDIC Consumer News.
- A Year 2000 customer account "statement stuffer."

Due to the substantial demand anticipated for both publications, the FDIC is providing all FDIC-insured institutions with the attached camera-ready versions that they may use to produce their own supplies. More details, including procedures for obtaining or printing extra copies, follow in this letter. One copy of the Fall 1998 FDIC Consumer News also is enclosed.

#### ***FDIC Consumer News – The Year 2000, Your Bank and You***

Consumers are looking for information on the Year 2000 from credible sources. That is why the FDIC has devoted the latest edition of its quarterly consumer newsletter to the Year 2000. *The Year 2000, Your Bank and You* includes:

- Answers to questions bank customers may have about the Year 2000;
- Comments from FDIC Chairman Donna Tanoue about how the agency's Year 2000 efforts will serve the interests of banking customers;
- Information about how banking institutions are working to minimize the potential for Y2K disruptions;
- Suggested steps bank customers can take to protect themselves;
- Reminders that FDIC-insured deposits are completely safe; and
- A list of useful government resources on Y2K matters, including Internet sites and toll-free call centers.

The attached camera-ready copy of the newsletter has been specially designed for use by institutions. In particular, this version does not carry a publication date so that institutions can easily use it in educational campaigns throughout 1999. Also, the back page was

intentionally left blank so that an institution could add its name, logo, a special message to customers and/or self-mailing information. FDIC Consumer News or related articles may be reprinted without advance permission. Institutions cannot alter articles by, for example, adding or deleting a sentence or paragraph in a reprinted version. Please credit material used to "FDIC Consumer News, a publication of the Federal Deposit Insurance Corporation."

#### **FDIC Statement Stuffer**

The FDIC's Year 2000 statement stuffer is an envelope-sized document intended to help institutions reassure customers that the Year 2000 computer conversion will not affect the safety of their insured deposits. One side of the statement stuffer contains a brief message from the FDIC describing the steps being taken to address the Year 2000 problem, and reminding customers that the Year 2000 computer conversion will not affect their deposit insurance coverage. The opposite side contains a message from your institution. The statement stuffer currently is available only in English. The FDIC will issue a Spanish language version in the first quarter of 1999.

The statement stuffer may be reprinted without modification and in its entirety without permission from the FDIC. An institution may add its name, logo, and contact information only. If the text of the document will be modified in any way, except to include the institution's identifying information, the FDIC logo may not be used, and no attribution to the FDIC is permitted. In addition, an institution may translate the statement stuffer into another language without advance approval from the FDIC but copies should be sent to the FDIC's Year 2000 Project Manager, 550 17th Street, NW, MB-5092, Washington, DC 20429.

#### **Obtaining or Printing Extra Copies**

**Camera-Ready Art to Make Your Own Reprints:** One camera-ready copy of both the consumer newsletter and the statement stuffer are enclosed for use by institutions in printing any quantity desired. Additional single copies of the camera-ready art may be obtained by writing to: FDIC Public Information Center, 801 17th Street, NW, Room 100, Washington, DC 20434. Requests may also be faxed to the Public Information Center at 1-202-416-2076 or e-mailed to [publicinfo@fdic.gov](mailto:publicinfo@fdic.gov). Your written request should include your institution's letterhead, a contact name, a telephone number where the contact may be reached, and the title of the document requested. Note: The attached camera-ready versions include instructions for your printer's use, including the designated locations for adding an institution name or logo.

**Single Copies of FDIC Consumer News – The Year 2000, Your Bank and You:** Financial institutions may tell consumers that single copies are available free of charge from these two government agencies:

- **The Consumer Information Center:** Write to the Consumer Information Center, Item 613-F, Pueblo, Colorado 81009. Consumers also may call toll-free 1-888-878-3256 or 1-888-8-PUEBLO. Consumers also can order a copy of *The Year 2000, Your Bank and You* through the Consumer Information Center's Internet site at [www.pueblo.gsa.gov](http://www.pueblo.gsa.gov).
- **The Federal Deposit Insurance Corporation:** Write, fax or e-mail a request to the FDIC Public Information Center at the addresses listed previously in this letter.

**Bulk Copies of FDIC Consumer News – The Year 2000, Your Bank and You:** The FDIC will provide each institution up to 50 additional copies of the Fall 1998 edition of the consumer newsletter free of charge. Please fax your request to the FDIC Warehouse at 1-703- 516-5201. Your request should be written on your institution's letterhead and include a contact name, a telephone number, the title of the document and the number of copies requested. For more than 50 copies, institutions may either produce their own supplies



(using the attached camera-ready version or photocopying an actual newsletter) or they can order copies from **banking industry trade associations that will be duplicating and selling printed copies of the newsletter in large quantities.**

***Internet:*** Both the consumer newsletter and the statement stuffer can be accessed from the FDIC's Year 2000 Web site at [www.fdic.gov/about/y2k](http://www.fdic.gov/about/y2k). Institutions that have their own Internet sites also are encouraged to include links to the FDIC's Year 2000 publications for consumers at this same Web site.

Carmen Sullivan  
Director  
Division of Compliance  
and Consumer Affairs

Nicholas J. Ketcha Jr.  
Director  
Division of Supervision

Phil Battey  
Director  
Office of Corporate  
Communications

Enclosures:

Year 2000 issue of Consumer News

PDF version of statement stuffer

Distribution: All Insured Institutions

NOTE: A paper copy of this financial institution letter with the **camera-ready art of both attachments** will be available around January 5, 1999, at the FDIC's Public Information Center, 801 17th Street, NW, Room 100, Washington, DC 20434 (800-276-6003 or 202-416-6940).



## Year 2000 Customer Communication Outline

**To:** The Board of Directors and Chief Executive Officers of all federally supervised financial institutions, service providers, software vendors, federal branches and agencies, senior management of each FFIEC agency, and all examining personnel.

The Federal Financial Institutions Examination Council (FFIEC) has issued numerous interagency statements concerning the Year 2000 project management process and other significant Year 2000 issues. In May 1998, the FFIEC issued guidance advising financial institutions to develop customer awareness programs that would provide information on their Year 2000 readiness efforts and ensure complete and accurate responses to customer questions and concerns. The FFIEC has noted that educating customers about the Year 2000 issue is critical to minimizing unwarranted public alarm that could cause serious problems for financial institutions and their customers. Customer awareness programs should consider appropriate communications channels to effectively respond to and anticipate these customer concerns. The programs also should address how a financial institution will respond to its customers should Year 2000 disruptions occur, whether caused by internal problems or external events.

The FFIEC believes that providing meaningful information to customers is an important part of a financial institution's Year 2000 project plan and financial institutions are in the best position to communicate with their customers. The FFIEC also recognizes that solutions to the Year 2000 challenge are as different as financial institutions themselves, and therefore, each institution will need to tell its own Year 2000 story. Financial institutions may consider: training tellers and other front-line personnel to provide information and respond to customer inquiries; providing informational brochures or other written disclosures in monthly or quarterly statements; establishing toll-free hot lines for customer inquiries; holding educational seminars; and developing Year 2000 Web sites. These efforts can be an important part of a program to help maintain customer confidence in the institution.

Many of the customer awareness programs developed by financial institutions use common elements in crafting effective communications statements on Year 2000 readiness. The FFIEC encourages financial institutions to consider incorporating the following elements in future communications with customers. The appropriate level of detail may vary depending on the financial institution's business activities and customer base.

### Elements of a Year 2000 Customer Communication Statement

- **Describe the Year 2000 Issue:** Explain that the purpose of the communication is to inform customers of efforts undertaken by the financial institution to be prepared for the century date change and other dates that may affect its computer systems. Clearly explain what the Year 2000 issue is and how extensive it is, including, where appropriate, its effect on businesses and governments worldwide.
- **Address Customer Expectations:** Inform customers up-front that maintaining their confidence in banking with the financial institution -- now and after the Year 2000 -- is a top priority. Explain that the institution takes this project very seriously and mention the resources devoted to it and the level of senior management involvement. Explain that the institution and federal and state regulators are working hard to make sure that customer service is not disrupted. In particular, state that the institution will have contingency plans in place to ensure customers have access to their money and accurate account information in the event any problems occur. The institution may want to point out that the Federal Deposit Insurance Corporation and National Credit Union Share Insurance Fund have issued Year 2000 notices to remind consumers that the Year 2000 date change will not affect their \$100,000 deposit insurance coverage.

- **Describe the Financial Institution's Year 2000 Project Plan:** Describe the institution's comprehensive plan to address the Year 2000 challenge, including remediation efforts and testing of internal and external systems. Track the institution's progress and discuss the milestones put in place, as reflective of business priorities and customer needs. Financial institutions may want to outline their progress using the five phases of Year 2000 project planning in the FFIEC guidelines -- awareness, assessment, renovation, testing, and implementation. Institutions also may want to discuss the status of mission-critical systems.
- **Describe Year 2000 Contingency Plans:** Provide information on the institution's business resumption contingency plans to be used in the event of a Year 2000 disruption. Describe how the plan will help the institution resume operations and continue to provide services in the event of a Year 2000 disruption.

Financial institutions may wish to consult with their legal counsel in designing their Year 2000 customer awareness programs. Among other things, they can review with counsel the application and effect of the recently enacted "Year 2000 Information and Readiness Disclosure Act" of 1998, which is available on the Web site of President's Council on Year 2000 Conversions ([www.y2k.gov/text/y2kinfo.html](http://www.y2k.gov/text/y2kinfo.html)).

## YEAR 2000: ASSESSMENT, READINESS & REMEDIATION

The Y2K problem, in some manner, has or will impact virtually every business enterprise. In order to identify and properly address the legal risks associated with Y2K, you should have an understanding of Y2K related claims and defenses. Armed with that understanding, you can take the steps that will help your company either avoid or prevail in Y2K litigation.

### CLAIMS AND DEFENSES

#### Insurance

Every company should check the status of their insurance coverage to make sure it has appropriate Y2K coverage. Insurance companies have responded to the potential Y2K litigation explosion in three different ways:

1. A number of insurance companies have "added" exclusions to their policies in an effort to exclude coverage for Y2K problems. If a business receives an "endorsement" that purports to exclude Y2K coverage, common sense steps should be taken - depending on the applicable language - to make sure the business does not waive its rights. For example, if the business believes that the original policy should cover Y2K matters, then a letter to that extent may be of significant evidentiary value.
2. Some insurance companies are offering riders or separate policies that expressly provide Y2K coverage. Each business should do a risk analysis and determine whether to purchase such coverage.
3. Some insurance companies are doing nothing with their policies and are taking the position that Y2K is a foreseeable event that is implicitly excluded from business interruption coverage.

In order to avoid any misunderstandings and coverage disputes, insureds should check with their insurers now to determine the status of coverage. Their respective positions should be documented in writing, with a view that those documents may be necessary court exhibits.

#### Directors and Officers Liability

As a general rule, directors and officers are legally bound by the fiduciary duties of loyalty and due care to manage the corporation in the best interest of its shareholders. If a corporation fails to address Y2K problems successfully, and the business is significantly impacted, shareholders may seek to hold the directors and officers liable.

The general defense to such claims is the "business judgment rule," which provides that directors and officers are insulated from liability if they can make a showing that they acted in good faith, were reasonably diligent in informing themselves of the facts, and relied upon knowledgeable experts. The following basic steps should be taken and documented by the board:

1. Designate a company Y2K committee that includes representatives from all management areas.
2. Mandate and document a company Y2K compliance and contingency plan.
3. Consult with knowledgeable experts and budget a realistic line item for Y2K expenditures.
4. Require regular Y2K progress reports to the board.

If a Y2K claim is brought, the entire process in which the company handled Y2K issues will be the subject of discovery in the litigation. Therefore, you should involve the proper technical and legal experts to make sure nothing is overlooked or can be misconstrued under the scrutiny of an opposing litigator.

#### Securities Claims

Various federal and state securities statutes import a duty to public companies to disclose material facts. Counsel and company management should make sure that reasonable care is exercised in making appropriate Y2K disclosures.

The general spectrum of common defenses to securities actions may apply, including: lack of materiality, Y2K exposure is common knowledge, and lack of intent to mislead.

#### Intellectual Property and Consultant Claims

Numerous intellectual property and trade secret issues arise with respect to Y2K remediation measures. Commonly litigated issues are whether existing software can be accessed to outside remediation companies in violation of license agreements, and whether software can be reversed engineered for remediation purposes.

Counsel should be fully aware of the company's rights and duties before enlisting outside assistance for preventative and remediation measures. It may be necessary to extend, modify, or renegotiate applicable agreements - or to obtain a Court approved protective order - in order to achieve the desired result of avoiding the often conflicting nature of intellectual property claims and Y2K claims.

### Compliance Letters

The economy has been flooded with compliance requests and response correspondence between vendors and purchasers. Purchasers send compliance requests in order to determine whether they are reliant on vendors who are not Y2K complaint. The end result is a massive paper trail of contractual rights, duties, warranties, representations and disclaimers.

It is imperative that counsel thoroughly review the contents of compliance request and response letters. Many of these documents will become court exhibits and serve as the evidentiary cornerstone of the rights and duties between claimants.

In the fall of 1998, the federal Y2K Readiness and Disclosure Act was signed into law. The Act significantly impacts the enforceability of compliance letters. The Act requires a company to include certain "magic language" in compliance letters in order to enjoy the protection of the Act.

### Contract Claims

Y2K contract claims usually arise when a business is unable to fulfill its obligations because of a computer failure somewhere in the supply chain. Each contract claim is governed by the terms of the particular contract, as reflected in written agreements, compliance letters, purchase orders and invoices.

Typically these types of disputes are viewed as "sales of goods" which are governed by the UCC. (It should be noted that the courts are split on whether software sales or license agreements are governed by Article 2 of the UCC.)

Within the normal business context, most companies have at some time had their contract forms reviewed by counsel so they are protected under the UCC. It is important to recognized that some vendors are expressly disclaiming Y2K liability in their purchase documents. Counsel should review the status of the contract forms being received and generated by the company to make sure UCC protections remain in place.

Particular attention should be paid to whether the writings are creating or disclaiming expressed or implied warranties, and whether the writings limit remedies by excluding indirect or consequential damages, or require only repair or replacement.

### Tort Claims

Depending of the particular fact situation, Y2K tort claims have or will run the gambit of tort claims ranging from fraud, misrepresentation, negligence, and strict liability.

A tort claim requires more than "economic injury." There must be injury to property or to a person. Some courts have held that the requisite "property damage" must occur to the property of another, rather than to the property itself. Hence, the failure of computer software has not been viewed as "property damage" - even though the business lost valuable information as a result of the failure.

It is believed that Y2K tort claims for personal injury will arise from the failure of imbedded chips in equipment such as medical devices, elevators, traffic control devices, motor vehicles, and environmental and electrical support systems. Such claims will follow the traditional analysis of negligence, and strict liability claims.

In order to avoid such claims, each business should review its equipment and systems. It is noteworthy that the FDA has assembled a lengthy list of types of medical equipment that have embedded chip problems.

Counsel and company management should realized that with the bombardment of Y2K publicity, the "foreseeability" of Y2K defects has been heightened and the applicable "standard of care" has risen.

#### Statutory

Numerous federal acts are being considered by Congress to address what is perceived to be a flood of Y2K litigation that could seriously disrupt the global economy. The acts presently under consideration seek to curtail Y2K suits, require "cooling off periods", and limit punitive damages, attorneys' fees, and class actions.

Some states (such as California) have consumer protection statutes under which Y2K actions have been brought.

### THE REALITY OF Y2K LITIGATION

No one knows whether Y2K will lead to a litigation explosion. But one thing is certain - Y2K defects are real, and litigation has begun. Suits have already been filed in Michigan, California, and even in Kentucky over equipment that either is not Y2K compliant, or which has already failed. Computer failures have caused the temporary closure of an airport in the Orient, and of a manufacturing plant in Europe. Damages in those case have been calculated as running in the millions of dollars.

\* \* \* \* \*

J. Mark Grundy has been engaged in a full-time business litigation practice for the past 12 years with the Greenebaum Doll & McDonald, PLLC. He has advised and represented numerous companies in Y2K related matters.



# BUSINESS FIRST®

VOLUME 14, NUMBER 1

The Weekly Business Newspaper of Greater Louisville

WEEK OF AUGUST 10, 1998

## Are you ready for Y2K litigation?

Year 2000 has yet to arrive, but the litigation has already begun over widespread defects in many computer programs that fail to process data related to the year 2000 and beyond.

The "Y2K" problem — and potential litigation — threatens virtually every business.

Either the business has a computer system that may be at risk or the business is faced with the potential failure of computer systems at the companies that it relies upon for materials, supplies, services or revenue.

Has your business adequately addressed the Y2K problem? Are you reliant on suppliers and customers who have not addressed the problem?

Word to the wise — in most instances, it is not enough to simply rely on an "opinion" that your system is Y2K "compliant."

For example, a Michigan grocery store chain bought computerized cash registers in 1995 based on assurances that the registers were "free of problems" and would enhance customer service and profitability.

After the registers were put into operation, the store learned that the registers do not process credit cards with expiration dates of the year 2000 or beyond. As a result, the system repeatedly fails, shuts down and needs to be "rebooted" at least once a day.

The grocery has filed suit against the register vendor seeking to recover its lost profits and remediation costs.

Many businesses have been somewhat "luckier" in that they have performed Y2K audits and have upgraded their systems to avoid any such business interruptions.

A large number of those businesses have discovered that their software vendors are charging substantial fees for the upgrade, however.

Irate over such practices, a group of businesses in California recently filed a class action suit seeking to recoup their upgrade costs. The lawsuit alleges that as recently as last year, the software companies sold systems that are not Y2K compliant and are improperly requiring the businesses to pay substantial fees to purchase upgrades.

As has been widely reported, the heart of the Y2K problem is a defect in software programs that express the year in two digits on the assumption that the first two digits of the year are always going to be "19."

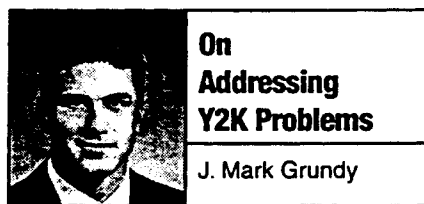
Therefore, those programs are not geared to address data that relate to the year 2000 and beyond. When data for that time period is entered, such computer programs either incorrectly roll back to the year 1900, shut down, or experience other technical difficulties.

The problem is so significant that the U.S. Securities and Exchange Commission has adopted strict disclosure requirements, and public corporations — including their management personally — can be subjected to liability if they fail to make the disclosures. Similarly, Congress is setting in motion

a task force in the event the Y2K problem leads to a severe disruption of our economy.

Accounting firms are now including Y2K audits as an exception in their audit reports. Law firms have begun to include Y2K audits as due diligence matters in acquisitions.

Many businesses are requiring that vendors and



### On Addressing Y2K Problems

J. Mark Grundy

suppliers provide certification that they are Y2K compliant.

Many business owners face a wide range of legal and business issues as a result of the Y2K problem.

As evident by the Michigan and California lawsuits, the initial round of litigation consists of two types of cases. Businesses are suing either to recoup their remediation costs, or in the worse case scenarios, an interruption of their businesses' operations has actually occurred, and they have sued to recover lost profits and other consequential damages.

By all accounts, a second round of lawsuits soon will be under way that will seek to spread the liability for the Y2K problem — and its "chain reaction" in the economic world.

Potential targets of such litigation include business advisers who failed to timely address the need for Y2K audits; accountants who failed to make adequate disclosures in audit reports; corporate officers and directors who failed to take reasonable and prudent measures to avoid or timely remedy Y2K problems; software consultants; and insurance companies.

Speculation suggests that the Y2K problem may even lead to personal injury or medical malpractice claims.

For example, it was recently reported that a hospital had to postpone an operation because a Y2K glitch in a hospital computer system incorrectly told the doctors that swabs needed during the surgery were out of stock.

The legal theories that most likely will be asserted to spread the Y2K liability range from basic contract and breach of warranty claims to negligent or fraudulent misrepresentation. Claims have also been filed under state and federal consumer protection statutes.

It is even contemplated that disgruntled shareholders will bring actions against corporate officers and directors in the event Y2K glitches cause a reduction in the value of the company stock.

If the Y2K problem is as extensive as has been initially predicted, the potential scenarios for litigation are numerous. For example, reports have been

made of predicted litigation in the following illustrative areas:

- Pension and fund computers that miscalculate or fail to process benefits for participants;
- Health care settings where drug inventory and distributions systems miscalculate the delivery and expiration dates of medicines and supplies;
- Banking systems that provide improper accountings and fail to allow the filing of timely regulatory reports;
- Companies that have interfaced their computer systems with defective systems from other companies;
- Insurance companies that reject claims because their systems inaccurately reflect that the time allowed for the claims has expired;
- Businesses and individuals who are at the mercy of computer systems that operate transits, traffic devices, environmental controls for buildings, elevators, telephone switches, and countless other industrial and commercial activities.

What can your company do to avoid or to prepare for Y2K litigation? Although not an exhaustive list, some basic steps to consider include the following:

- Put together a Y2K "team" and evaluate your exposure.
  - Prepare a contingency plan in the event a Y2K emergency arises.
  - Consider measures such as keeping hard copies of critical records.
  - Institute a Y2K compliance audit program.
  - Work with certified and bonded specialists to correct existing Y2K problems.
  - Review not only your company's systems, but also require your suppliers and vendors to certify that their systems are Y2K compliant and that they will reimburse or indemnify you for any related losses.
  - Educate your customers and revenue sources about Y2K issues so they do not experience business interruption.
  - Have an expert review your business forms and contracts to make sure you have protection in the event Y2K problems arise.
  - Check your insurance coverage. It has been widely reported that insurance companies may deny Y2K claims on the grounds that the problem should have been foreseen by the insured and timely remedied. Consider purchasing a separate rider for coverage of Y2K-related losses.
- Finally, if a Y2K problem requires you to upgrade your system or interrupts your business, immediately speak to a knowledgeable consultant or attorney who can advise you as to your rights and duties and assist you with mitigating your losses.

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**BANKRUPTCY UPDATE:**

**Bankruptcy Cases and Developments  
of Interest to Financial Institutions**

**Lea Pauley Goff  
Stoll, Keenon & Park, LLP  
Louisville, Kentucky**



# BANKRUPTCY UPDATE

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## **BANKRUPTCY UPDATE:**

### **BANKRUPTCY CASES AND DEVELOPMENTS OF INTEREST TO FINANCIAL INSTITUTIONS**

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#### **I. INTRODUCTION**

This outline is intended to bring the reader up to date on selected developments in bankruptcy case law during approximately the last year. This material concentrates on developments of interest to lenders, and particularly U.S. Supreme Court, Sixth Circuit and Kentucky decisions. Decisions of interest during the past year demonstrate continued development of the law on subjects such as discharge, plan confirmation, good faith and other subjects which are of particular interest to financial institutions today.

The 1997 recommendations of the National Bankruptcy Review Commission do not appear to be moving toward enactment. Numerous other proposals are pending. Also, Chapter 12 has been extended.

#### **II. BANKRUPTCY CASES OF INTEREST TO FINANCIAL INSTITUTIONS**

##### **A. Discharge**

The general discharge available to debtors, and the dischargeability of particular debts continue to be active areas for litigation. There are several recent and interesting discharge cases. Review of the discharge provisions of the Code is useful in analyzing them.

The Bankruptcy Code provides for the discharge of debts under 11 U.S.C. §§ 727, 1141, 1228 and 1328. A debtor may be denied a discharge generally for various types of misconduct. 11 U.S.C. § 727. Also, particular debts may be excepted from discharge for reasons related to the nature of the debt themselves. These include, among other things, certain tax-related debts, debts for fraud or defalcation while acting in fiduciary capacity, debts for domestic obligations and debts arising from willful injuries. The exceptions which probably are of most interest to the banking

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<sup>1</sup>Many thanks to my partners for their thoughts and advice regarding this presentation, and to our associate Richard Warne for his very valuable research and drafting assistance.

community are the exceptions to discharge for debts incurred as a result of borrower misrepresentation. 11 U.S.C. §523(a) excepts from discharge debts including that:

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extension, renewal, or refinancing of credit, to the extent obtained by:

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing:

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive; or

(C) for purpose of subparagraph (A) of this paragraph, consumer debts owed to a single creditor and aggregating more than \$1,000 for "luxury goods or services" incurred by an individual debtor on or within 60 days before the order for relief under this title, or cash advances aggregating more than \$1,000 that are extensions of consumer credit under an open end credit plan obtained by an individual debtor on or within 60 days before the order for relief under this title, are presumed to be nondischargeable; "luxury goods or services" do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor; an extension of consumer credit under an open end credit plan is to be defined for purposes of this subparagraph as it is defined in the Consumer Credit Protection Act;

If the creditor brings and loses a nondischargeability action concerning consumer debt under § 523(a)(2), there is a statutory provision which may result in an award to the debtor of his or her attorney fees. 11 U.S.C. § 523(d) provides:



(D) If a creditor requests a determination of dischargeability of a consumer debt under subsection (a)(2) of this section, and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, the proceeding if the court finds that the position of the creditor was not substantially justified, except that the court shall not award such costs and fees if special circumstances would make the award unjust.

The Sixth Circuit Court of Appeals has rendered a couple of recent decisions in favor of creditors who have objected to discharge on the ground that the credit was obtained improperly under § 523(a)(2)(A) - - *In re Campbell*, 159 F.3d 963 (6<sup>th</sup> Cir. 1998), and *In re Rembert*, 141 F.3d 277 (6<sup>th</sup> Cir. 1998). In *Campbell*, the Sixth Circuit stated the issue as:

Whether a fraudulently obtained new promise to forebear on an unpaid, non-fraudulent, dischargeable old indebtedness should render the new extension of credit non-dischargeable, even though the creditor may in fact be no worse off economically as a result of the fraudulent refinancing.

The Sixth Circuit answered the questions with an emphatic yes, stating "otherwise, an insolvent debtor would have no legal incentive to be truthful in obtaining refinancing." *Id.* at 964.

In this case, the initial debt was acquired free from fraud or misrepresentation. After the debtor's business began to falter, several extensions of payment were procured from the lenders. Thereafter, the debtor forwarded to the lenders several earnings statements and balance sheets which significantly overstated the assets of his company in an attempt to secure refinancing. The parties reached an oral understanding in April, 1993 extending the repayment period and providing more frequent interest payments, to begin in July, 1993. The borrower failed to make that July interest payment and the lender filed suit. The debtor's bankruptcy followed.

The first issue for the Sixth Circuit was whether the forbearance from collection is a "debt for money property services, or an extension, renewal, or refinancing of credit." The court determined that it need not decide whether the mere forbearance from instituting collection proceedings constituted an extension of credit within the scope of §523(a). Here, there was more than the mere act of forbearance. There was a promise to forebear in exchange for new promises given by the debtor. Although the forbearance agreement was only oral and not in writing, the Sixth Circuit determined that, even if the arrangement did not constitute a legally binding bilateral contract, it was nonetheless enforceable under principles of promissory estoppel. Thus, even an oral forbearance or renewed extension of credit, if obtained by fraud, may possibly satisfy the requirements for nondischargeability in §523(a).

The second question for the Sixth Circuit was one of causation. The decision reflects no dispute on appeal that the lender had reasonably relied on the debtor's false representations agreeing

to forebear from collection. Instead, the debtor argued that his fraud caused the lenders no additional injury beyond the original loan, which was legitimately obtained. As the Sixth Circuit phrased it:

[Debtor] argues that the statutory phrase 'to the extent obtained by' requires a creditor to demonstrate in a quantifiable manner that he was further injured because he lost a collection remedy or incurred some other detriment for forbearing . . . In other words, [debtor] claims that the [lenders] lost nothing as a result of waiting to pursue collection because they would not have been able to collect from him anyway at the time they decided to forbear.

*Id.* at 966. The Sixth Circuit noted a split among the circuits on the requirement injury, siding with those who do not require the creditor to prove damage. It held:

As a result of their reliance on the false financial statements [the debtor] provided the [lenders] elected not to exercise their right to demand immediate repayment of the remaining \$391,000 due on the note. Thus, the entire amount was 'obtained by' [debtor's] use, within intent to deceive, of a false statement in writing regarding [his company's] financial condition, and the entire amount is nondischargeable under §523(a)(2)(B).

To hold otherwise would create a perverse incentive for insolvent debtors to lie to creditors to get them to forbear collection of past due indebtedness and would remove the primary legal incentive for fair dealing namely, nondischargeability in bankruptcy when a contract is induced by fraud. A borrower's incentive to act with integrity should not end once he becomes insolvent. The bankruptcy law should encourage, not discourage, honesty among contracting parties, especially when there is temptation to lie because of the risk of default. We believe the nondischargeability provision is designed to establish such a set of incentives for borrowers, including borrowers who seek to roll over or refinance previous loans.

*Id.* at 967.

*Rembert* is one of many recent decisions concerning dischargeability in the context of an underlying gambling problem. In this case, over a seven-month period the debtor incurred gambling losses of between \$18,000 and \$24,000. To finance the gambling, the debtor withdrew cash from automated teller machines at the casino on two separate credit card accounts. In order to repay these debts, the debtor obtained a second mortgage on her home approximately half-way through this six-month period in the amount of \$28,000. The debtor used the loan proceeds to pay off roughly

\$9,000 on two of the credit cards. Nonetheless, the debtor continued to gamble, and ran up significant balances on each of her credit cards. In the month prior to filing bankruptcy, the debtor paid an additional \$3,500 to her credit card accounts. Both credit card issuers filed adversary proceedings against the debtor, seeking an adjudication that their debts were non-dischargeable pursuant to Code § 523(a)(2)(A).

The debtor testified at trial that, at the time she used the credit cards to obtain cash advances, she believed that she would be able to win enough money to repay her credit card debts. Neither of the credit card issuers presented evidence tending to contradict the debtor's subjective intent. Nonetheless, the bankruptcy court found that the debtor did not intend to repay the debts and had reason to know that she would not be able to repay them. The district court reversed, concluding that the debts were dischargeable because the cardholders had not established the debtor's fraudulent intent at the time of the case advances. The Sixth Circuit agreed that the debts were dischargeable.

The Sixth Circuit first reiterated that, in order to demonstrate a material misrepresentation and intent to defraud, the bankruptcy court must focus on whether the debtor possessed a subjective intent to defraud. The Sixth Circuit expressly rejected a view which would permit a court to gauge a debtor's intention to repay by her ability to do so. The court concluded that, when a cardholder uses a credit card in a transaction, the only representation made is that the debtor intends to repay the debt. The court acknowledged that establishing a debtor's subjective intent is a difficult matter of proof. It likewise acknowledged that the hopeless state of a debtor's financial condition may certainly be relevant as a basis for inferring the debtor's subjective intent. The court also set forth a non-exclusive list of factors which may be of assistance in determining the debtor's state of mind. In this case, the court considered it significant that the debtor took out a second mortgage on her home and used a large portion of it to pay her credit card debts, and made further substantial payments to the credit card issuers after her balances again grew large.

The Sixth Circuit Bankruptcy Appellate panel recently held that a creditor's settlement and release of a fraud claim does not convert that creditor's claim from a nondischargeable claim to a dischargeable one. It also discussed collateral estoppel in the context of nondischargeability litigation. In *Ed Schory & Sons, Inc. v. Francis (In re Francis)*, 226 B.R. 385 (6<sup>th</sup> Cir. BAP 1998), the creditor sued the debtor for fraud, and they settled in 1991. The debtor gave the creditor a note, secured by a mortgage on real property. The parties released each other. The debtor defaulted on the note and the creditor foreclosed. The parties then entered into an amended settlement agreement with an attached letter from the debtor admitting the misappropriation of funds. The debtor again defaulted on the amended agreement and the creditor again foreclosed. The debtor counterclaimed that he had been coerced into signing the letter and that the creditor had defamed him by showing it to others. The trial court in Ohio granted summary judgment to the creditor. The debtor appealed to the Ohio Court of Appeals, which affirmed, and to the Ohio Supreme Court, which affirmed. The debtor filed a bankruptcy proceeding in 1997 and sought to discharge the debt. The bankruptcy court held the debt to be nondischargeable. The BAP affirmed.

The bankruptcy court held the debt to be nondischargeable based on the admission, and not withstanding the settlements. The panel noted that the issue of whether the acceptance of a note for, and the release of, a nondischargeable debt works a novation, making the "new" debt dischargeable, is an issue of first impression in the Sixth Circuit. The panel noted that the Eleventh and Seventh Circuits disagree on the issue. The *Schory* panel held that ". . . a general release as part of a tort settlement does not constitute a novation which extinguishes a creditor's fraud claim in the context of § 523(a)(2)(A)." *Id.* at 387-8. Further, the panel affirmed the bankruptcy court's use of principles of collateral estoppel to find the debt nondischargeable in bankruptcy as a result of the Ohio court's decision concerning the fraud. The panel so concluded because "the elements of a dischargeability claim under 11 U.S.C. § 523(a)(2)(A) are virtually identical to the elements of a fraud claim in Ohio." *Id.* at 389.

There are other recent decisions concerning the effect in a bankruptcy of a prior state court judgment. Prior to *Schory*, in 1998, Judge Howard ruled that the elements of fraud in Ohio were substantially the same as those required for a nondischargeability judgment under § 523(a)(2)(A), in the context of the preclusive effect of a state default judgment for fraud. *See In re Brown*, 215 B.R. 844 (Bankr.E.D.Ky., 1988).

The Sixth Circuit recently addressed a similar issue - - when a state court judgment for malicious prosecution will be deemed nondischargeable pursuant to 11 U.S.C. § 523(a)(6). In the case of *In re Abbo*, 168 F.3d 930 (6<sup>th</sup> Cir. 1999), the Sixth Circuit held that a judgment against a debtor obtained in state court for malicious prosecution and abuse of process was nondischargeable in bankruptcy. The court determined, based on the language and wording of the jury instructions and the definitions of the acts, that the state court fully and necessarily determined, in each instance, that the harm was the result of willful and malicious injury. The court thus determined that the bankruptcy court properly found each judgment debt (including both compensatory and punitive damages) nondischargeable pursuant to 11 U.S.C. § 523(a)(6).

In *In re Madaj*, 149 F.3d 467 (6<sup>th</sup> Cir. 1998), the Sixth Circuit confirmed that a debt will not be excepted from discharge merely because a debtor fails to list it in the schedules. In *Madaj*, the debtor's foster parents lent him a substantial sum of money prior to his bankruptcy filing. The debtor listed the debt in neither the petition nor the schedules, and the debtor obtained a discharge pursuant to 11 U.S.C. § 727. This was a no asset case. The debtor subsequently moved to reopen the Chapter 7 proceeding in order to list the debt. The Sixth Circuit affirmed the bankruptcy court's denial of the debtor's motion to reopen, holding that the unlisted debt was discharged. The Sixth Circuit stated that a discharge under § 727 discharges every pre-petition debt, regardless of whether a proof of claim has been filed, unless the debt is nondischargeable under § 523. Section 523(a)(3) sets forth the discharge exceptions for unlisted or unlisted debts. Section 523(a)(3)(B) excepts from discharge debts incurred by means of fraud or false pretenses, or malicious conduct; § 523(a)(3)(A) excepts from discharge all other debts such as debts other than those fraudulent debts specified in 523(a)(2), (4), or (6), which are not listed. The Sixth Circuit reasoned that, in a no asset Chapter 7 case, the court does not set a deadline for filing a proof of claim. Therefore, there is no date by which a proof of claim needs to be filed in order to be timely. However, in a no asset case,

there is no estate from which a creditor can recover. Thus, a debtor has his debt discharged in a no asset case, even where he has filed to include it in the schedules, assuming that the discharge exceptions of § 523(a)(3) do not apply. The Sixth Circuit further held that the failure, whether knowing or inadvertent, to schedule a debt, does not transform an otherwise, dischargeable debt into a fraudulently incurred debt which may be rendered nondischargeable.

*In re Penick*, 1998 WL 344039 (6<sup>th</sup> Cir. 1998) (unpublished opinion noted at 149 F.3d 1184) is a case in which the creditor bank made a series of loans to the debtor and his wholly-owned corporate entity. For a period of several years, the debtor transferred money from his business drawn on the account of the corporation and designated them as loans or "shareholder receivables." The funds were invested in a hotel which eventually failed. The total of these transfers grew to approximately \$500,000. When the debtor filed for bankruptcy, the bank sought to hold the debt non-dischargeable pursuant to § 523(a)(4), which excepts from discharge debts incurred by fraud or defalcation from one acting in a fiduciary capacity. The creditor bank argued that the law of Kentucky creates a trust whenever a corporation is insolvent, placing upon the director of the corporation a fiduciary duty not to make payments to shareholders to the detriment of the insolvent corporation's creditors.

At the outset, the Sixth Circuit noted that § 523(a)(4) applies only to express or technical trusts, and not to mere constructive trusts that courts may impose as an equitable remedy. The Sixth Circuit employs a narrow and limited exception from discharge for defalcation while acting in a fiduciary capacity. It requires a preexisting fiduciary relationship, and a preexisting express or technical trust whose res encompasses the property at issue. For example, the Sixth Circuit has held that the attorney-client relationship standing alone, is not the kind of fiduciary relationship which may satisfy § 523(a)(4). In response to the bank's argument for a trust, the Sixth Circuit held:

We find that [the creditor] has failed to establish that, under Kentucky law, the assets of an insolvent corporation form the res of a trust fund that the directors of the insolvent corporation hold in trust for their creditors. The cases upon which [the creditor] relies failed to establish more than the principle that an insolvent corporation owes fiduciary duties to its creditors.

*Id.* at 4.

The cases discussed above address the dischargeability of particular debts. There is also a recent Kentucky bankruptcy discussion concerning the denial of a discharge generally for debtor misconduct, *In re Keeney*, 221 B.R. 401 (Bankr.E.D.Ky. 1998). In this case, a judgment creditor sought a determination that a Chapter 7 debtor should be denied the bankruptcy discharge pursuant to 11 U.S.C. § 727(a)(4)(A) (the making of a false oath or account in a case) and § 727(a)(2)(A) (transfer or concealment of property within a year preceding the bankruptcy). Several years prior to the filing of bankruptcy, the debtor had placed title to both real and personal property in his parents' names. However, the debtor maintained his residence at the real estate and made mortgage

payments on it. Section 727(a)(2)(A) only sanctions the debtor if he or she transfers or conceals property within one year before the filing of the bankruptcy petition. In this case, the transfer of title to his parents' names occurred well before this period. However, the case law recognizes that a transfer of property before the one-year period may warrant the denial of a discharge if the transfer is concealed or beneficial interests are retained into and during the one-year period before the filing of bankruptcy. The Court found this "continuous concealment" doctrine satisfied in this case, and denied a discharge under § 727.

In *In re Brown*, 224 B.R. 595 (Bankr.W.D.Ky. 1998) underscores the scrupulous attention that bankruptcy courts pay to the narrow time limits prescribed by Bankruptcy Rule 4007, for objection to discharge or seeking the nondischargeability of a particular debt. In this case, the plaintiff, a federal credit union, timely filed a complaint stating a cause of action under § 727. The plaintiffs had noticed the deposition of the debtors pursuant to Bankruptcy Rule 2004, but the debtors have failed to appear at that deposition. The parties executed an agreed order extending the bar date for filing nondischargeability actions. The debtors failed to appear at a second deposition, but the plaintiffs were unable to reach debtors' counsel to again extend the deadline. The plaintiffs then filed their complaint under § 727, and stated therein that it desired to preserve possible nondischargeability grounds under § 523, but did not make any factual allegations to support such a claim. Thereafter, the debtors were deposed, and the plaintiff filed a motion to amend its complaint to assert its nondischargeability claim under § 523. Under these facts, the plaintiff had failed to file its nondischargeability action within the time frame required by Bankruptcy Rule 4007. The plaintiff asserted that the nondischargeability claims should relate back to the filing of the original complaint pursuant to Federal Rule of Civil Procedure 15. The Court, applying the "sufficient identity" test, determined that the factual allegations set forth in the § 727 complaint were not sufficiently identical to or related to the allegations that would be required to make out a § 523 claim, and thus failed to provide the defendants with fair notice of the § 523 claims against them. Accordingly, the amended complaint could not relate back to the filing of the § 727 complaint, and thus the nondischargeability claims were time barred.

## B. Plan Confirmation

### 1. Property Valuation And Cram-Down.

In *In re Tower*, 168 F.3d 845 (5<sup>th</sup> Cir. 1999), deals with a debtor's attempt to divide collateral in a Chapter 13 cram-down. Here, the debtor owed slightly over \$1000 on a single note, secured by a long and varied list of personal property (personal and household items). The debtor sought to modify a prior Chapter 13 plan by returning some of the personal property items and paying the present value (i.e., the cram-down value) of the remaining personal property items she wanted to keep. The bankruptcy court declined to approve the modification and the district court affirmed. The Fifth Circuit agreed. The debtor argued that since § 1325(a)(5) permits a debtor to either retain the property and pay its value "or" surrender the property, the term "or" is not exclusive and she should be able to split the collateral. The court concluded that the drafters of the Code did not use the term "or" with the intent to create another alternative and a debtor must retain or surrender the

collateral as a whole, at least where the creditor is undersecured. The court also rejected her alternative argument that, by seeking to transfer some of the property to the creditor, she was making a "distribution" to the creditor on the theory that distributions need not be in cash.

In determining that the Code does not give debtors the option which the *Tower* debtor suggests, the Fifth Circuit relied heavily on the discussion of how to determine cram-down value which is found in *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S.Ct. 1879, 138 L. Ed.2d 148 (1997). The *Rash* decision resolved a conflict among the circuits regarding the appropriate valuation of collateral for "cram down" purposes in a Chapter 13. In *Rash*, the debtor financed the purchase of a truck. He subsequently filed a chapter 13 and sought to cram-down a plan under which he would keep the truck and pay the lender the net amount it would realize if it repossessed and sold the truck - - which was much less than what the debtors would have to pay to replace the truck. Pursuant to 11 U.S.C. §506(a), a lender's claim is secured only to the extent of the value of the collateral. In order to have a plan confirmed, a debtor must (a) gain the secured creditor's acceptance of the plan; (b) surrender the collateral; or (c) invoke the cram down power. In a cram down, the debtor keeps the property over the objection of the creditor, with the creditor retaining its lien and the debtor paying to that creditor the present value of the allowed secured claim over the life of the plan. The allowed secured claim is the present value of the collateral, and the source of the dispute in this case. The U.S. Supreme Court held that the proper measure of value is the replacement value (i.e., fair market value, not the cost of a new replacement item).

## 2. New Value And The Absolute Priority Rule

In 1997, the Seventh Circuit Court of Appeals followed the Ninth Circuit by concluding, in a single asset real estate case, that a "new value corollary" to the absolute priority rule still exists. The U.S. Supreme Court reversed the Seventh Circuit decision but expressly declined to answer the question.

The absolute priority rule provides generally that the members of one class of creditors cannot be paid until claims of a senior objecting class have been paid. "[A] dissenting class of unsecured creditors must be provided for in full before any junior classes can receive or retain any property under a reorganization plan." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202, 108 S.Ct. 963, 966, 99 L.Ed.2d 169 (1988) (internal quotations and brackets omitted). Thus, ordinarily, if unsecured creditors are not being paid in full, equity owners cannot retain their interest. The "new value corollary" to this rule provides that the equity owners can retain their interest if they contribute new and "reasonably equivalent" value in the form of money or "money's worth." There has been considerable discussion in the case law about whether this exception to the absolute priority rule still exists. The Sixth Circuit has impliedly acknowledged the new value corollary. *In re U.S. Truck*, 800 F.2d 581, 588 (6<sup>th</sup> Cir. 1986).

The Seventh Circuit confirmed its recognition of the new value corollary in *Matter of 203 N. LaSalle Street Partnership*, 126 F.3d 955 (7<sup>th</sup> Cir. 1997). LaSalle is a limited partnership which owns certain office space encumbered by a lien in favor of Bank of America. LaSalle owed Bank

of America over \$93 million, secured by a non-recourse mortgage. Bank of America was significantly undersecured and elected to split its claim, to be treated as a secured claim and an unsecured claim under 11 U.S.C. § 1111(b). Over the Bank of America's objection, the bankruptcy court approved a plan which paid Bank of America's secured claim valued at \$55.8 million over the course of a seven to ten year plan period, amortized over thirty years. If the property were sold or refinanced, the secured claim would be paid and any additional amounts would be applied towards Bank of America's \$38 million unsecured claim. The debtor's partners were permitted to retain their interest during this period of time in exchange for contribution of new capital in the amount of \$3 million, at the time of confirmation, and five annual installments of \$625,000. In exchange, the partners deferred or saved an enormous tax recapture and they retained an interest in property in the event that it increased over the term of the plan. The bankruptcy court also confirmed the plan notwithstanding Bank of America's argument that the plan was not feasible because the debtor's own projections anticipated cash flow shortfalls in years seven and eight of the plan.

The Supreme Court affirmed the Seventh Circuit on May 3, 1999. The Supreme Court's decision, by Justice Souter, does not actually decide whether there is indeed a new value corollary or exception to absolute priority rule. Rather, it simply holds that, if there were such a corollary, the equity holders' plan in this case would not meet its minimum requirements. As set forth above, a key issue in these cases is whether the junior interest holders (i.e., the equity holders) are retaining an interest "on account of" their prior interest, rather than for a sufficient infusion of new capital. The decision cites a 1939 decision, *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, which is apparently the source of what is now known as the new value corollary. The decision discusses at length potential interpretations of the "on account of" language. It hints that the inclusion of the language in the present Code could suggest that there is a new value corollary. The Court concluded that, even if there is a new value corollary, the LaSalle partners' proposal, made with the benefit of exclusivity and without competition, does not satisfy the requirement that old equity holders not retain their interest simply because they are old equity holders. The Court noted as follows:

If the price to be paid for the equity interest is the best obtainable, old equity does not need the protection of its exclusiveness (unless to trump an equal offer from someone else); if it is not the best, there is no apparent reason for giving old equity a bargain. . . . Hence it is that the exclusiveness of the opportunity, with its protection against the market scrutiny of the purchase price by means competing bids or even competing plan proposals, renders the partners' right a property interest extended "on account of" the old equity position and therefore subject to an unpaid senior creditor class's objection.

*Id.* at 20 (not final page numbers).

The Court finally concluded as follows:



Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity, is a question we do not decide here. It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).

*Id.* at 220-23.

Justice Stevens dissented, arguing that the court should use the opportunity presented by the case to hold that there is a new value exception or corollary and that the equity holders' retention of an interest is not "on account of" the old interest when they contribute adequate new value. He argues that whether an equity holder's plan provides for adequate new value can be determined by the bankruptcy court in the confirmation process and that such a plan should not be disqualified merely because it was not otherwise tested by the market.

### 3. Other Confirmation Issues.

In the case of *In re Markham*, 224 B.R. 599 (Bankr. W.D.Ky. 1998), the bankruptcy court determined that a Chapter 13 plan can separately classify a co-signed debt, but it can only pay a claim on a co-signed debt at a higher rate than other unsecured claims, not at a lower rate. In this case the debtor co-signed for a loan taken out by his brother in order to purchase a vehicle. The brother defaulted on the loan, and the bank repossessed and sold the vehicle, leaving a substantial deficiency. The debtor then filed for bankruptcy protection, proposing a Chapter 13 plan which classified the bank's unsecured deficiency claim at a substantially lower rate than other unsecured debt. The court sustained the bank's objection to confirmation under Code Section 1322(b)(1). The literal language of Section 1322(b)(1) appears to permit separate classification of unsecured claims, as long as there is not "unfair" discrimination. However, it is not clear that this is a limitation on separate classification of consumer claims with a cosigner. The court, citing the legislative history and the bankruptcy court's practical inability to ensure repayment of the co-signed obligation by the non-debtor party, stated a requirement that the co-signed debt be treated at least as well as other unsecured debt if separately classified.

In *In re Reed*, 226 B.R. 1 (Bankr. W.D.Ky. 1998), the court addressed the period of time in which a consumer lease can be cured. In this case, at the time the debtors filed their bankruptcy petition, they were several months in arrears on their automobile lease. The debtors' Chapter 13 plan proposed to cure the lease arrearage over a period of 18 months. The bankruptcy court held that this period was too long, and the plan could not be confirmed until the period was shortened. The court first determined that whether or not the cure period under Code §365(b)(1)(a) was reasonable must be determined on a case by case basis. The court recommended guidelines for evaluating the facts of each case. It held that a court should consider:

- (1) the nature of the leased property;
- (2) the lease provisions;
- (3) the amount of the arrearage under the lease;
- (4) the remaining term under the lease; and
- (5) the provisions of the debtor's proposed plan.

While noting that each case must be decided on its own facts, the court held that, "absent evidence to the contrary, six months in consumer cases would be considered the maximum permissible period of time in which to cure a lease arrearage under 11 U.S.C.A. §365(b)(1)." *Id.* at 2. The court stated that this period should be considered as a baseline for bankruptcy attorneys to use in other plans. The court further noted that it was allowing the debtors in this case the full six-month period only because there was no prior guidance as to a permissible cure period. The court suggested that, in the ordinary course, shorter cure periods for automobile leases should be required under Chapter 13 plans.

### C. Liens

In *In re Edwards*, 219 B.R. 970 (Bankr.W.D.Ky. 1998), the bankruptcy court determined that a transfer of funds to a judgment creditor pursuant to a valid order of garnishment is a perfected lien as of the date the garnishment order is entered. Citing *In re Battery One Stop Limited*, 36 F.3d 493 (6<sup>th</sup> Cir. 1994), the bankruptcy court held that in order to avoid a post-judgment garnishment as a preference, the garnishment order must be served upon the garnishee within the preference period. Interpreting the Kentucky garnishment statute, KRS 425.506(1), the bankruptcy court held that the date of the transfer for preference purposes is the date the garnishment lien is created, which is the date of service of the garnishment order upon the garnishee. Because the garnishment lien was perfected upon service, more than 180 days prior to the bankruptcy filing, the garnishment payments were not avoidable as a preference.

In *In re McPherson*, 230 B.R. 99 (Bankr.E.D.Ky. 1999) concerns the release of liens following Chapter 13 plans. In *McPherson* the Chapter 13 Trustee requested a secured creditor to release its lien on the debtor's vehicle after the secured creditor had received payment in full of its allowed secured claim pursuant to the Chapter 13 plan. The creditor refused, contending that the release of its lien was not required or permitted until the debtor had received its order of discharge. The bankruptcy court ordered that the release of a lien is required upon successful completion of a Chapter 13 plan, before the formalities of the entry of an order of discharge. It noted that, upon completion of its payments, the Debtor has nothing more to do under the plan in order to be entitled to release of the lien, and the secured creditor is no longer at risk of losing the value of its lien.

D. Secured Claims Issues

Appellate courts have issued two recent opinions concerning what a secured creditor may recover under 11 U.S.C. § 506. The Fifth Circuit Court of Appeals recently permitted a secured creditor a default rate of interest in Chapter 11 in *Southland Corp. v. Toronto-Dominion (In re The Southland Corp.)*, 160 F.3d 1054 (5<sup>th</sup> Cir. 1998). The Sixth Circuit affirmed a bankruptcy court's sharp curtailment of lender charges in *In re Brunswick Apartments of Trimbell County, Ltd.*, 169 F.3d 333 (6<sup>th</sup> Cir. 1999). 11 U.S.C. § 506(b) provides as follows:

"To the extent that an allowed secured claim is secured by the property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose."

Thus, the Bankruptcy Code generally permits an oversecured creditor to recover interest, but does not specify the rate, i.e., a contract rate or a default rate. A default rate obviously allows the secured creditor to recover more. It also makes it more difficult for the debtor in a plan. The court held that the contract itself should control this question and that, if it provides for a higher rate on default, there is a presumption that the rate should apply in the Chapter 11. The *Southland* court held that this rate applies during the entire period from the pre-bankruptcy default to the effective date of the reorganization plan. There is simply a "presumption" of the creditor's entitlement to a default interest rate because the court held that the lender will not get the higher default rate where the "equities" dictate otherwise.

Here, the debtor filed a Chapter 11. Its banks, which were oversecured, filed proofs of claim which did not expressly mention a default rate of interest, but which calculated the interest based on the default rate set forth in the loan documents. The bankruptcy court confirmed a plan reinstating the credit agreement and the debtor later objected to the banks' claims. The bankruptcy court overruled the objection and the debtor and a bondholders' committee appealed, claiming that the banks had not demanded the higher rate, the reinstatement of the credit agreement returned the parties to a pre-default state and that the equities did not support a default rate. The court held that a pre-bankruptcy letter telling the debtor that the default rate was applicable, together with the proofs of claim, constituted an adequate demand. The court further held that the "reinstatement" returned the parties to a pre-bankruptcy, not a pre-default, state. Finally, the court held that there is a presumption that the contract controls unless that would produce an inequitable result. The court noted that this equity determination is made on a case by case basis. The "equitable" factors the court considered here included the following:

- (1) The amount of difference between the regular contract rate and the default rate;

- (2) Whether the creditor was obstructing confirmation of the plan; and
- (3) Whether junior creditors would be harmed by the senior creditor getting interest at the default rate.

Here, the Fifth Circuit held that the 2% default premium was not too much, the lender must not have obstructed confirmation because the plan was confirmed in only four months, and the junior creditors would not be harmed.

In *Brunswick*, pursuant to §506(b) an over-secured creditor sought to recover fees and charges provided for by the loan documents. However, the court sharply limited the nature and extent of charges. In this case, the bank was owed a principal balance of \$1.25 million. To that balance, the bank sought to use § 506(b) to claim as secured its claims for \$220,000 in additional fees and costs. These included: (1) a \$46,000 "consultant's fee," (2) a "service charge" of \$62,000 (5% of the remaining principal balance), (3) \$23,000 in attorney's fees, and (4) \$39,000 of salaries and other costs of the employees of the bank working on the debtor's loan. The bankruptcy court determined that only the attorney's fees could constitute a portion of the secured claim, but greatly reduced the attorney fee. On appeal, the Bankruptcy Appellate Panel and the Sixth Circuit affirmed.

With respect to the consultant's fee, the bankruptcy court found that the consultant was both a director of the bank and the father of the principal shareholder of the bank. Further, the documentation of the time and effort made in consulting were incomplete to evaluate their reasonableness. In confirming the denial of the consultant's fee, the Sixth Circuit stated "a secured creditor of a debtor in default may not take advantage of its position to unjustly enrich itself by charging a debtor with unreasonable insider fees, windfall profits, and similar fees." *Id.* at 335. With respect to attorneys' fees, the bankruptcy court allowed attorneys' fees in just a fraction of the amount claimed. The Sixth Circuit affirmed. It agreed with the bankruptcy court's finding that the attorneys' fees were incurred due to the bank's desire to litigate unreasonable demands including to enforce a settlement agreement which the bankruptcy court found never to have been formed or agreed upon. With respect to the claim for charging the collateral with the fees of salaried employees of the bank, the court found that the proof failed to demonstrate any extraordinary costs in dealing with this particular loan, nor any basis in law for surcharging the collateral with the ordinary and normal business expenses associated with making loans in the ordinary course of business. The court also affirmed the disallowance of the service charge on the ground that it would apply only to installments, not to the principal balance.

In *In re Crutcher Concrete Construction*, 218 B.R. 376 (Bankr.W.D.Ky. 1998) involves surcharge under § 506(c). In this case, the trustee sought to recover from a secured creditor the costs and expenses incurred in selling the creditor's collateral - - three vehicles. 11 U.S.C. § 506(c) provides that "the trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim." The trustee sought to surcharge the bank's collateral.

For the trustee to recover the costs and expenses of such a sale from the secured creditor's collateral, the trustee must demonstrate that the costs and expenses were reasonable, necessary, and of benefit to the secured creditor. The bankruptcy court determined that it was the trustee's anticipation, at the time of the sale, that the vehicles were likely to produce a surplus available for unsecured creditors, and that this satisfied the requirement that the expenses associated with the sale were "necessary" for purposes of Code § 506(c). However, the trustee failed to demonstrate that his disposition of the collateral had produced any benefit to the secured creditor. Under § 506(c), the trustee's recovery is limited to the extent of the benefit conferred on the creditor. Not any benefit will suffice; rather, it is a benefit over and above that which the creditor could have realized without the trustee's involvement. In this case, the trustee's costs of sale were substantially higher than those that would have been incurred by the secured creditor. Furthermore, the secured creditor would have been entitled to add the costs of sale onto its secured claim pursuant to the terms of the loan agreement with the debtor. Accordingly, the surcharge was denied.

#### E. Reaffirmation

Sears appears to be concluding its reaffirmation agreement practice problems. Debtors may reaffirm debts, making them enforceable notwithstanding the discharge otherwise available under 11 U.S.C. § 727. The agreement must be filed with the court under 11 U.S.C. § 524(c)(3). This is not just an administrative requirement, but allows the bankruptcy court to ensure that the agreement was not obtained improperly or is too great a burden on the debtor. *See* 11 U.S.C. § 524(c).

A Massachusetts debtor signed a reaffirmation agreement with Sears in order to keep the television set he bought there. Sears did not file this agreement with the court. The debtor eventually asked the court to relieve him of the obligation. At that time, the bankruptcy judge discovered that no agreement had been filed, and eventually discovered that this was a nationwide practice. Sears is reported to have discovered approximately 187,000 of the agreements which were not filed with the courts. As a result, Sears was collecting debts which were no longer enforceable and in violation of the stay that arises as a result of discharge. Sears ultimately had to settle with customers, shareholders, the FTC and Attorneys General in all fifty states. The *Wall Street Journal* reported in February, 1999 that Sears will have paid or incurred \$185 million in reimbursements and penalties to card holders, \$40 million in state fines, \$12 million in shareholder suits, \$120 million in credit card debt written off, \$56 million in administrative and legal costs and a \$60 million criminal fine.

Sears is not alone. There is a national class action against G.E. Capital Corp. for failure to file reaffirmation agreements. The class includes those who purportedly reaffirmed in 1993-1996 and the first half of 1997. Consumer Bankruptcy News reports that there is a pending settlement that could cost GECC over \$100 million, for principal, interest, credit insurance and other charges in improperly "reaffirmed" debt and several million dollars for consumer bankruptcy education programs.

F. Set Off/Automatic Stay

In the case of *In re Excel Engineering, Inc.*, 224 B.R. 582 (Bankr.W.D.Ky. 1998), the bankruptcy court determined that a subcontractor willfully violated the automatic stay of § 362 by filing a statement of lien pursuant to the Public Lien Statute, KRS 376.210. Such a lien attaches only to the funds actually earned by the contractor, and not to the property improved. Since these funds constituted property of the estate under § 541, the subcontractor's action in liening the property of the estate constituted an attempt to encumber property of the debtor in violation of the automatic stay. The bankruptcy court further rejected the subcontractor's argument that the Statement of Lien should relate back to the time when the furnishing of materials began, and thus should be construed as occurring pre-petition. The lien filed pursuant to KRS 376.210 does not have a relation back provision and thus the action was clearly taken post-petition for purposes of 362.

In *In re Alexander*, 225 B.R. 145 (Bankr.W.D.Ky. 1998), addresses "whether a creditor may exercise a right of set-off against exempt property of the Debtor." Here, the bankruptcy court determined that the IRS was not entitled to setoff a dischargeable pre-petition tax debt, unsecured by a lien, against the debtor's tax refund for which he properly claimed an exemption. Section 553 of the Code permits a creditor to offset against a debt owed to the debtor, provided there exists a right of setoff under applicable non-bankruptcy law. However, noting that the court's decision whether or not to permit setoff is discretionary, the court noted that the IRS sought to setoff its obligation to the debtor against exempt property of the debtor. Because the debtor's tax refund was exempt under Code § 522(a), that refund was not available to pay an obligation arising pre-petition under §522(c).

G. Bad Faith Filings

In *In re Emge*, 226 B.R. 396 (Bankr.W.D.Ky. 1998), the Court dismissed the debtor's Chapter 7 case for bad faith. Here, the debtor filed the Chapter 7 in response to the bankruptcy court's prior determination in the debtor's previous Chapter 13 case that the debtor had failed to input all of her disposable income into the plan. In determining that the debtor's Chapter 7 case had not been filed in good faith, the court noted that the debtor continued to make substantial monthly contributions to her 401k plan, failed to disclose an IRA in her schedules, and had cashed the IRA post-petition and made a preferential transfer to her mother, was continuing to pay the graduate school expenses of her adult daughter, and continued to lease a \$40,000 vehicle. The debtor had also filed bankruptcy shortly after a single set of creditors obtained a \$90,000 judgment against the debtor. Analyzing the totality of the circumstances as required by the Sixth Circuit in *In re Zick*, 931 F.2d 1124 (6<sup>th</sup> Cir. 1991), the court determined the petition could be dismissed for lack of good faith under 11 U.S.C. § 707(a).

## H. Miscellaneous Cases of Interest.

*In re Andaco, Inc.*, 226 B.R. 578 (Bankr.W.D.Ky. 1998) addresses consignment issues. Here, the debtor operated a convenience store in Bullitt County, Kentucky. As part of this operation, the debtor sold fuel in separate tanks on a consignment basis. Upon breach of the consignment agreement, the owner repossessed the fuel, the tanks and all of the associated storage facilities. The debtor then filed for bankruptcy protection. The trustee then brought an adversary proceeding asserting that the trustee's removal of the tanks constituted a preferential transfer. On the consignor's motion for summary judgment, the bankruptcy court determined that there were genuine issues of material fact with respect to whether the property constituted property of the debtor's estate. The court noted that the property would not constitute property of the debtor where the consignor gives conspicuous notice of its ownership interest at the place where the property is located, where it is generally known by debtor's creditors that the debtor is substantially engaged in the business of selling goods on a consignment basis, or where the goods are subject to a properly perfected security interest. Each of these issues had to be determined by the specific facts of the case thus precluding entry of summary judgment. This suggests that a consignor runs the risk of the loss of the goods unless it is made clearly known to either creditors of the retailer or by the posting of a conspicuous notice of the consignment relationship and that the goods belong to the creditor.

In *In re National Financial Realty Trust*, 226 B.R. 586 (Bankr.W.D.Ky. 1998), the bankruptcy court determined that an option agreement to repurchase real property, executed pre-petition and assigned to another post-petition, was not an executory contract within the meaning of 11 U.S.C. § 365, which had to be assumed in a timely fashion. The court, utilizing Professor Countryman's definition, held that an unexercised option is distinguishable from an ordinary contract, in that while both sides have unperformed obligations, they only exist upon the optionee's decision to exercise the option. The bankruptcy court, noting a split of authority, held that an option contract is typically considered an executed unilateral contract, not an executory one. This is because the optionee (at the time of filing of the petition) has fulfilled its only unqualified obligation, which is to pay for the option itself. Accordingly, an unexecuted option is not an executory contract requiring assumption.

*In re Holland*, 151 F.3d 547 (6<sup>th</sup> Cir. 1998) appears to be the first case decided by the Sixth Circuit regarding the effect of the 1994 Bankruptcy Amendments to §522(b) of the Code. Prior to the 1994 amendments, the Sixth Circuit had held that a debtor's homestead exemption under Ohio law, while available to the debtor, was not effective until a judicial sale or involuntary execution. This determination was based on the language of the Ohio statute. The 1994 amendments were specifically directed to change this anomalous result. Section 522(f)(1) permits a debtor to avoid a judicial lien on exempt property to the extent it impairs the exemption. The 1994 amendments to §522 add a definition of impairment of an exemption. The amended section provides: "for the purposes of this subsection, a lien shall be considered to impair an exemption to the extent that the sum of (i) the lien; (ii) all other liens on the property; (iii) the amount of the exemption that the debtor could claim if there were no liens on the property; exceeds the value that the debtor's interest in the property would have in the absence of any liens." 11 U.S.C. §522(f)(2)(a). This new federal

definition of impairment provides a mathematical formula which, applied along with the Ohio exemption statute, makes clear that even absent a forced judicial sale or pending involuntary execution, the homestead exemption is available to the debtor, and may be used along with §522(b) to remove a judicial lien that impairs it.

### **III. LEGISLATIVE DEVELOPMENTS**

Chapter 12, permitting family farm reorganizations, was to have expired, but once again has been extended.

House Bill 833, designated HR 833, the Bankruptcy Reform Act of 1999, proposes numerous changes to the Bankruptcy Code, some of which are noted here.

Section 211 of the Act amends the ordinary course of business exception to § 547(c)(2) of the Code, which applies to preferential transfers. Under the revised Code section, a creditor must only prove that the transfer was in accord with the historical business relationship between the debtor and creditor without the necessity of putting on proof regarding industry standards. This should reduce the amount and complexity of proof that a transfer was made in the ordinary course of business. This section would also increase the minimum threshold requirement to \$5,000 for avoidance of non-consumer debt.

Section 212 of the Act requires that the venue of preference actions to avoid a non-consumer debt of less than \$10,000 be commenced at the creditor's place of business. While such a provision helps to reduce the burden on small trade creditors by requiring that litigation of small preference actions against them be held locally, this change will dramatically increase costs to the debtor in instances where the debtor has a large number of trade creditors in a variety of locations.

Section 216 of the Act amends § 365(d)(2)(D) of the Code to clarify that assumption of an unexpired lease or executory contract does not require the trustee to cure a default in the nature of a penalty rate of interest or a penalty provision arising from a default.

Section 1101 eliminates the \$4,000,000 cap for single asset real estate cases. Section 1117 adds a new Section 547(h) to the Code. This section is designed to further pull the Code away from the consequences of the *Deprezio* case.

Section 1129 of the Act extends the time period to perfect a security interest, currently 20 days, to 30 days. This period prevents the perfection of a security interest from constituting an avoidable preference within the stated period.

Also pending before Congress is Senate Bill 625, also titled the Bankruptcy Reform Act of 1999. Section 306 of the Act amends § 1325(a)(5)(B)(1) to prevent a Chapter 13 debtor from discharging a secured creditor's lien upon completion of payments on the secured creditor's lien, delaying it until the completion of the entire plan and an order of discharge is entered. Section 306

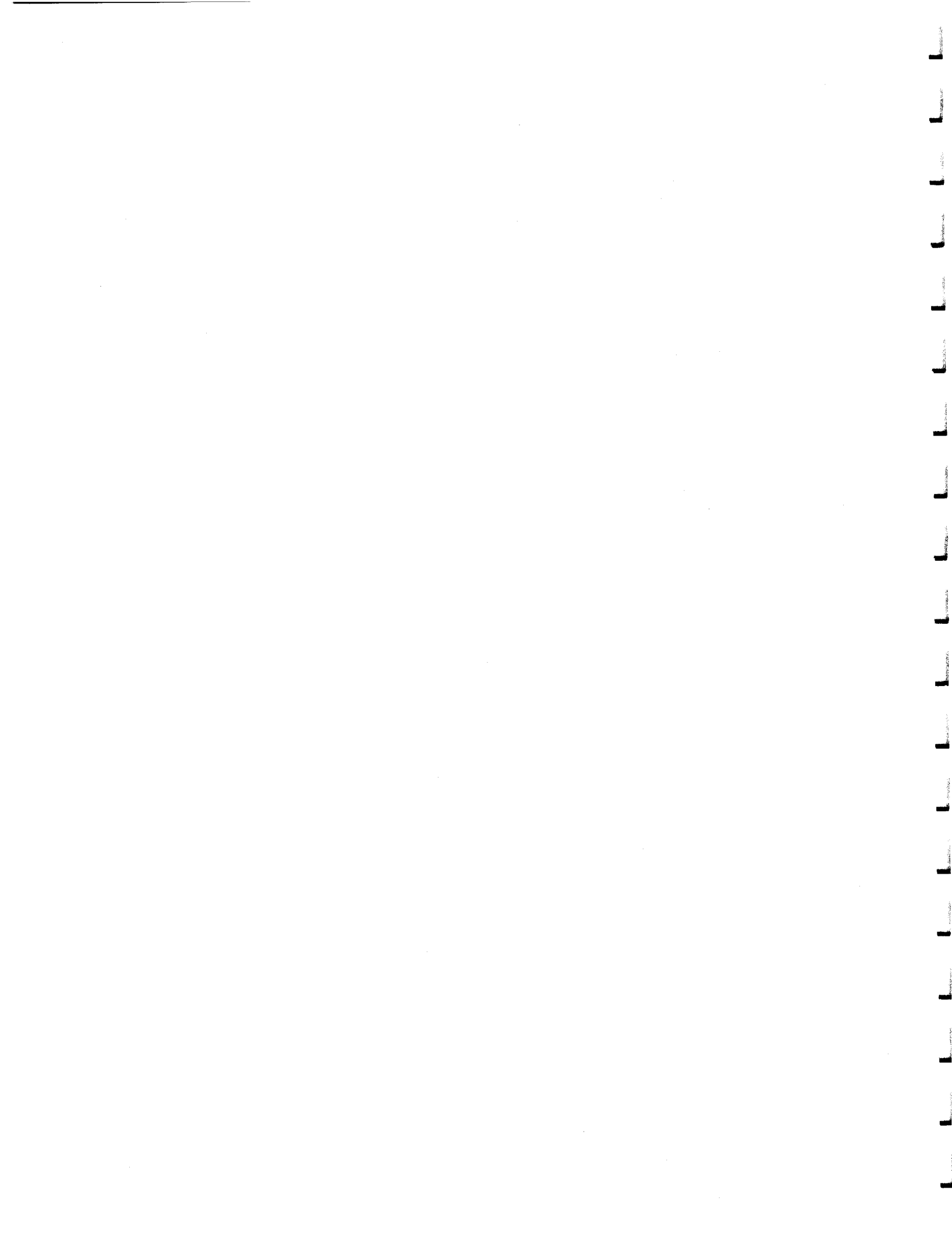


further amends § 506 of the Code by barring the stripping of liens for any automobile acquired by the debtor within five years prior to the filing of the bankruptcy petition.

Section 314 of the Act changes § 523 of the Code by rendering nondischargeable any debt incurred to pay an otherwise nondischargeable debt with the intent to discharge the newly acquired debt. Section 314 also imposes a presumption of nondischargeability for most debts incurred to pay nondischargeable debts incurred within 70 days of the filing of the petition.

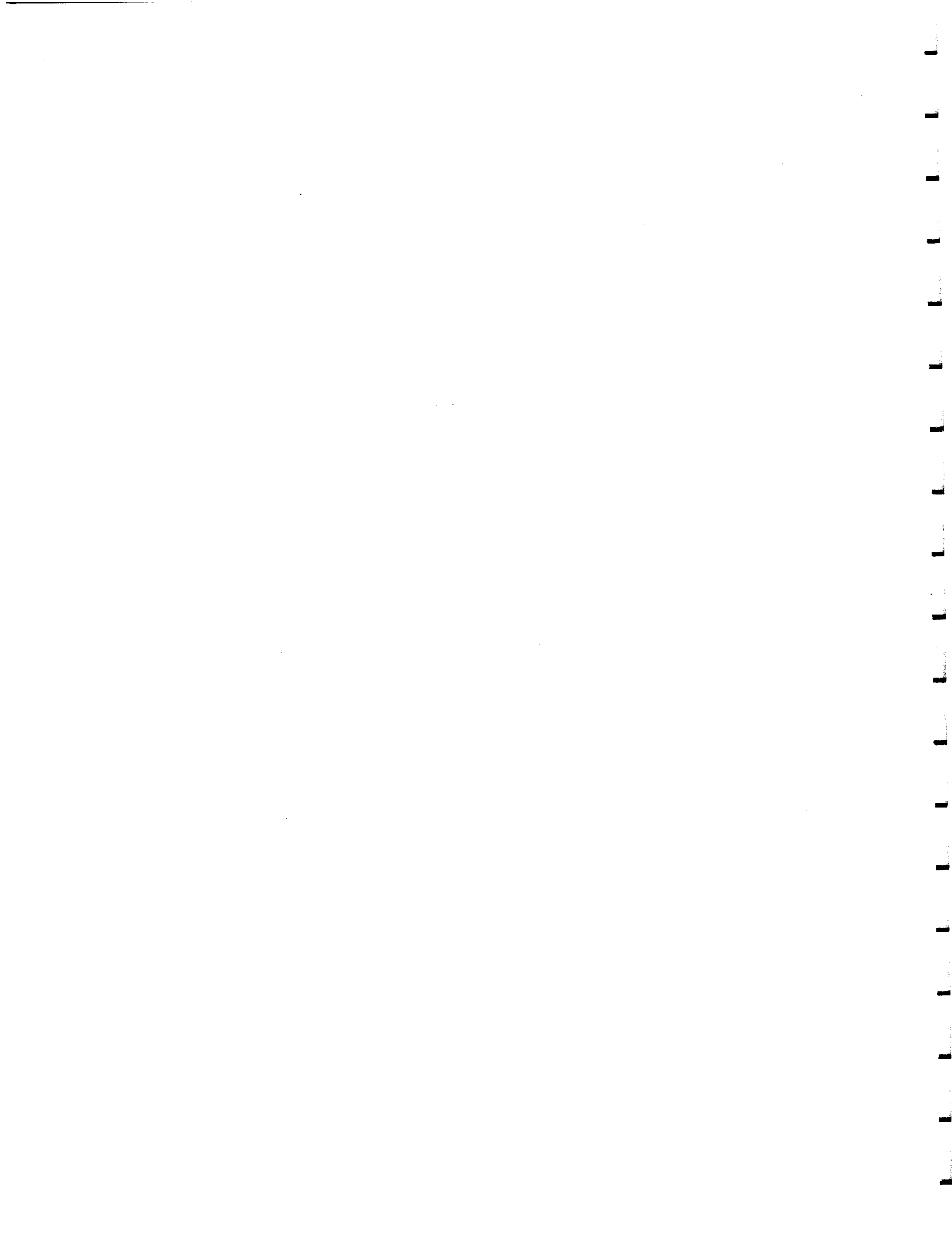
The controversy over a bankruptcy trustee's ability to recover debtors' pre-petition transfers to churches has been addressed by legislation. 11 U.S.C. § 548 provides that a trustee may avoid, or recover, certain pre-bankruptcy transfers for which the debtor received less than "reasonably equivalent value." In *In re Young*, 82 F.3d 1407 (8<sup>th</sup> Cir. 1996), the Eighth Circuit held that a bankruptcy court could not recover funds that the debtors had tithed to their church. The appellate court agreed that the transfers would ordinarily be avoidable transfers but concluded that permitting the recovery of the money would violate the Religious Freedom Restoration Act, as a substantial burden on the debtor's free-exercise of religion without furthering a compelling governmental interest. In 1997, the U.S. Supreme Court vacated and remanded *Young* in light of its decision in *City of Boerne v. Flores*, 521 U.S. 507, 117 S.Ct. 2157 (1997), reversing a Fifth Circuit decision that RFRA is constitutional. See *Christians v. Crystal Evangelical Free Church*, \_\_\_, U.S. \_\_\_, 117 S.Ct. 2502, 138 L. Ed.2d 1007 (1997). The Religious Liberty and Charitable Donation Protection Act has now been enacted, which protects those contributions if they do not exceed 15% of the debtor's income in that year or the transfer is consistent with the debtor's past charitable practices. 11 U.S.C. § 548(a)(2)(A).

The current versions of both H.R. 833 and S. 625 include provisions which prohibit the use of Chapter 7 by those debtors who have the means to repay 25% of their unsecured nonpriority debts over 5 years.



**RECENT DEVELOPMENTS  
AT  
THE HOLDING COMPANY LEVEL**

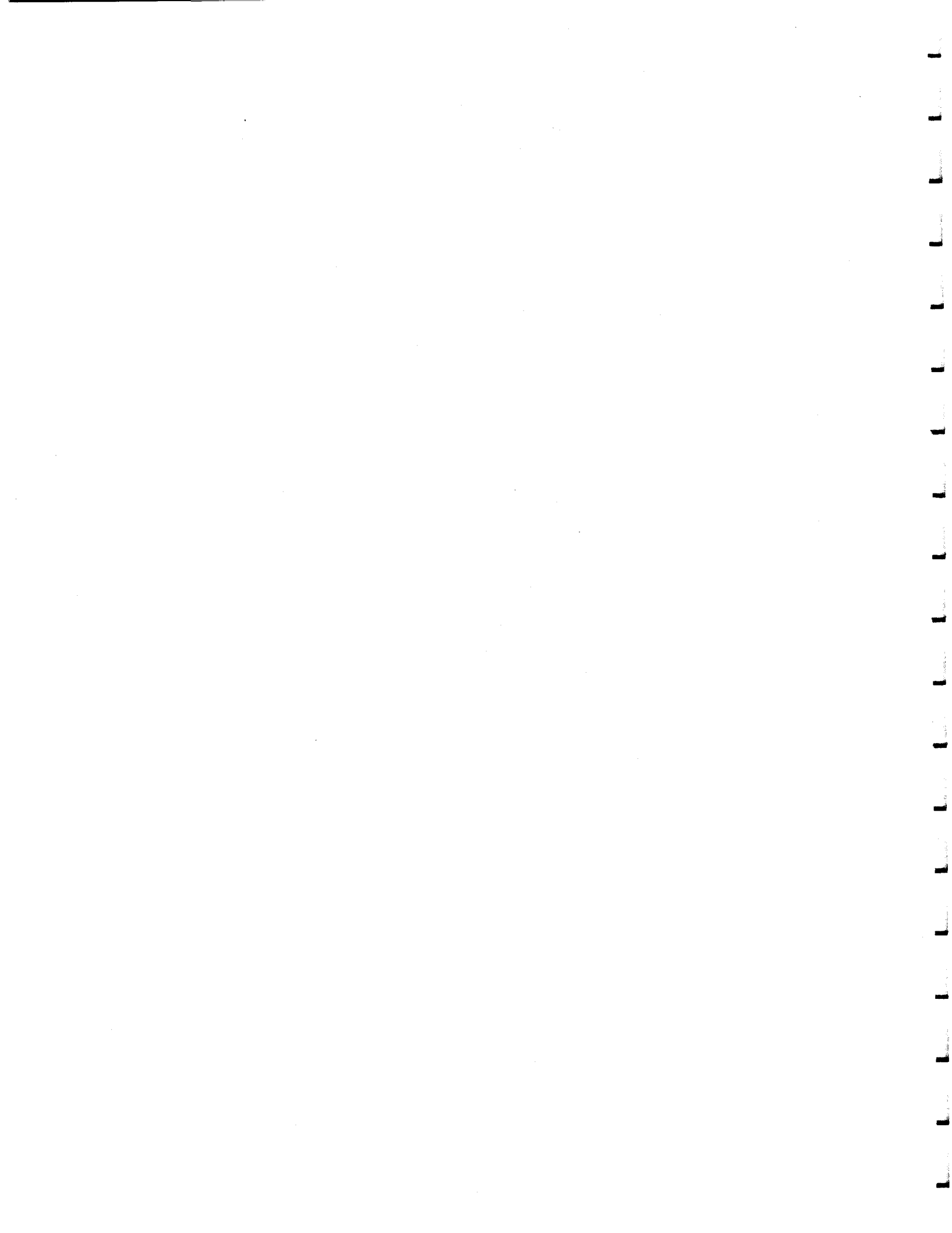
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# RECENT DEVELOPMENTS AT THE HOLDING COMPANY LEVEL

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# RECENT DEVELOPMENTS AT THE HOLDING COMPANY LEVEL

**OVERVIEW.** The purpose of this outline is to provide a brief overview of certain recent developments involving banks and bank holding companies, and is not intended to provide a complete discussion or analysis on any of the specific topics. My comments are limited to: (1) loan loss reserve provision issues; (2) branching and main office relocations in Kentucky; (3) "pooling of interests" accounting treatment for acquisitions; (4) SEC "Plain English" and proposed new securities offering regime; and (5) a quick review of several issues affecting holding companies.

## I. LOAN LOSS RESERVE PROVISION: HOW MUCH IS ENOUGH?

- A. Sun Trust Dilemma. In late 1998, the SEC began reviewing the loan loss reserve practices of several large bank holding companies, including Sun Trust Banks, Inc. The SEC expressed concern that Sun Trust may not have followed GAAP in establishing its loan loss reserve and, moreover, may have intentionally inflated the reserve in an attempt to manipulate its earnings. At the same time, bank regulators were generally encouraging financial institutions like Sun Trust to bolster their loan loss reserves to provide protection against a possible down turn in the economy. A classic dilemma of one regulator saying one thing and a second regulator demanding the opposite.
- B. First Joint Interagency Statement. On November 24, 1998, the SEC, FDIC, Federal Reserve, OCC and the OTS (the "Agencies") issued a joint statement, a copy of which is attached hereto as Exhibit "A," which provides the following guidance:

Although management's process for determining allowance adequacy is judgmental and results in a range of estimated losses, it must not be used to manipulate earnings or mislead investors, funds providers, regulators or other affected parties. Management's process must be based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan

portfolio. The depository institution must ensure that its allowance is supportable in light of the accompanying disclosures made to investors, including those made in management's discussion and analysis and financial footnotes, with respect to the underlying economics and trends in the portfolio and any other facts that significantly affect the collectability of loans.

C. Second Joint Interagency Statement. On March 10, 1999, the Agencies issued a second joint statement, a copy of which is attached as Exhibit B to this outline, which acknowledges "continued uncertainty among financial institutions, as to the expectations of the banking and securities regulators" with respect to loan loss reserves. The joint statement also stated:

- the issue will be addressed prospectively
- Agencies are to establish a "Joint Working Group to seek industry comments and provide "improved guidance" within a year on (1) appropriate methodologies and supporting documentation; and (2) enhanced disclosures.

## II. BRANCHING AND MAIN OFFICE RELOCATIONS IN KENTUCKY.

- A. Existing Kentucky Branching Laws. Kentucky bank branching statutes are presently governed by KRS 287.180 (dealing with banking business where done - branch and agency banks); KRS 287.915 (dealing with branching by acquisitions); and KRS 287.920 (dealing with interstate branching).
- B. Proposed Changes to Branching Statute. At the present, the Department of Financial Institutions is promoting a change to be considered at the next regular session of the legislature that would amend Kentucky laws to permit banks to branch statewide with no intrastate geographic restrictions.
- C. Principal Office Relocations for Banks. The Office of the Comptroller ("OCC") presently permits a national bank to relocate its main office on an intrastate basis up to 30 miles pursuant to the provisions of 12 U.S.C. § 30 and retain its existing branches pursuant



to the provisions of 12 U.S.C. § 36 including the location of the former main office. The Commissioner of the Department of Financial Institutions has issued Parity Letter 98-1 (see Exhibit "C" attached hereto) which permits and presently deals with principal office relocations for state chartered banks in Kentucky.

- D. Resurrection of Former Main Office Charter. KRS 287.915(2)(d) permits a holding company to resurrect a banking charter that has been surrendered after a banking combination pursuant to KRS 287.915 with the approval of the commissioner.
- E. Federal Thrift Branching Rights. Many bank holding companies have formed or acquired thrifts to take advantage of a federal thrift's favorable branching rights which allow both interstate and intrastate branch banking. Thrifts are permitted to be merged into commercial banks with the approval of the regulators and are permitted to retain their branches.
- F. ATM's of National Banks. On April 1, 1997, the OCC issued OCC Interpretative Letter No. 772 (March 6, 1998) permitting national banks to set up ATMs free of geographic restrictions.

### III. "POOLING OF INTERESTS" ACCOUNTING TREATMENT FOR ACQUISITIONS.

- A. Existing accounting practice for acquisitions. The present financial accounting for business combinations applying GAAP as set forth in Accounting Principals Board Opinion No. 16 requires that a business combination must be reported as either:

- "pooling of interests" accounting; or
- "purchase" accounting

APB 16 sets forth 12 detailed conditions (briefly described below) which must each be present to utilize "pooling of interests" accounting. If any one of the 12 pooling conditions is not satisfied, then the business combination must be accounted for utilizing "purchase" accounting.

B. "Pooling of Interests" Financial Accounting. The 12 conditions which are set forth in APB 16 for pooling of interests are briefly summarized as:

- Neither of the combining companies may have been a subsidiary or a division of another corporation within two years before the combination is initiated.
- Each of the combining companies is independent (generally 10% or less) of the other combining companies.
- There may be no change of equity interests in contemplation of the combination within two years prior to the initiation of the combination.
- There may be no unusual transaction involving reacquiring voting common stock during the two years preceding the initiation of the combination.
- The ratio of interest of individual stockholders to those of other stockholders in a combining company remains the same (*i.e.*, pro-rata) as a result of the exchange to effect the combination.
- Shares issued must possess immediate voting rights.
- No voting shares may be issued contingent upon future operating sales or earnings or the future price of the acquirer's stock.
- Consummation of the combination must occur within one year after initialization.
- No special financial arrangements made for the benefit of a target's stockholders.
- Shares issued in a pooling may not be reacquired from distributees under a plan to reacquire the shares.
- The issuers may not intend to sell off significant assets within two years of the target after combining other than the normal course of business.

- Only voting common shares may be issued in the combination in exchange for at least 90% of the outstanding voting common shares of the target corporation. SEC limits the resale by affiliates for a period of time.

In general, pooling of interests accounting reflects that the two combining companies have been combined since inception. The companies' balance sheets are added together at their stated historical cost values and not revalued to fair value. As a result of "pooling," no intangible assets (*i.e.*, goodwill) are created. Income statements of constituents are retroactively combined including prior periods.

- C. **"Purchase" Accounting.** If the 12 conditions set forth for "pooling of interests" are not met, the combination will be accounted for utilizing purchase accounting.

In general under "purchase accounting", all assets that are acquired and liabilities that are assumed or incurred in connection with the purchase are recorded at their respective fair value at the date of consummation. Under purchase accounting, the acquiring company must allocate the excess value of the stock issued, or other consideration paid, over the fair value of the assets acquired as goodwill or other intangible assets. The goodwill or other intangible assets must be amortized against earnings over a period of time appropriate to the assets not to exceed 40 years as set forth in APB 17.

- D. **FASB Proposes Changes to Accounting for Business Combinations.** On April 21, 1997, the Financial Accounting Standards Board ("FASB") tentatively decided to eliminate the "pooling of interests" method of accounting for business combinations, and utilize only the "purchase" method of accounting. This ruling would be consistent with international standards now being utilized by other countries to solely utilize "purchase" accounting methods for business combinations.

The timetable for the elimination of poolings would be effective for business combinations initiated after FASB issues final rules on the topic. This date is likely to be in late 2000. Draft rules may be ready for comment by late July, 1999. The FASB had earlier tentatively

agreed that purchased goodwill should be amortized over its presumed valuable life, 10 years, with an absolute cap of 20 years. FASB proposes to discuss further likely amortization period for purchased goodwill.

- E. Effect of Accounting Change. The accounting change to eliminate "poolings" may slow business combinations short term and lower premiums offered to target companies. The net effect to acquiring companies undertaking business combinations with premiums attached to the price would be lower earnings per share. This impact could be mitigated by changing the acceptable amortization period for goodwill. Some commenters have suggested that if everyone looks at cash earnings instead of the bottom line, then the accounting change would be less bleak.

In 1998, the total value of bank mergers accounted for as poolings was \$257.6 billion, according to Sheshunoff Information Services, where purchase accounting amounted to only \$19.6 billion. This is partly so because banking regulators call for strong capital and require the deduction of intangible assets from a bank's capital for purposes of meeting required capital standards.

The essence of the difference between "poolings" versus "purchase" accounting is that "poolings" avoid potential earning dilution from intangible amortization where premiums are paid.

#### IV. SEC's "PLAIN ENGLISH" REQUIREMENTS AND PROPOSED NEW SECURITIES OFFERING REGIME.

- A. SEC's "Plain English." On October 1, 1998, the SEC commenced requiring the use of "plain English" when preparing prospectuses filed under the Securities Act of 1933. The staff at the SEC screens all filings to determine if a good faith effort was made to incorporate "plain English" and may return a prospectus for non-compliance. Substantial delays have resulted as both issuers and SEC staff work through what constitutes "plain English."

Rule 421(d)(2) requires as a minimum that "plain English" be utilized when preparing the front and back cover pages, the summary and the risk factors sections of a prospectus. Some of the requirements are:

- short sentences
- definite, concrete, every day words
- active voice
- no legal jargon (*i.e.*, hereof, notwithstanding, etc.) or highly technical business terms
- no multiple negatives
- use plain English throughout prospectus
- do not use defined terms
- use descriptive headings where possible
- avoid glossaries and defined terms
- avoid boilerplate
- avoid copying directly from legal documents
- avoid repetition
- do not use the terms "Company," "Certain," "Such," or "(as defined below)"
- do not (a) define commonly understood terms; (b) use parenthetical phrases; or (c) use right justified margins
- avoid long paragraphs
- avoid vague terminology like "strategic alternatives," "synergy," "leverage"
- limit overuse of footnotes and cross-references

The SEC staff has issued "A Plain English Handbook" for greater detail and many publishing companies have produced plain English pamphlets.

B. Proposed New Securities Offering Regime. In October, 1998, the SEC released a proposed major over-haul of its rules on mergers, tender offers and other types of business combinations. The proposals are quite extensive and have been commonly referred to as the "aircraft carrier" proposals. The proposal constitutes a complete overhaul of the registration/distribution process coupled with significant changes that are required for mergers, acquisitions and tender offers.

1. Proposal contains two principal registration forms under the 33 Act.
  - a. Form B - eligibility for large or well-followed seasoned issuers
  - b. Form A - issuers not eligible to use Form B, which would become the basic registration form, replacing Forms S-1, S-2, and S-11, among others.
  - c. Form SB-1 and SB-2 - eligibility for small business issuers
2. All mergers, other business combinations and exchange offers, other than those involving a small business issuer as registrant, should be registered on Form C (which would replace the S/4). However, small business issuers would use Form SB-3.
3. One aspect to the new regime is to give registrants greater freedom to communicate with shareholders.

V. MISCELLANEOUS POINTS FOR DISCUSSION.

- A. Proposed revisions to ease rules for S corporations.
- B. New Joint Policy Statement by agencies on income tax allocation (See "Exhibit D").
- C. Pending Litigation on what constitutes "fair value" as set forth in KRS 271B.13-010(3) in a dissenters' action.

- D. Pending litigation challenging a main office relocation by the Commissioner of Department of Financial Institutions pursuant to "parity" authority.





FIRST JOINT INTERAGENCY STATEMENT TO FINANCIAL INSTITUTIONS  
ON LOAN LOSS RESERVE PRACTICES

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*Release Date: November 24, 1998*

For immediate release

The Securities and Exchange Commission, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision have jointly issued the following statement on the allowance for loan losses of depository institutions.

**Joint Interagency Statement**

The Securities and Exchange Commission, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency and Office of Thrift Supervision (the Agencies) recognize the importance of meaningful financial statements and disclosure for both the benefit of investors and a safe and sound financial system. The Agencies also recognize the importance of depository institutions having prudent, conservative, but not excessive loan loss allowances that fall within an acceptable range of estimated losses. Accordingly, the Agencies are issuing this Statement to better ensure the consistent application of loan loss accounting policy and to improve the transparency of financial statements.

In 1986, the Securities and Exchange Commission issued FRR 28 concerning *Procedural Discipline in Determining the Allowance and Provision for Loan Losses to be Reported*. In 1993, the four Federal banking agencies jointly issued the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (Interagency Statement). These documents provide guidance to depository institutions on the establishment and maintenance of an allowance consistent with generally accepted accounting principles (GAAP). As these materials make clear, the allowance for loan losses should reflect estimated credit losses for specifically identified loans, as well as estimated probable credit losses inherent in the remainder of the loan portfolio at the balance sheet date. When determining the appropriate level for the allowance, management should always ensure that the overall allowance appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses. Management's judgment should be exercised in a disciplined manner that is based on and reflective of adequate detailed analyses of the loan portfolio.

Although management's process for determining allowance adequacy is judgmental and results in a range of estimated losses, it must not be used to manipulate earnings or mislead investors, funds providers, regulators or other affected parties. Management's process must be based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan portfolio. The depository institution must ensure that its allowance is supportable in light of the accompanying disclosures made to investors, including those made in management's discussion and analysis and financial footnotes, with respect to the underlying economics and trends in the portfolio and any other factors that significantly affect the collectibility of loans.

The Agencies have discussed their respective concerns about accounting for allowances for loan losses and agree that the approach to the allowance should be consistent with the guidance noted above. Accordingly, each of the Agencies will continue to fulfill its respective responsibilities for ensuring that the allowance for loan losses is appropriately

determined and that earnings are not improperly managed, consistent with safety and soundness objectives and investor protection objectives. The banking agencies understand that the SEC's general concerns about earnings management issues extend to all SEC registrants, not merely banking organizations, and that questions have arisen with respect to loan loss allowances in this context only with regard to a small number of banking organizations.

The Agencies today have agreed to work together with the public accounting profession and banking industry in developing further guidance consistent with GAAP, the Interagency Statement and FRR 28. This additional guidance will help to ensure the transparency of the reported amounts, improve auditability, and serve as a benchmark for the exercise of prudent judgment. The Chief Accountants of each of the Agencies will meet quarterly to coordinate this and other projects of mutual interest.

SECOND JOINT INTERAGENCY STATEMENT TO FINANCIAL INSTITUTIONSON LOAN LOSS RESERVE PRACTICES**JOINT INTERAGENCY LETTER TO FINANCIAL INSTITUTIONS**

Last November, the Securities and Exchange Commission, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision (the Agencies) issued a Joint Interagency Statement in which they reaffirmed the importance of credible financial statements and meaningful disclosure to investors and to a safe and sound financial system. The Joint Interagency Statement underscored the requirement that depository institutions record and report their allowance for loan and lease losses in accordance with generally accepted accounting principles (GAAP). We stress and continue to emphasize the importance of depository institutions having prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses. We recognize that today instability in certain global markets, for example, is likely to increase loss inherent in affected institutions' portfolios and consequently require higher allowances for credit losses than were appropriate in more stable times.

Despite the issuance of the November Joint Interagency Statement, there is continued uncertainty among financial institutions as to the expectations of the banking and securities regulators on the appropriate amount, disclosure, and documentation of the allowance for credit losses. The Agencies now announce additional measures designed to address this continued uncertainty. These measures are consistent with the Agencies' mutual objective of, and focus on, addressing prospectively, where feasible, issues related to improving the documentation, disclosure, and reporting of loan loss allowances of financial institutions.

- The Agencies are establishing a Joint Working Group, comprised of policy representatives from each of the Agencies, to gain a better understanding of the procedures and processes, including "sound practices," used generally by banking organizations to determine the allowance for credit losses. An important aspect of the Joint Working Group's activities will be to receive input from representatives of the banking industry and the accounting profession on these matters, and will not involve joint examinations of institutions. The common base of knowledge that results will facilitate the joint and individual efforts of the Agencies to provide improved guidance on appropriate procedures, documentation, and disclosures to the banking industry. This will assist the banking community in complying with GAAP and will improve comparability among financial statements of depository and other lending institutions. The Joint Working Group will also share information and insights concerning issues of mutual concern that may arise.
- Using information gathered through the Joint Working Group and from representatives of the accounting profession and the banking industry, the Agencies will work together to issue parallel guidance, on a timely basis, and within a year on the first two items listed below, in the following key areas regarding credit loss allowances:
  - Appropriate Methodologies and Supporting Documentation. The Agencies intend to issue guidance that will suggest procedures and processes necessary for a reasoned assessment of losses inherent in a portfolio and discuss ways to ensure that documentation supports the reported allowance.
  - Enhanced Disclosures. This guidance will address appropriate disclosures of allowances for credit losses and the credit quality of institutions' portfolios by identifying key areas for enhanced disclosures, including the need for institutions to disclose changes in risk factors

and asset quality that affect allowances for credit losses. The enhanced disclosures would contribute to better understanding by investors and the public of the risk profile of banking institutions and improve market discipline.

- The Agencies will work together to encourage and support the Financial Accounting Standards Board's process of providing additional guidance regarding accounting for allowances for loan losses. The Agencies emphasize that GAAP requires that management's determination be based on a comprehensive, adequately documented, and consistently applied analysis of the particular institution's exposures, the effects of its lending and collection policies, and its own loss experience under comparable conditions.
- In addition, the Agencies will support and encourage the task force of the American Institute of Certified Public Accountants (AICPA) that is developing more specific guidance on the accounting for allowances for credit losses and the techniques of measuring the credit loss inherent in a portfolio at a particular date. In particular, the AICPA task force will focus on providing guidance on how best to distinguish probable-losses inherent in the portfolio as of the balance sheet date -- the guidepost agreed to by the Agencies for reporting allowances in accordance with GAAP -- from possible or future losses not inherent in the balance sheet as of that date. Additionally, the Agencies will ask the AICPA task force to consider recently developed portfolio credit risk measurement and management techniques that are consistent with GAAP as part of this effort. The AICPA project already has been initiated and will include representatives from the accounting profession and the banking industry, as well as observers from the SEC and the banking agencies.
- Senior staff of the Agencies will continue to meet to discuss banking industry accounting and financial disclosure policy issues of interest that affect the transparency of financial reporting and bank safety and soundness. These discussions will address progress in the application of accounting and disclosure standards by banking institutions, including those impacting the allowance for credit losses, with particular focus on recently identified issues and trends. The meetings also will be used to coordinate projects of the Agencies in areas of mutual interest. The first of these meetings was held on January 27.

The Agencies believe that the actions announced above will promote a better and clearer understanding among financial institutions of the appropriate procedures and processes for determining credit losses in accordance with GAAP. The Agencies intend that these steps will enhance the transparency of financial information and improve market discipline, consistent with safety and soundness objectives. In recognition of the specialized regulatory nature of the banking industry and in order to resolve ongoing uncertainties in the industry, with the announcement of these initiatives, the Agencies' focus, in so far as feasible, will be on enhancing allowance practices going forward.

PARITY LETTER 98-1, REGARDING PRINCIPAL OFFICE RELOCATIONS  
FOR CHARTERED BANKS IN KENTUCKY



DEPARTMENT OF FINANCIAL INSTITUTIONS  
477 VERSAILLES ROAD  
FRANKFORT, KENTUCKY 40601  
TELE. 502/573-3390  
FAX 502/573-8787

ARTHUR L. FREEMAN  
COMMISSIONER

PAUL E. PATTON  
GOVERNOR

MEMORANDUM

TO: All Kentucky State Chartered Banks

FROM: Arthur L. Freeman  
Commissioner

RE: Parity Letter 98-1  
Principal Office Relocations

DATE: October 12, 1998

Attached is a copy of Parity Letter 98-1 relating to the relocation of a Kentucky state chartered bank's principal office. The effective date of Parity Letter 98-1 is October 12, 1998.

If you have any questions, please feel free to contact me at (502) 573-3390.

**PARITY LETTER 98-1**

**PRINCIPAL OFFICE RELOCATIONS**

**EFFECTIVE DATE: October 12, 1998**

## PARITY LETTER 98-1

### PRINCIPAL OFFICE RELOCATIONS

EFFECTIVE DATE:            October 12, 1998

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#### HISTORICAL PERSPECTIVE

On June 24, 1996, under the authority of KRS 287.020(3), then Commissioner Larry D. Lander issued Parity Letter 96-1. That Parity Letter allowed a Kentucky state chartered bank to take advantage of the principal office relocation powers that 12 USC §30(b) grants to a national bank.

At the time Commissioner Lander issued Parity Letter 96-1, the Office of the Comptroller of the Currency, based on its interpretation of 12 USC §30(b) and its rulings concerning intrastate relocations, permitted a national bank to:

- 1) relocate its principal office up to thirty miles across state and county lines,
- 2) retain former branches,
- 3) establish a branch at the location of its former principal office under 12 USC §36(c), and
- 4) establish additional branches in the Kentucky counties where the bank could have established branches prior to the relocation under 12 USC §36(c).

Parity Letter 96-1 applied only to a request for a principal office relocation to a new county and permitted a state bank, upon a vote of the shareholders owning two-thirds of the stock of the bank and upon approval of the Commissioner, to:

- 1) relocate its principal office to a site in another county that was within thirty miles of the city, town, or village of its existing principal office;
- 2) retain its former branches;
- 3) establish a branch at the location of its former principal office under KRS 287.180; and
- 4) establish additional branches in the Kentucky counties where the bank could have established branches prior to the relocation under KRS 287.180.

While permitting the above, Parity Letter 96-1 contained certain restrictions limiting the ability of some state banks to relocate their principal office. It provided that a state bank, which was not in existence on or before May 31, 1996, must have been in existence for a minimum of five years before it could apply to relocate its principal office to another county. In addition, it

provided that a state bank which had relocated its principal office to another county must wait at least five years before it could apply to again relocate its principal office to another county.

## **PARITY STATEMENT**

The Department believes that competitive inequalities have arisen since Commissioner Lander issued Parity Letter 96-1. These inequalities have resulted because the Office of the Comptroller of the Currency has not placed the same restrictions on principal office relocations by national banks as the Department has placed on principal office relocations by state banks. Because the Department no longer believes that public policy requires these restrictions, Parity Letter 96-1 is nullified.

Consequently, to eliminate the competitive inequalities and increase parity with national banks, the Department will permit a Kentucky state chartered bank to:

- 1) file an application to relocate its principal office to a site in another county that is within thirty miles of the city, town, or village of its existing principal office,
- 2) file an application for a branch in any county where it has a principal office or an existing branch, and
- 3) file an application for a branch simultaneous with the closure of its former principal office if the bank has an existing branch in the county of its former principal office.

A state bank may file an application regardless of the date that the bank was chartered or the bank's length of existence. Further, a state bank which has relocated its principal office may, at any time, file a subsequent application to again relocate its principal office.

## **PUBLIC COMMENT**

On July 24, 1998, the Commissioner issued Proposed Parity Letter 98-1 and invited public comments on the Proposed Finding of Permissible Activities, Services, or Products contained in the Letter. The comment period ended on August 14, 1998. A number of financial institutions submitted comments both in favor of and opposed to the Proposed Finding. The Commissioner has considered all the comments.

A number of institutions expressed concerns with multiple relocations that might occur under this Parity Letter. To address these concerns, the Finding of Permissible Activities requires that the Commissioner make a determination that a relocation will serve the public convenience and advantage and that the principal office will have a reasonable probability of successful operation in the new location. In addition, to avail itself of the branching activities permitted by the Finding, a bank that relocates its principal office to another county must have an existing branch office in the original county. If the bank has no branch in the original county then the bank may not establish a branch at its former principal office after the relocation nor may it establish a new branch in the original county.



## FINDING OF PERMISSIBLE ACTIVITIES, SERVICES, OR PRODUCTS

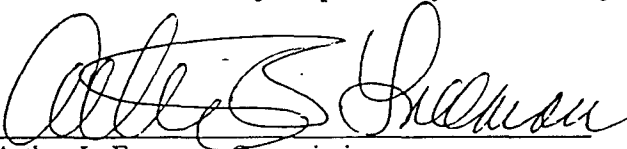
Under KRS 287.020(3), the Commissioner of the Department of Financial Institutions issues this Finding of Permissible Activities, Services, or Products.

On and after the effective date of this Finding, a state bank may, through a resolution of its board of directors, adopt the provisions of 12 USC §30(b). Then, upon a vote of the shareholders owning two-thirds of the stock of the bank and upon approval of the Commissioner, the state bank may:

- 1) relocate its principal office to a site in another county that is within thirty miles of the city, town, or village in which its principal office was originally located;
- 2) retain its former branches;
- 3) establish a branch at the location of its former principal office; and
- 4) establish additional branches in the Kentucky counties where the bank could have established branches prior to the relocation.

A bank may engage in the permissible activities regardless of the date that the bank was chartered or the bank's length of existence. However, the Commissioner, when considering an application for relocation, shall determine that the relocation will serve the public convenience and advantage and that the principal office will have a reasonable probability of successful operation in the new location. In addition, to avail itself of the branching activities permitted by this Finding, a bank that relocates its principal office to another county must have an existing branch office in the original county. If the bank has no branch in the original county then the bank may not establish a branch at its former principal office after the relocation nor may it establish a new branch in the original county.

In accordance with this Finding, Parity Letter 96-1 is nullified and Parity Letter 98-1 shall control those subjects previously controlled by Parity Letter 96-1.



Arthur L. Freeman, Commissioner

October 12, 1998



INTERAGENCY POLICY STATEMENT ON INCOME TAX ALLOCATION

IN A HOLDING COMPANY STRUCTURE

Federal Register / Vol. 63, No. 225 / Monday, November 23, 1998 / Notices

64757

**DEPARTMENT OF THE TREASURY**

**Office of the Comptroller of the Currency**

[Docket No. 98-17]

**FEDERAL RESERVE SYSTEM**

[Docket No. R-1022]

**FEDERAL DEPOSIT INSURANCE CORPORATION**

**DEPARTMENT OF THE TREASURY**

**Office of Thrift Supervision**

[Docket No. 98-93]

**Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure**

**AGENCIES:** Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

**ACTION:** Notice of interagency policy statement.

**SUMMARY:** The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the Agencies) are adopting a uniform interagency policy statement regarding intercompany tax allocation agreements for banking organizations and savings associations (institutions) that file an income tax return as members of a consolidated group. The intent of this interagency policy statement is to provide guidance to institutions regarding the allocation and payment of taxes among a holding company and its depository institution subsidiaries. In general, intercorporate tax settlements between an institution and its parent company should be conducted in a manner that is no less favorable to the institution than if it were a separate taxpayer. This policy statement is the result of the Agencies' ongoing effort to implement section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI Act), which requires the Agencies to work jointly to make uniform their regulations and guidelines implementing common statutory or supervisory policies.

**DATES:** This interagency policy statement is effective November 23, 1998.

**FOR FURTHER INFORMATION CONTACT:**  
OCC: Gene Green, Deputy Chief

Accountant, (202/874-4933), or Tom Rees, Senior Accountant, (202/874-5411), Office of the Chief Accountant, Core Policy Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

*Board:* Charles Holm, Manager, (202/452-3502), or Arthur Lindo, Supervisory Financial Analyst, (202/452-2695), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452-3544).

*FDIC:* For supervisory issues, Robert F. Storch, Chief, (202/898-8906), or Carol L. Liquori, Examination Specialist, (202/898-7289), Accounting Section, Division of Supervision; for legal issues, Jamey Basham, Counsel, (202/898-7265), Legal Division, FDIC, 550 17th Street, NW, Washington, DC 20429.

*OTS:* Timothy J. Stier, Chief Accountant, (202/906-5699), or Christine Smith, Capital and Accounting Policy Analyst, (202/906-5740), Accounting Policy Division, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

**SUPPLEMENTARY INFORMATION:**

**I. Background**

Section 303(a)(3) of the CDRI Act directs the Agencies, consistent with the principles of safety and soundness, statutory law and policy, and the public interest, to work jointly to make uniform regulations and guidelines implementing common statutory or supervisory policies. Section 303(a)(1) of the CDRI Act also requires the Agencies to review their regulations and written policies and to streamline those regulations where possible.

In 1978, the FDIC, the OCC, and the Board each published a separate policy statement regarding the allocation and payment of income taxes by depository institutions which are members of a group filing a consolidated income tax return. The OTS provides supervisory guidance on this subject in its Holding Company Handbook. As part of the ongoing effort to fulfill the section 303 mandate, the Agencies have reviewed, both internally and on an interagency basis, the present policy statements and the supervisory guidance that has developed over the years. As a result of this review, the Agencies identified minor inconsistencies in the policy statements and supervisory guidance. Although largely limited to differences in language and not to the substance of

the policies and guidelines themselves, the Agencies determined that it would be beneficial to adopt a uniform interagency policy statement regarding intercorporate tax allocation in a holding company structure.

**II. Policy Statement**

This interagency policy statement reiterates and clarifies the position the Agencies will take as they carry out their supervisory responsibilities for institutions regarding the allocation and payment of income taxes by institutions that are members of a group filing a consolidated return. The interagency policy statement reaffirms that intercorporate tax settlements between an institution and the consolidated group should result in no less favorable treatment to the institution than if it had filed its income tax return as a separate entity. Accordingly, tax remittances from a subsidiary institution to its parent for its current tax expense should not exceed the amount the institution would have paid had it filed separately. The payments by the subsidiary to the parent generally should not be made before the subsidiary would have been obligated to pay the taxing authority had it filed as a separate entity. Similarly, an institution incurring a tax loss should receive a refund from its parent. The refund should be in an amount no less than the amount the institution would have received as a separate entity, regardless of whether the consolidated group is receiving a refund. However, adjustments for statutory tax considerations which may arise in a consolidated return are permitted as long as the adjustments are made on a basis that is equitable and consistently applied among the holding company affiliates. Regardless of the method used to settle intercorporate income tax obligations, when depository institution members prepare regulatory reports, they must provide for current and deferred income taxes in amounts that would be reflected as if the institution had filed on a separate entity basis.

An institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to its parent since these are not liabilities required to be paid in the current reporting period. Similarly, transactions in which a parent "forgives" any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. This is because a parent cannot relieve its subsidiary of this potential future obligation to the taxing authorities, since these authorities can collect some or all of a group liability

from any of the group members if tax payments are not made when due.

Finally, the Agencies recommend that financial institution members of a consolidated group have a written, comprehensive tax allocation agreement to address intercorporate tax policies and procedures.

This interagency policy statement revises and replaces the Board's "Policy Statement on Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State Member Banks," (43 FR 22782, May 26, 1978); the OCC's "Statement of Policy on Income Tax Remittance to Holding Company Affiliates," (Banking Circular No. 105, May 22, 1978); the FDIC's "Statement of Policy on 'Income Tax Remittance by Banks to Holding Company Affiliates'" (43 FR 22241, May 24, 1978); and the OTS's "OTS Tax-Sharing Policy," (Section 500, "Funds Distribution," OTS Holding Companies Handbook). This interagency policy statement does not materially change any of the guidance previously issued by any of the Agencies.

The text of the interagency policy statement follows:

#### **Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure**

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision ("the Agencies") are issuing this policy statement to provide guidance to banking organizations and savings associations regarding the allocation and payment of taxes among a holding company and its subsidiaries. A holding company and its depository institution subsidiaries will often file a consolidated group income tax return. However, each depository institution is viewed as, and reports as, a separate legal and accounting entity for regulatory purposes. Accordingly, each depository institution's applicable income taxes, reflecting either an expense or benefit, should be recorded as if the institution had filed on a separate entity basis.<sup>1</sup> Furthermore, the amount and timing of payments or refunds should be no less favorable to the subsidiary than if it were a separate taxpayer. Any practice that is not

<sup>1</sup> Throughout this policy statement, the terms "separate entity" and "separate taxpayer" are used synonymously. When a depository institution has subsidiaries of its own, the institution's applicable income taxes on a separate entity basis include the taxes of the subsidiaries of the institution that are included with the institution in the consolidated group return.

consistent with this policy statement may be viewed as an unsafe and unsound practice prompting either informal or formal corrective action.

#### **Tax Sharing Agreements**

A holding company and its subsidiary institutions are encouraged to enter into a written, comprehensive tax allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. Although each agreement will be different, tax allocation agreements usually address certain issues common to consolidated groups. Therefore, such an agreement should:

- Require a subsidiary depository institution to compute its income taxes (both current and deferred) on a separate entity basis;
- Discuss the amount and timing of the institution's payments for current tax expense, including estimated tax payments;
- Discuss reimbursements to an institution when it has a loss for tax purposes; and
- Prohibit the payment or other transfer of deferred taxes by the institution to another member of the consolidated group.

#### **Measurement of Current and Deferred Income Taxes**

Generally accepted accounting principles, instructions for the preparation of both the Thrift Financial Report and the Reports of Condition and Income, and other guidance issued by the Agencies require depository institutions to provide for their current tax liability or benefit. Institutions also must provide for deferred income taxes resulting from any temporary differences and tax carryforwards.

When the depository institution members of a consolidated group prepare separate regulatory reports, each subsidiary institution should record current and deferred taxes as if it files its tax returns on a separate entity basis, regardless of the consolidated group's tax paying or refund status. Certain adjustments for statutory tax considerations that arise in a consolidated return, e.g., application of graduated tax rates, may be made to the separate entity calculation as long as they are made on a consistent and equitable basis among the holding company affiliates.

In addition, when an organization's consolidated income tax obligation arising from the alternative minimum tax (AMT) exceeds its regular tax on a consolidated basis, the excess should be consistently and equitably allocated among the members of the consolidated

group. The allocation method should be based upon the portion of tax preferences, adjustments, and other items generated by each group member which causes the AMT to be applicable at the consolidated level.

#### **Tax Payments to the Parent Company**

Tax payments from a subsidiary institution to the parent company should not exceed the amount the institution has properly recorded as its current tax expense on a separate entity basis. Furthermore, such payments, including estimated tax payments, generally should not be made before the institution would have been obligated to pay the taxing authority had it filed as a separate entity. Payments made in advance may be considered extensions of credit from the subsidiary to the parent and may be subject to affiliate transaction rules, i.e., Sections 23A and 23B of the Federal Reserve Act.

A subsidiary institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to the parent. The deferred tax account is not a tax liability required to be paid in the current reporting period. As a result, the payment of deferred income taxes by an institution to its holding company is considered a dividend subject to dividend restrictions,<sup>2</sup> not the extinguishment of a liability. Furthermore, such payments may constitute an unsafe and unsound banking practice.

#### **Tax Refunds From the Parent Company**

An institution incurring a loss for tax purposes should record a current income tax benefit and receive a refund from its parent in an amount no less than the amount the institution would have been entitled to receive as a separate entity. The refund should be made to the institution within a reasonable period following the date the institution would have filed its own return, regardless of whether the consolidated group is receiving a refund. If a refund is not made to the institution within this period, the institution's primary federal regulator may consider the receivable as either an extension of credit or a dividend from the subsidiary to the parent. A parent company may reimburse an institution more than the refund amount it is due on a separate entity basis. Provided the

<sup>2</sup> These restrictions include the Prompt Corrective Action provisions of section 38(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831o(d)(1)) and its implementing regulations: for insured state nonmember banks, 12 CFR part 325, subpart B; for national banks, 12 CFR 6.6; for savings associations, 12 CFR part 565; and for state member banks, 12 CFR 208.45.

institution will not later be required to repay this excess amount to the parent, the additional funds received should be reported as a capital contribution.

If the institution, as a separate entity, would not be entitled to a current refund because it has no carryback benefits available on a separate entity basis, its holding company may still be able to utilize the institution's tax loss to reduce the consolidated group's current tax liability. In this situation, the holding company may reimburse the institution for the use of the tax loss. If the reimbursement will be made on a timely basis, the institution should reflect the tax benefit of the loss in the current portion of its applicable income taxes in the period the loss is incurred. Otherwise, the institution should not recognize the tax benefit in the current portion of its applicable income taxes in the loss year. Rather, the tax loss represents a loss carryforward, the benefit of which is recognized as a deferred tax asset, net of any valuation allowance.

Regardless of the treatment of an institution's tax loss for regulatory reporting and supervisory purposes, a parent company that receives a tax refund from a taxing authority obtains these funds as agent for the consolidated group on behalf of the group members.<sup>3</sup> Accordingly, an organization's tax allocation agreement or other corporate policies should not purport to characterize refunds attributable to a subsidiary depository institution that the parent receives from a taxing authority as the property of the parent.

#### *Income Tax Forgiveness Transactions*

A parent company may require a subsidiary institution to pay it less than the full amount of the current income tax liability that the institution calculated on a separate entity basis. Provided the parent will not later require the institution to pay the remainder of the current tax liability, the amount of this unremitted liability should be accounted for as having been paid with a simultaneous capital contribution by the parent to the subsidiary.

In contrast, a parent cannot make a capital contribution to a subsidiary institution by "forgiving" some or all of the subsidiary's deferred tax liability. Transactions in which a parent "forgives" any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. These transactions lack economic substance because the parent cannot legally relieve the

subsidiary of a potential future obligation to the taxing authorities. Although the subsidiaries have no direct obligation to remit tax payments to the taxing authorities, these authorities can collect some or all of a group liability from any of the group members if tax payments are not made when due.

Dated: October 14, 1998.

**Julle L. Williams,**

*Acting Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System, October 29, 1998.

**Jennifer J. Johnson,**

*Secretary of the Board.*

By order of the Board of Directors.

Dated at Washington, DC, this 5th day of November, 1998.

Federal Deposit Insurance Corporation.

**Robert E. Feldman,**

*Executive Secretary.*

Dated: October 14, 1998.

By the Office of Thrift Supervision.

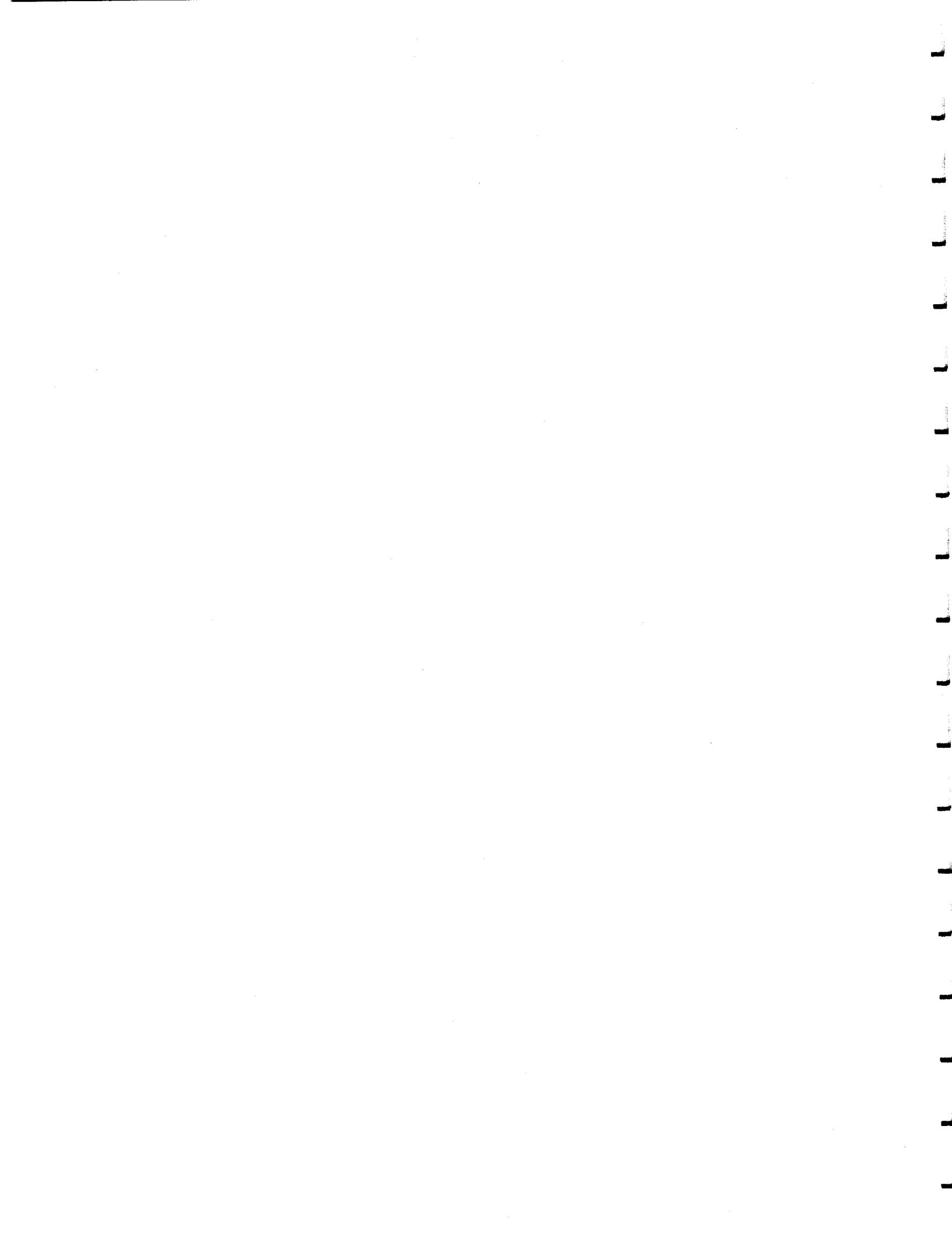
**Ellen Seidman,**

*Director.*

[FR Doc. 98-31179 Filed 11-20-98; 8:45 am]

BILLING CODE 4810-13-P, 6210-01-P, 6714-01-P, 6720-01-P

<sup>3</sup> See 26 CFR 1.1502-77(a).



**UNIFORM COMMERCIAL CODE  
UPDATE**

**John T. McGarvey  
Morgan & Pottinger  
Louisville, Kentucky**





# UNIFORM COMMERCIAL CODE UPDATE

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## UNIFORM COMMERCIAL CODE UPDATE

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### I. CASE LAW DEVELOPMENTS.

#### A. *In Re: Grieb Printing Company*, 230 BR 539 (Bankr. W.D. Ky. 1999).

Judge Stosberg decided a classic battle between a secured creditor, Bayer Financial Services, and a Trustee in Bankruptcy, each vying for the proceeds from the sale of the bankrupt debtor's equipment. The Trustee argued that the secured party's lien was not perfected because it was not signed by the debtor but was signed by the secured party as the debtor's "Attorney-in-Fact."

The principle that a financing statement must be signed by an individual authorized to sign on behalf of a corporate debtor was established in *American Pulverizer Co. v. Cantrell*, 694 S.W.2d 714 (Ky. App. 1985). The Trustee for Grieb argued that the financing statement filed and signed by Bayer Financial Services did not have a valid signature of the debtor for three reasons: (1) the document from Grieb to Bayer did not grant Bayer a power of attorney; (2) if Grieb granted Bayer a power of attorney it was invalid because it was not recorded; and (3) Bayer did not act within the scope of its power of attorney, or its authorization, when it signed the financing statement without first seeking a signature from Grieb.

The lease executed by Grieb's CEO granted Bayer a security interest and specifically authorized Bayer to execute for Grieb "... any and all necessary documents to effect any such filing as aforesaid (including the filing of any such financing or continuation statement) without further authorization of lessee."

Bayer's problem stemmed from the designation of the signature as by an "Attorney-in-Fact". Bayer was not acting as an attorney-in-fact but was acting as Grieb's agent. Judge Stosberg correctly distinguished the fact situation from the one in *American Pulverizer* and found that the debtor's signature on the financing statement, as executed by Bayer, was a valid exercise of the power granted to Bayer under the terms of the lease.

An important part of Judge Stosberg's Opinion is its concluding reference to KRS 355.1-102. The Judge stated that he evaluated the Trustee's attack on the financing statement in light of the purposes and policies of the UCC set forth in the statute: "(a) to simplify, clarify, and modernize the law governing commercial transactions; (b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties; (c) to make uniform law among the various jurisdictions." The Judge also cited KRS 355.1-103(1): "... that this chapter shall be liberally construed and applied to promote its underlying purposes and policies." The Judge then

observed that Bayer clearly intended to comply with the purpose of the UCC to notify interested parties of its security interest. He concluded that sustaining the Trustee's argument would defeat the underlying purposes of the UCC.

**B. Ousley v. First Commonwealth Bank of Prestonsburg, 1999 W.L. 93233 (Ky. App. February 12, 1999). (NOT FINAL)**

This is a declaratory judgment action brought by former customers of a bank seeking access to all of the bank's records pertaining to their past loans and accounts. The first impression case in Kentucky finds that the former customers have a fundamental right to the bank's records of their past accounts regardless of their reason for seeking access to the records, and that neither the corporation's dissolution nor its bankruptcy precluded the customers from seeking the records. The decision references, and mis-cites, KRS 355.4-406. In its analysis, the Court correctly states that the statute does not require a bank to send a periodic statement of account to its customer. The Court also notes that if a bank does not send the customer a periodic statement that ". . . the customer does not have a duty to reasonably discover any unauthorized payment." The Court then states that if the bank does not send a statement it cannot take advantage of the one year "statute of limitation" contained in the statute.

The one year outer limit of K'S 355.4-406 is *not* a statute of limitation. It is an important absolute bar rule. See *Concrete Materials Corporation v. Bank of Danville and Trust Company*, 938 SW2d 254 (Ky. 1997). "It is the holding of this Court that the Court of Appeals and the Circuit Court correctly determine that the failure of Concrete Materials to inspect its bank statement and to notify the bank of the claimed unauthorized withdrawals within one year of the time the statements and items were made available to it, precludes any claim for such unauthorized withdrawals." *Id.* at p.260.

**C. Star Bank, Kenton County, Inc. v. Parnell, 1998 W.L. 655693 (Ky. App. September 25, 1998, as modified October 9, 1998) (NOT FINAL).**

The Court of Appeals reversed a lender liability jury verdict finding that the bank could not enforce personal guarantees on the basis that the bank's acceleration of a recreational vehicle dealership loan, on the grounds of general insecurity, was not in good faith. In reversing the jury verdict the Court looked to K'S 355.1-201(19) that defines "good faith" as "honesty in fact in the conduct or transaction concerned." (*This definition changes in the Revised Article 9.*) The Court then applied the definition to K'S 355.1-208 that limits acceleration on the grounds of insecurity to situations where the creditor ". . . in good faith believes that the prospect of payment . . . is impaired." The statute places the burden of establishing lack of good faith on the party against whom the power has been exercised.

The Court also cited the intent of the UCC "to make uniform law among the various jurisdictions", and looked to cases from other jurisdictions discussing both the standard of good faith and its application to acceleration on insecurity cases.

The Court of Appeals found that the trial court erred in denying Star Bank's motion for a directed verdict and reversed the judgment of the Kenton Circuit Court.

## II. THE KENTUCKY LIEN INFORMATION SYSTEM.

### A. Overview.

1. Secured parties who file, continue, amend, assign, partially release, or terminate a financing statement in Kentucky must meet the new filing and debtor identification requirements of House Bill 739 that became law on July 15, 1998.
2. Two Distinct Changes:
  - a. Identification Number Requirement for UCC Statements. New requirement that a debtor's "identification number" be added to all financing statements (UCC-1s), and continuation, amendment, assignment, partial release and termination statements (UCC-3s).
  - b. Additional Filing With Secretary of State. Secured parties must make an additional filing with the Secretary of State for certain UCC filings.
3. Effective Dates:
  - a. Identification Numbers. July 15, 1998 (some argument for January 4, 1999)
  - b. Additional Filings. January 4, 1999 (some argument for July 15, 1998).
4. Computerized Searching Capability Established  
<http://www.sos.state.ky.us>.
5. Special Issues:
  - a. Title Lien Statements.
6. Exhibits To Outline:
  - a. 30 KAR 4:010.

- b. Secretary of State Web Pages.
- c. "Kentucky's New filing Requirements for Personal Property Liens",  
*63 Kentucky Bench & Bar* 1 (1999).

**B. Identification Number Requirement.**

- 1. HB739 amends sections 9-402, 9-403, 9-404, 9-405, and 9-406 of Article 9 of the Uniform Commercial Code to require that "the identification number of the debtor" be included in financing, continuation, termination, assignment, and partial release statements.
- 2. What is an "Identification Number"?
  - a. Defined in K'S 355.9-105(1)(i) and 30 KAR 4:010 §2.
  - b. Natural persons (including sole proprietorships):
    - i. Social Security Number or an alphanumeric designator that consists of the first three letters of the individual's last name followed by their date of birth in the format mm/dd/yy. If an individual's name has only two letters, the letter "z" is used as the third letter.
    - ii. 30 KAR 4:010 §2(2) provides the individual with the right to refuse to provide social security number. No express obligation of secured party to advise debtor of that option.
    - iii. What about twins?
  - c. Any other legal entity: its federal taxpayer identification number.
    - i. Is there a legal entity without a federal taxpayer identification number? Foreign corporations?
- 3. What new information must be included on UCC forms?
  - a. Debtor identification numbers should be included in *all* financing, continuation, amendment, assignment, partial release, and termination statements filed with a Kentucky county clerk beginning July 15, 1998.

- b. UCC filings must include this information even if the document does not have to be filed with the Kentucky Secretary of State because it is a fixture filing or relates to minerals (other than coal) or timber to be cut. Mortgages filed as a financing statement must also meet the information requirements of part 4 of Article 9, including the debtor's identification number.
  - c. No specific location is specified. The best location is probably the box as part of the debtor's name and address, and our firm is suggesting using the format "Id#: \_\_\_\_\_".
4. What if you filed a UCC document after July 15 that did not contain an identification number?
- a. A UCC-3 amendment can be used to correct errors, however, priority arguments may arise between competing filings. If a continuation statement did not contain the I.D. number, and you are within the six-month window for filing, file a new continuation statement with the required information.
  - b. The "not seriously misleading" defense of KRS 355.9-402(8) always remains available.
5. **Effective Date.** The legislative intent was clearly that the effective date for the amendments would coincide with the January 4, 1999, operational date for the Kentucky Lien Information System, however, the Legislature included no special effective date in the bill. Thus, the consensus is that the requirement for identification numbers was effective July 15, regardless of the date that filing is required with the Secretary of State.
6. **No Special Penalty For Non-Compliance.**

**C. Secretary Of State Filing Requirement.**

1. **Applicability.**
- a. Unlike the ID number requirement, the requirement for filing with the Secretary of State does not cover all UCC filings.
  - b. KRS 355.9-401A(3) provides: "The filing requirement of this section shall not apply when the collateral is timber to be cut or is minerals or the like, including oil and gas, other than coal, or accounts subject to subsection (5) of KRS 355.9-103 [accounts resulting from the sale

at the wellhead or minehead of minerals, oil and gas], other than accounts arising out of the sale of coal, or when the financing statement is filed as a fixture filing under K'S 355.9-33 and the collateral is goods which are or are to become fixtures."

- c. Filings made outside KRS Chapter 355 (e.g., title liens) are also exempt from the Secretary of State's system.

2. What do you file with the Secretary of State?

- a. The administrative regulation specifies that the document to be filed is "a file stamped copy" of the document filed with the county clerk. The Secretary of State will *not* promulgate either a special form to be filed or a transmittal form to accompany documents to be filed.
- b. The filing sent to Frankfort need not be a "carbon" of the UCC-1 or UCC-3 but may be a copy of an acknowledgment received from a county clerk. The document filed with the Secretary of State must show all of the local filing information such as file number, date, and time.
- c. If the county clerk's filing stamp is illegible, the Secretary of State will attempt to contact the clerk to obtain the local filing information. Filings on which the local filing information has been "enhanced" for clarity will be accepted. If the copy submitted to the Secretary of State does not evidence the place of filing that information should be included in a transmittal letter.

3. How do you file?

- a. The file stamped copy is sent with \$1.00 per form to the Secretary of State, UCC Filings, P.O. Box 1470, Frankfort, KY 40602-1470.
- b. While not expressly permitted by the regulation, the address for courier delivery is: Secretary of State, UCC Division, Rm. 86, The Capitol, 700 Capitol Avenue, Frankfort, KY 40601.

4. When do you file?

- a. Filing with the secretary of state became mandatory January 4, 1999. The legislation states that the Secretary of State's system will be "operational" (unfortunately, the drafters did not use the word "effective") on that date, and the administrative regulation states that



“[t]he requirement to file . . . shall begin on January 4, 1999.” However because of the July 15, 1998, effective date for the statute, the Secretary of State accepted filings on that date and has include the filings in the lien information system.

- b. Secured parties must make the filing with the Secretary of State within “twenty (20) business days from the date the statement was filed with the county clerk.” See 30 KAR 4:010 §3

5. What if you do not file?

a. Statutory Provisions.

- i. KRS 355.9-401A(5) states:

“The filings in the Office of the Secretary of State required under this section are for information purposes only and are not intended to convey notice or constitute perfection. Any legal reliance shall be on the basis of the requirements of KRS 355.9-401 and the filings under KRS 355.9-401.”

- ii. Regardless, the new filing requirements are a new part of Article 9. Despite good arguments to the contrary, the most serious potential consequence of not filing with the Secretary of State will be a court decision that invalidates a security interest because the secured party did not comply with all of the requirements of Article 9.

b. Regulatory Penalties.

- i. The administrative regulation imposes a fine of \$100.00 on secured parties that do not file with the Secretary of State within 20 business days of filing with a county clerk.
- ii. There is no express statutory authority in the bill for this administrative penalty. However, in a worst case situation the Secretary of State could attempt to collect tens of thousands of dollars from creditors who either were unaware of the new system or chose to flout the additional filing requirements.

**D. Secretary Of State’s Internet Web-Site And Search Capabilities.**

**E. Special Issues.**

1. Title Lien Statements.

On the day that the new law became effective, a controversy developed about whether Title Lien Statements should carry the debtor's identification number. KRS Chapter 186A directs the Transportation Cabinet to develop and promulgate the form of the Title Lien Statement and that it should carry the information required by KRS 355.9-402 (at least as that statute existed in 1986). On July 30, the Cabinet notified the county clerks that it would not require identification numbers on Title Lien Statements.

**III. TOBACCO SETTLEMENT DOLLARS, LENDER'S RIGHTS, AND THE UNIFORM COMMERCIAL CODE.**

**A. Background.**

There are two major settlement payments. The first class of payments are those to be made under Article IX of the Master Settlement Agreement between settling states and participating tobacco manufacturers. This is in settlement of state tobacco-related health care expenditures and is sometimes referred to as the Medicaid Fund or the Phase One settlement. As we understand it, payments to Kentucky under the Phase One settlement are projected to be in the range of \$120-\$140 million/year and total \$3.5 billion over the next 25 years. The second class of payments are those to be paid to establish a national trust for tobacco grower communities. This second settlement is often referred to as the Growers Trust Fund or the Phase Two settlement, and Kentucky expects to receive \$1.5 billion in Phase Two settlement funds. Lenders must closely watch payments made under the Phase Two settlement and how those payments relate to the mortgage and security interests held by lenders.

**B. Phase Two Settlement Implementation Status.**

The Phase Two settlement was negotiated early this year, however, there is no formal document establishing the national trust into which the tobacco companies will make payments. A draft of a national trust document is being circulated among the grower states but remains in the discussion stage.

Establishing a state trust document would be difficult until the national trust document is finalized. The national trust document may affect the governance of state trusts. No payments can be made to the states until the national trust is funded. The earliest possible date for a payment to the state trust is December 1999.

Lenders' interest in the Phase Two-Grower's Fund can be affected by the language of the state trust document and can be affected legislatively in the 2000 session of the General Assembly.

If spendthrift provisions are inserted in the trust, or legislation prohibits the transfer, assignment, pledge, grant of security interest, etc. in the payments agricultural lenders would be precluded from using any portion of the payments to repay their loans.

Lenders are concerned that payments made to their farmer customers can be viewed as representing a portion of the value of the land in which the bank holds a mortgage interest. Most observers feel that the trust payments signal the demise of the tobacco price support system. Philip Morris's direct growing contracts with Tennessee farmers is already causing concern among both warehousemen and growers. It has been predicted that tobacco prices will drop a minimum of forty cents per pound without the price support system. An agricultural economist could easily factor this into a farmer's poundage allotment and produce a factor by which a farm's value will be diminished. Thus, banks and lending institutions that made loans based upon prior estimates of the value of tobacco farms have a more significant claim to the tobacco settlement funds than many who are clamoring for a part of the money. Similarly, lenders who financed farm implement purchases can be viewed as making credit decisions based upon projections of tobacco sale profitability that will not come true because of the settlements.

The latest information from Frankfort is that the Governor will soon issue an Executive Order that establishes a state certification entity. The entity will probably take a form similar to a municipal corporation that will afford the entity and the members of its board of directors immunity. The purpose of the state certification entity will be to certify the names and percentages of those entitled to share in the proceeds of the Growers Fund.

At this time there is no reason to believe that the interest of the state's lenders has been addressed in the creation of the state certification entity. One possibility is to establish a claims registry for lenders that hold mortgages or security interests on real or personal property associated with the production of tobacco. The state certification entity could certify lenders' interests just as the interest of the grower. What must be negotiated is the lenders' rights to payment upon certification of their interests.

### **C. Practical Collateral Issues.**

The collateral implications are driven by the various number of possible claimants to settlement payments which ultimately are distributed: (a) fee simple land owners; (b) life interest land owners; (c) owners having remainder or contingent interests in farm land; (d) tobacco grower lessees; and (e) existing real property creditors of all of the foregoing; (f) future real property creditors of classes (a) through (d); (g) existing farm implement and other farm personalty lenders; (h) future farm implement and other farm personalty lenders. The sheer number of different classes of interested claimants may make a resolution difficult.

The collateral implications are also driven by how the payments are characterized. It is impossible to accurately categorize the nature of the payments to be received by our state's farmers until the national trust and state trust documents are available. However, our best guess at this time

is that the payments will fall under the Uniform Commercial Code category of general intangibles. While the payments may be viewed as representing compensation for the decrease in the value of a parcel of land to generate income by growing tobacco, the payments will be in cash and the right to payment is probably a form of personal property.

A bank lending money secured by land on which tobacco is grown should, in addition to taking a mortgage on the land, take and perfect a security interest in general intangibles plus attempt to specifically describe future payments to be made from the Grower's Fund. Additionally, the lender should attempt to restrict the borrower's ability to transfer or assign any Phase Two payments, including requiring tobacco leases to include provisions that clearly state that the lessee is not entitled to any portion of the Phase Two payments and to require that, absent the lender's written consent, any Phase Two payments would have to be applied to the lender's debt notwithstanding that the loan is current at the time the payments are received by the borrower. Banks making agricultural loans secured by personalty may want to include similar provisions in their loan documents. Lenders should clearly communicate to their borrowers that it is the lender's desire to obtain Phase Two payments as collateral and that those payments be used to pay down the debt absent the express written consent of the lender.

#### **IV. REVISIONS TO ARTICLE 9—SECURED TRANSACTIONS.**

##### **A. History and Overview.**

The revision process began in 1990 when the Permanent Editorial Board for the Uniform Commercial Code established a committee to study Article 9. The study committee issued a report on December 1, 1992, and recommended the establishment of a drafting committee for the revision of Article 9. A final draft was approved by both the American Law Institute and the National Conference of Commissioners on Uniform State Laws in 1998, however, drafting of the Official Comments was not complete until early this year. The American Law Institute began distribution of the Revised Article 9, together with its Official Comments, the first week of April 1999.

The drafters of Revised Article 9 inserted an effective date of July 1, 2001. It is anticipated that all states adopting the new Article will use the model effective date to minimize conflicts between the old and new versions.

This is the first complete revision of Article 9. The original version, the drafting of which began in the early 1950's, was effective in Kentucky on July 1, 1960. Experience with the original version led to the 1972 amendments that Kentucky did not adopt until 1986. The 1972 amendments were a fine tuning whereas the new version is a complete rewrite and renumbering.

Revised Article 9 seeks greater certainty in secured transactions through expanding the scope of the Article to cover more types of property and transactions and by simplifying the rules relating to the creation, perfection, and enforcement of security interests. Following is a summary of the

principal changes. The summary follows the outline established in the Official Comment to the new 9-101.

The Revision has been introduced before the legislatures of 14 states including our neighbors of West Virginia and Missouri. The 2000 session of the Kentucky General Assembly will be the only opportunity for our state to pass the legislation before the model effective date of July 1, 2001.

**B. Scope of Article 9.**

The following types of property are now included as subject to the rules of Article 9:

**Deposit accounts;** formerly included only as proceeds of other collateral, the new Article allows, even encourages, the specific taking of a security interest.

**Sales of payment, intangibles, and promissory notes;** recognizing the rapid growth of the securitization of this class of property.

**Healthcare insurance receivables;** the new Article continues to exclude most interests in insurance policies but carves out "healthcare insurance receivables."

**Nonpossessory statutory agricultural liens;** original drafts of the revised Article included many types of nonpossessory statutory liens, however, the compromise final version restricted the expanded coverage to agricultural liens.

**Consignments;** are brought out of Article 2 and included in Article 9 as purchase money security interests. The "generally known by its creditors to deal substantially in the goods of others" exception is retained.

**Supporting obligations and properties securing rights to payment;** e.g., guarantees and letters of credit that support the payment or performance of collateral such as accounts, payment intangibles, etc.

**Commercial tort claims;** may now be assigned within Article 9, however, bodily injury and non-business tort claims continue to be excluded from Article 9.

**Transfers by states and governmental units of states;** are now included unless the transfer is specifically exempt by another statute.

**C. Duties of Secured Party.**

A secured party is required to release control of collateral when there is no secured obligation and no commitment to give value. Secured parties will have expanded duties to provide the debtor

with information concerning collateral and the obligation it secures. There are additional obligations on the secured party regarding default and enforcement.

**D. Choice of Law.**

**Where to file;** the location of the debtor will control choice of law governing the perfection of most collateral.

**Debtor's location;** the new Article follows the former § 9-103 that deems a debtor to be located at its chief executive office. However, there are three significant exceptions under the new 9-307. A "registered organization" will be deemed to be located in the state under whose law the debtor is organized. An individual is deemed located at his or her principal residence. There are special rules for determining the location of the United States and registered organizations organized under the law of the United States.

**Priority;** for tangible collateral, the law governing priority will be the law of the jurisdiction where the property is located. For intangible collateral it will be the jurisdiction in which the debtor is located.

**E. Perfection.**

The principal means of perfecting a security interest will continue to be the filing of financing statements. However, the sole means of perfecting an interest in certain types of collateral such as letter of credit rights or deposit account will be control of the collateral, similar to the means of perfection on investment property. The rules governing priority continue to be found in Part 3.

1. Purchase Money Security Interest.

Rules governing purchase money security interest are broadened to recognize the "dual status" rule (legislatively rejecting the "transformation rule") and expand the PMSI concept in inventory to include security interests in livestock. The revision recognizes a PMSI in software that is a part of goods otherwise subject to a PMSI.

2. Investment Property.

There is little change from the rules of the former § 9-115 enacted as part of the 1994 revisions to UCC Article 8. Control remains the key. An addition is that security interests obtained through control agreements are now ranked according to the time when the control agreement is entered into.

3. Deposit Accounts.

This is a new class of collateral, however, the priority rules follow the familiar rules on control established by the former 9-115. A new rule in 9-340 makes a depository bank's right of setoff generally senior to a security interest held by another secured party. However, if the other secured party becomes the depository bank's customer with respect to the deposit account, then its security interest is senior to the depository bank's security interest and right of setoff.

**F. Proceeds.**

The definition of "proceeds" of collateral includes additional rights in property that arise out of collateral, such as distributions on account of collateral and claims arising out of the loss or nonconformity of, defects in, or damage to collateral.

**G. Provisions Relating to Third Parties.**

A new Part 4 sets rules relating to third parties to secured transactions. Various sections cover the alienability of debtor's rights, specify a secured party is not obligated on a debtor's contracts, cover rights acquired by an assignee, and hold that restrictions on the creation or enforcement of security interest in leasehold interest or lessor's residual interest is ineffective.

**H. Filing.**

Filing is now governed by Part 5. The former Part 4, responsible for much of the litigation involving Article 9, has been substantially rewritten to simplify the text and deal with problems of interpretation and implementation that are highlighted by various court decisions.

1. Where to File.

The former Article 9 allowed the states three alternatives for rules on where to file. The revision provides for centralized filing and retains local filing for only real estate related collateral.

2. Form of Financing Statement.

A new national form of UCC-1 and UCC-3 is proposed. The revision does not mandate but facilitates electronic filing by not requiring a debtor's signature on the financing statement. The requirement for the debtor's signature is replaced with a requirement that the filing be authorized by the debtor. Amendments must be authorized by a secured party of record. However, if a secured party fails to provide a termination statement a debtor is authorized to file a termination statement which indicates it has been filed

by the debtor. This also cures the problem of the secured party that disappears.

3. Description of Collateral.

Super generic descriptions such as "all assets" or "all personal property" are allowed. The revision overrules court decisions on this point. However, a more specific description must be included in the security agreement.

4. Filing Office Operations.

Filing officers are generally required to accept initial financing statements and may only refuse to accept a financing statement on the bases enumerated in 9-516(b). The filing officer is required to link all subsequent records to the initial financing statement to which the subsequent record relates. The filing officer may delete a financing statement and its related records no earlier than one year after it lapses.

**I. Default and Enforcement.**

1. Parties to Transactions.

The current Article 9 recognizes only debtors and secured parties. The revision redefines debtor, and establishes the new categories of obligor and secondary obligor. The revision generally prohibits pre-default waivers by a secondary obligor of suretyship defenses, even in commercial transactions.

2. Rights of Collection and Enforcement of Collateral.

The new sub-part 6 sets rules on the collection and enforcement of the new forms of collateral such as payment intangibles and is more specific in regard to accounts. The right of self-help repossession was retained following lengthy debate.

3. Rights of Secondary Lienholder.

The revisions returns to the pre-1972 rule that the secured party must give notice of disposition to all other secured parties who have filed financing statements covering the same collateral. The 1972 rule required secondary lienholders to notify the first filed lienholder if the secondary lienholder wanted the notice.

4. Disposition of Collateral.



Safe harbor notices of sale are found at 9-613 for commercial collateral and a plain English version at 9-614 for consumer transactions. Under 9-613 a ten day notice is deemed sufficient.

5. Strict Foreclosure.

Except in consumer transactions, the right of strict foreclosure is expanded to allow acceptance of collateral as partial satisfaction, as well as full satisfaction, of the obligation secured. The right of strict foreclosure is also extended to intangible property. The statute rejects court crafted strict foreclosure in situations where a secured party has retained collateral for what a debtor deemed to be an unreasonable time.

6. Effect of Noncompliance.

The "rebutable presumption" test is adopted for commercial transactions.

**J. Consumer Goods and Transactions.**

Early drafts of Revised Article 9 would have in essence adopted a consumer credit code. Compromises between consumer groups and secured creditor groups deleted many of the early provisions but included special rules on consumer goods and transactions:

The rebutable presumption rule on deficiencies applies only to non-consumer transactions. The remedy for consumer transactions is left to the courts. Presumably the rule of *Holt v. Peoples Bank of Mt. Washington*, 814 S.W.2d 568 (Ky. 1991), will continue to apply in Kentucky. That decision adopted the rebutable presumption rule for sale deficiencies other than notice.

The dual status rule for PMSIs does not apply to consumer transactions.

The FTC anti-holder in due course rule is effective regardless of whether it appears on the secured party's documentation.

Super generic descriptions of collateral are rejected. Greater specificity is required to put the consumer on notice of the collateral that is covered.

Deposit accounts may not be used as original collateral on a consumer transaction.

The minimum civil penalty of 9-507(1) is retained in 9-625(c)(2).

The safe harbor notice of sale must be in the plain English form prescribed by 9-614.

A secured party must provide its debtor with special notification of how a deficiency is calculated at the time it first undertakes to collect the deficiency.

**K. Good Faith.**

The definition of good faith, currently "honesty in fact" is expanded to include "the observance of reasonable commercial standards." this is similar to the changes made in Revised Articles 3 and 4. However, in the context of Article 9, it is sure to increase the risk of lender liability litigation.

V. UCC SCORECARD.

A. 50 State Survey of Adoptions of Revised Official Text of the UCC,  
as of February 1, 1999.

STATES	Article 2A <sup>1</sup> (1990)	Articles 3 & 4 (1990)	Article 5 (1995)	Article 6 <sup>2</sup> (1989)	Article 8 (1994)	Article 9 (1999)
Alabama	Enacted '92	Enacted '95	Enacted '97	REPEAL '96	Enacted '96	No Action
Alaska	Enacted '93	Enacted '93	No Action	REPEAL '93	Enacted '96	No Action
Arizona	Enacted '92	Enacted '93	Enacted '96	REVISE '92	Enacted '95	Intro HB 2235
Arkansas	Enacted '93	Enacted '91	Enacted '97	REPEAL '91	Enacted '95	No Action
California	Enacted '91	Enacted '92	Enacted '96	REVISE '90	Enacted '96	Intro SB 45
Colorado	Enacted '91	Enacted '94	Enacted '96	REPEAL '91	Enacted '96	No Action
Connecticut	Intro HB 5135	Enacted '91	Enacted '96	REPEAL '93	Enacted '97	No Action
Delaware	Enacted '92	Enacted '95	Enacted '98	REPEAL '96	Enacted '97	No Action
District of Columbia	Enacted '92	Enacted '94	Enacted '97	REVISE '97	Enacted '97	No Action
Florida	Enacted '90	Enacted '92	No Action	REPEAL '93	Enacted '98	No Action
Georgia	Enacted '93	Enacted '96	No Action	No Action	Enacted '98	No Action
Hawaii	Enacted '91	Enacted '94	Enacted '96	REPEAL '98	Enacted '97	Intro SB 1582 HB 1626
Idaho	Enacted '93	Enacted '93	Enacted '96	REPEAL '93	Enacted '95	No Action
Illinois	Enacted '91	Enacted '91	Enacted '96	REPEAL '91	Enacted '95	No Action
Indiana	Enacted '91	Enacted '93	Enacted '96	REVISE '97	Enacted '95	Intro SB 409
Iowa	Enacted '94	Enacted '94	Enacted '96	REPEAL '94	Enacted '96	No Action
Kansas	Enacted '91	Enacted '91	Enacted '96	REPEAL '92	Enacted '96	No Action
Kentucky	Enacted '90	Enacted '96	No Action	REPEAL '92	Enacted '96	No Action
Louisiana	No Action	Enacted '92	No Action	REPEAL '91	Enacted '95	No Action
Maine	Enacted '92	Enacted '93	Enacted '97	REPEAL '92	Enacted '97	Intro ' 99
Maryland	Enacted '94	Enacted '96	Enacted '97	No Action	Enacted '96	No Action
Massachusetts	Enacted '96	Enacted '98	Enacted '98	REPEAL '96	Enacted '96	No Action
Michigan	Enacted '92	Enacted '93	Enacted '98	REPEAL '98	Enacted '98	No Action
Minnesota	Enacted '91	Enacted '92	Enacted '97	REPEAL '91	Enacted '95	No Action

STATES	Article 2A <sup>1</sup> (1990)	Articles 3 & 4 (1990)	Article 5 (1995)	Article 6 <sup>2</sup> (1989)	Article 8 (1994)	Article 9 (1999)
Mississippi	Enacted '94	Enacted '92	Enacted '96	REPEAL '94	Enacted '96	No Action
Missouri	Enacted '92	Enacted '92	Enacted '97	No Action	Enacted '97	No Action
Montana	Enacted '91	Enacted '91	Enacted '97	REPEAL '91	Enacted '97	Intro SB 153
Nebraska	Enacted '91	Enacted '91	Enacted '96	REPEAL '91	Enacted '95	Intro LB 550
Nevada	Enacted '91	Enacted '93	Enacted '97	REPEAL '91	Enacted '97	No Action
New Hampshire	Enacted '93	Enacted '93	Enacted '98	REPEAL '93	Enacted '98	No Action
New Jersey	Enacted '94	Enacted '94	Enacted '98	REPEAL '94	Enacted '97	No Action
New Mexico	Enacted '92	Enacted '92	Enacted '97	REPEAL '92	Enacted '96	No Action
New York	Enacted '94	No Action	No Action	No Action	Enacted '97	No Action
North Carolina	Enacted '93	Enacted '95	No Action	No Action	Enacted '97	No Action
North Dakota	Enacted '91	Enacted '91	Enacted '97	REPEAL '93	Enacted '97	No Action
Ohio	Enacted '92	Enacted '94	Enacted '97	REPEAL '96	Enacted '97	No Action
Oklahoma	Enacted '91	Enacted '91	Enacted '96	REPEAL '97	Enacted '95	Intro SB 249
Oregon	Enacted '89	Enacted '93	Enacted '97	REPEAL '91	Enacted '95	No Action
Pennsylvania	Enacted '92	Enacted '92	No Action	REPEAL '92	Enacted '96	No Action
Puerto Rico <sup>3</sup>	No Action	Enacted '95	No Action	REPEAL '96	Enacted '96	No Action
Rhode Island	Enacted '91	No Action	No Action	No Action	No Action	No Action
South Carolina	No Action	No Action	No Action	No Action	No Action	No Action
South Dakota	Enacted '89 <sup>1</sup>	Enacted '94	Enacted '98	REPEAL '93	Enacted '98	No Action
Tennessee	Enacted '93	Enacted '95	Enacted '98	REPEAL '98	Enacted '97	No Action
Texas	Enacted '93	Enacted '95	Intro HB 366 SB 85	REPEAL '93	Enacted '95	No Action
Utah	Enacted '93	Enacted '93	Enacted '97	REPEAL '96	Enacted '96	No Action
Vermont	Enacted '94	Enacted '94	Enacted '98	REPEAL '94	Enacted '96	Intro HB 25
Virginia	Enacted '91	Enacted '92	Enacted '97	REVISE '97	Enacted '96	No Action
Washington	Enacted '93	Enacted '93	Enacted '97	REPEAL '93	Enacted '95	No Action
West Virginia	Enacted '96	Enacted '93	Enacted '96	REPEAL '95	Enacted '95	Intro '99
Wisconsin	Enacted '92	Enacted '96	No Action	No Action	Enacted '98	No Action
Wyoming	Enacted '91	Enacted '91	Enacted '97	REPEAL '91	Enacted '96	No Action

1. South Dakota has adopted only 1987 Official Text without the 1990 Amendments.
2. States which have repealed Article 6 are identified by indicating "Repeal" next to the state name; states adopting the revisions suggested in Alternative B to the 1989 Official Text are identified by indicating "Revise" next to the state name.
3. In addition to the enactments noted, Puerto Rico has only adopted the following Articles: Article 1, Article 4A, the original versions of Article 5 and Article 7, and the 1972 version of Article 9.

Please note that the Enactment Dates does not necessarily reflect the effective date. Please refer to the applicable statute for the relevant effective date. These revisions are based on information available as of February 1, 1999.

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"UCC Scorecard" by John McCabe/Katie Robinson, National Conference of Commissioners on Uniform State Laws, published in Commercial Law Newsletter, ABA Section of Business Law, March 1999. Reprinted by Permission.



**KENTUCKY ADMINISTRATIVE REGULATIONS**  
**REGARDING IMPLEMENTATION OF THE KENTUCKY LIEN INFORMATION SYSTEM**  
**Kentucky Administrative Regulations: Title 30, Chapter 4**

**30 KAR 4:010E. Implementation of Kentucky Lien Information System.**

**RELATES TO: 1998 Ky. Acts ch. 542**

**STATUTORY AUTHORITY: 1998 Ky. Acts ch. 542**

**EFFECTIVE: July 15, 1998**

**NECESSITY, FUNCTION, AND CONFORMITY:** 1998 Ky. Acts ch. 542 establishes the Kentucky Lien Information System and requires the Secretary of State to promulgate administrative regulations for implementing the requirements of 1998 Ky. Acts ch. 542.

**Section 1. Form of Statements.** The form of a financing statement, amendment, assignment, continuation, release, or termination filed pursuant to 1998 Ky. Acts ch. 542 shall be a file-stamped copy of the statement that has been filed with the county clerk pursuant to KRS 355.9-403, 355.9-404, 355.9-405 or 355.9-406. If the file-stamped copy does not indicate the location of filing, the secured party shall state the county of filing on a transmittal letter accompanying the statement and filing fee. When the proper place to file a statement under KRS 355.9-403, 355.9-404, 355.9-405 or 355.9-406 is the office of the Secretary of State, a filing made with the Secretary of State shall serve as a filing pursuant to 1998 Ky. Acts ch. 542 and the filing fee set forth in 1998 Ky. Acts ch. 542 shall not be required. All statements filed pursuant to 1998 Ky. Acts ch. 542 shall be sent to the Secretary of State, UCC Filings, P.O. Box 1470, Frankfort, Kentucky 40602-1470.

**Section 2. Identification Number of Individual.** The identification number for an individual shall be the person's Social Security number or designation consisting of the first three (3) characters of the individual's last name and date of birth in the format mm/dd/yy. If an individual only has two (2) characters in his last name, the letter Z shall be used as the last character. An individual shall not be required to provide a Social Security number as an identification number.

**Section 3. Time of Filing.** A secured party shall have twenty (20) business days from the date the statement is filed with the county clerk to file a file-stamped copy of the statement with the Secretary of State pursuant to 1998 Ky. Acts ch. 542.

**Section 4. Effective Date.** The requirement to file statements pursuant to 1998 Ky. Acts ch. 542 shall begin on January 4, 1999.

**Section 5. Penalty.** A secured party shall be fined \$100 for failure to file a statement pursuant to 1998 Ky. Acts ch. 542 within twenty (20) business days from the date the statement is filed with the county clerk. (25 Ky.R. \_\_\_\_; eff. 7-15-98.)





KENTUCKY SECRETARY OF STATE WEB PAGE  
TO FACILITATE SEARCHES FOR STATEMENTS FILED  
ON THE KENTUCKY LIEN INFORMATION SYSTEM

[SOS Home](#)

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Name Search](#)

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Screen](#)

## **UCC** Kentucky Lien Information System Search

Welcome to the Kentucky Lien Information System Search. This service is offered free-of-charge, 24 hours a day and is updated as filings are made on the system. The Kentucky Lien Information System is a pointer index to all Uniform Commercial Code (UCC) statements filed throughout the state on or after January 4, 1999. The database also includes the complete UCC index of the Secretary of State for nonresident debtors.

Search for statements filed on the Kentucky Lien Information System by name of debtor, name of secured party, county of filing, date of filing, county identification number or any combination of these.

### Debtor

Last Name /  
Company  
Name

First Name

Middle  
Name

### Secured Party

Last Name

First Name

Middle  
Name

County  ▾

County ID

Date Filed  
(County)

<http://www.sos.state.ky.us/intranet/default.htm>



**KENTUCKY'S NEW FILING REQUIREMENTS FOR PERSONAL PROPERTY LIENS**

John T. McGarvey  
M. Thurman Senn  
**Morgan & Pottinger, P.S.C.**

Secured parties who file, continue, amend, assign, partially release, or terminate a financing statement in Kentucky must meet the new filing and debtor identification requirements of House Bill 739 that became law on July 15, 1998.

The new law makes two distinct and equally important changes to the Article 9 lien perfection process. First, the law adds a requirement that a debtor's identification number be included on all financing statements (UCC-1s), and continuation, amendment, assignment, partial release and termination statements (UCC-3s). Second, the law requires that secured parties must make an additional filing with the Secretary of State. The filing with the Secretary of State must be made beginning January 4, 1999, however, due to an ambiguity in the statute, some creditors began filing with the Secretary of State on July 15, 1998.

HB739 amended sections 9-402, 9-403, 9-404, 9-405, and 9-406 of Article 9 of the Uniform Commercial Code (KRS Chapter 355) to require that "the identification number of the debtor" be included in financing, continuation, termination, assignment, and partial release statements. The legislative intent was clearly that the effective date for the amendments would coincide with the January 4, 1999, operational date for the Kentucky Lien Information System, however, the Legislature did not include a special effective date in the bill. Thus, the consensus is that the requirement for identification numbers took effect July 15, regardless of the date that filing is required with the Secretary of State.

Business entities are identified on UCC filings by their taxpayer identification number. Individuals are most often identified by their social security number, however, individuals who object to the use of their social security number are provided an alternative means of identification. An administrative regulation, set forth at 30 KAR 4:010E, allows individuals to select an alphanumeric designator that consists of the first three letters of the individual's last name followed by their date of birth in the format mm/dd/yy. If an individual's name has only two letters, the letter "z" is used as the third letter.

If you filed a UCC document after July 15, 1998, and did not include a debtor identification number, a UCC-3 amendment can be used to correct the error, however, priority arguments may arise between competing filings. If you filed a continuation statement without the identification number, and you are still within the six-month window for filing, one possible solution is to file a new continuation statement with the identification number. The "not seriously misleading" defense (KRS 355.9-402(8)) always remains available, particularly during this transition period.

The document to be filed with the Secretary of State is "a file stamped copy" of the document filed with the county clerk. The Secretary of State will *not* promulgate either a special form to be filed or a transmittal form to accompany documents to be filed. The filing sent to Frankfort need not be a "carbon" of the UCC-1 or UCC-3 but may be a copy of an acknowledgment received from a county clerk. The primary requirement is that the document filed with the Secretary of State contain all of the local filing information such as file number, date, and time.

If the county clerk's filing stamp is illegible, the Secretary of State will attempt to contact the clerk to obtain the local filing information. Filings on which the local filing information has been

“enhanced” for clarity will be accepted. If the copy submitted to the Secretary of State does not evidence the place of filing, that information should be included in a transmittal letter.

Secured parties must file with the Secretary of State within 20 business days from the date that a county clerk stamps the document to be filed in Frankfort. The file stamped copy is sent with \$1.00 per form to: Secretary of State, UCC Division, P.O. Box 1470, Frankfort, KY 40602-1470. The address for courier delivery is: Secretary of State, UCC Division, Rm. 86, The Capitol, 700 Capitol Avenue, Frankfort, KY 40601.

The administrative regulation imposes a fine of \$100.00 on secured parties who do not file with the Secretary of State within 20 business days of filing with a county clerk. In a worst case situation the Secretary of State could attempt to collect tens of thousands of dollars from creditors who are either unaware of the new system or chose to ignore the additional filing requirements.

The final section of the legislation creating the new filing system states: “The filings in the Office of the Secretary of State required under this section are for information purposes only and are not intended to convey notice or constitute perfection. Any legal reliance shall be on the basis of the requirements of KRS 355.9-401 and the filings under KRS 355.9-401.” Regardless, the new filing requirements are a new part of Article 9. The filing with the Secretary of State may not “constitute perfection, however, the most serious potential consequence of not filing with the Secretary of State could be a court decision that finds a security interest is not perfected because the secured party did not comply with the new requirements of part 4 of Article 9.

Fixture filings, filings that relate to minerals (other than coal) and timber to be cut, and filings where the Secretary of State is initially the proper filing officer are not required to be filed in the Secretary of State’s new system. But secured parties must remember that the requirement for debtor

identification numbers applies to **all** UCC filings, even mortgages filed as a fixture filing, and is not related the requirement to file with the Secretary of State . Only lien filings outside the UCC system do not require an identification number.

The statutory direction of KRS Chapter 186A created a controversy over whether the identification number had to be included on Title Lien Statements. Amendments enacted in 1986 directed the Transportation Cabinet to develop and promulgate the form of the Title Lien Statement that carries the same information required by KRS 355.9-402. After discussions among officials of the Transportation Cabinet, county clerks, and the authors, on July 30, the Cabinet notified Kentucky's county clerks that it would not require identification numbers on Title Lien Statements.

Identifying debtors by an alphanumeric designator and establishing a central repository of lien information for search purposes are major steps in taking Kentucky's lien filing system into the digital age. Filings in the Kentucky Lien Information System will be instantly accessible through the Secretary of State's web page ([www.@sos.state.ky.us](http://www.sos.state.ky.us)). The goal is to eventually establish a system that preserves the convenience of local filing with county clerks but has the utility of electronic access to a central search system.

To improve the near term usefulness of the new system, the Secretary of State is trying to obtain UCC filing data from the clerks' offices that already use an electronic filing index. But without a requirement to refile existing financing statements (such as those enacted in Colorado and North Dakota) it will be five years and 20 business days from January 4, 1999 until the Kentucky Lien Information System will contain information on all active financing statements in Kentucky.

**QUICK VIEWS ON HOT TOPICS**  
**CRITICAL TO THE KENTUCKY BANKING INDUSTRY**

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**Kentucky Bankers Association**  
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**QUICK VIEWS ON HOT TOPICS  
CRITICAL TO THE KENTUCKY BANKING INDUSTRY**

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## QUICK VIEWS ON HOT TOPICS CRITICAL TO THE KENTUCKY BANKING INDUSTRY

### I. INTRODUCTION

This outline is intended to serve as a general overview of topics not covered in another section of this conference that the Kentucky Bankers Association considers of particular importance to our membership at this point. These topics include issues that are developing currently and are, for the most part, not clearly delineated by case law or established legislation. In addition, as the next legislative session is not until 2000, there is little coverage given to likely legislation. If additional information is needed regarding any of the topics covered, other issues of importance to the banking industry or regarding services offered by the Kentucky Bankers Association and its Bank Counsel Division, you may call at 502-582-2453 or by e-mail at [dstamper@kybanks.com](mailto:dstamper@kybanks.com).

### II. "KNOW YOUR CUSTOMER" COMPLIANCE

**A. The Proposed Rule** - After years of anticipation, the primary federal banking regulators (the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation) finally published for comment, in December 1998, a Notice of Proposed Rulemaking on "Minimum Security Devices and Procedures and Bank Secrecy Act Compliance"—the now infamous "Know Your Customer" regulations. 63 FR 67529. The notice provided for the comment period to expire on March 8, 1999.

By the expiration of the comment period, the FDIC alone had received in excess of 250,000 comments. The comments are notable for a number of reasons. First, the sheer volume is unprecedented. Second, comments were received via both e-mail and hard copy. Third, for the first time, consumer comments greatly outweighed industry comments. This is attributable mainly to the use of the Internet as a source of information or misinformation and the corresponding ease of comment through Internet "point and click."

Of the hundreds of thousands of comments received, approximately 100 were in favor of the regulations. Consumers challenged the proposal on privacy grounds and the industry challenged it on a number of grounds including: unnecessary and redundant additional compliance burdens, consumer privacy concerns, lack of uniformity among all financial service providers (i.e., credit unions and brokerages were not covered by the proposals), and lack of legal authority.

On March 29, 1999 the proposals were withdrawn. 64 FR 14845.

**B. Where Do We Go From Here?** – Despite the withdrawal of the proposed regulations, additional “Know Your Customer” regulations are expected and compliance requirements have not ceased. As you may know, most banking institutions already have in place some security policy, which helps them to identify the accurate identity of customers and to assist with compliance requirements of the Bank Secrecy Act. These are in place for two reasons. One, it has been considered good business. Banks operate under a complicated scheme of regulations, and carefully implemented and followed policies and procedures are the best way to insure compliance. These types of policies help banks to identify who their customers really are and may help to avoid criminal prosecution for even inadvertent involvement in money laundering. Two, the regulators have required and reviewed “KYC” policies as a standard part of their BSA examination for many years, even though there is no clear legal requirement. Whether institutions will want to revisit current policies in light of this recent fiasco is to be seen.

When the regulators publish new proposals, it is unlikely that they will be called “KYC,” due to the huge amount of negative response and attention received from the last attempt. It is more likely to come under the heading of Bank Secrecy Act compliance or security procedures. It is also unlikely to come in a form that is substantially similar to these most recent proposals. It is, however, impossible to guess what that form will be. What we know as a certainty, however, is that the regulators still consider this to be a top priority and continue to review it. We also know that consumer and privacy advocates also see this as a top priority and will not ignore it. Most recently, the American Civil Liberties Union added a page to its website that deals specifically with this issue and financial privacy. The ACLU denounces banks as “spies” and urges consumers to fight for their right to privacy. <http://www.aclu.org/privacy/financial.html>. (See attachment A). The Kentucky Bankers Association will continue to keep a close watch on this and other privacy issues as they relate to our industry.

### **III. CONSUMER PRIVACY ISSUES REVISITED**

Today, more than ever, privacy rights of consumer financial information are a hot topic of discussion. On the one hand, traditional providers of financial services (banks and thrifts) have held a unique position of trust with their customers because of the integrity and necessary responsibility associated with the safekeeping of money and other valuables, including financial information. On the other hand, members of the banking industry have taken full advantages of the available technology and have some of the best and most valuable databases today. Technology today allows this data to be “mined” and therefore is valuable to a number of interested groups—including the government for tracking

information and assets, the banking industry for cross marketing and recommendations for the best economic advantage of the customer, the customer for managing finances and criminals for obvious reasons.

These varied interests in the same information have caused conflict—a conflict that has presented itself when consumers, advocates, legislators and the current Administration is more aware than ever of the potential abuses and frauds relating to the use of and access to financial information. In this developing area, the issue is who has a right to know, access or use this information.

**A. Case Law** – There is very little case law in Kentucky on the issue of consumer privacy rights in financial information. The two cases found are Brents v. Morgan, 299 S.W. 2d 967 (Ky. 1927) and Voneye v. Turner, 240 S.W. 2d 588 (Ky. 1951), which was reaffirmed in Lucas v. Moscan Stores, Inc., 262 S.W. 2d 679 (Ky. 1953).

In the Brents case the Court recognized a private “invasion of privacy” action. In that case the plaintiff, Morgan, owed a debt of \$49.67 to the defendant, Brents. After repeatedly failure to pay, the defendant hung a 5x8 foot sign advising all of his bad debt. The Court in Voneye, however, distinguishes its similar facts from that of Brents on the fact that the disclosure of the bad debt was made to the employer of the debtor. It should be noted, however, that the cases cited here do not set precedent for a clear right of privacy in financial documents.

**B. Legislative Efforts** – Amazingly, there is also very little legislation currently in effect, which limits privacy rights in financial information. The first argument that consumers usually raise regarding privacy concerns is that the action they challenge somehow violates the Fourth Amendment of the U.S. Constitution. That Amendment, however, provides very little of the protection that it is usually cited to offer. The Fourth Amendment applies only to governmental intrusions and had even been interpreted by the U.S. Supreme Court to exclude originals or microfilms of checks, deposit slips and other records of customer bank accounts. U.S. v. Miller, 425 U.S. 435 (1976).

In response to that interpretation, the Right to Financial Privacy Act (12 USC 3401 et seq.) was passed in 1978, which is also often relied upon, in error, by consumers as a shield against information access. The RFPA, like the Fourth Amendment, still only provides limited restriction upon federal agencies in their attempts to access certain consumer information from banks.

A similar protection against government attempts to use certain consumer information, specifically social security numbers, is provided by the Privacy Act of 1974 (5 USC 552a). This Act regulates the collection, maintenance, use and dissemination of information by federal agencies. It limits federal agencies' right to collect social security numbers of individuals to particular

circumstances. Although consumers, particularly those involved in certain militia groups, often cite this statute as limiting a financial institution's right to gather social security numbers as a prerequisite to establishing an account, the Act contains no restrictions on private industry.

More directly impacting the financial service industry's ability to collect and share information, there were a number of consumer protection efforts passed in the 1970's. The most detailed provisions are offered in the Fair Credit Reporting Act (15 USC 1681 et seq.), as amended in 1996, which restricts "consumer reporting agencies" in the furnishing of "consumer reports" only for "permissible purposes." Of course, the first obstacle is to determine whether the entity offering the information is considered a "reporting agency" under the Act and whether the information reported is covered. Once those two determinations are made, the information can only be released for one of the five permissible purposes: a) if the consumer has given written permission; b) for a credit transaction or for insurance underwriting; c) for employment purposes; d) for a legitimate business need for a transaction initiated by the consumer; or e) to an affiliate, provided the consumer is given a reasonable opportunity to, but does not, "opt out." This last section was added in 1996 and has caused the most recent confusion because of the lack of guidance regarding what constitutes a "reasonable opportunity to opt out." The OCC released some guidelines, dated March 29, 1999 regarding acceptable efforts. (See **attachment B**).

Additionally, more limited privacy provisions were included in the Electronic Funds Transfer Act, the Fair Debt Collection Practices Act, the Fair Credit Billing Act and the Telemarketing and Consumer Fraud and Abuse Prevention Act.

Since 1996, the Administration, the Commerce Department, the Federal Trade Commission and the primary banking regulators have warned that, absent strict self-regulation by the industry, there will be a need for stricter privacy laws. Industry representatives, including trade associations, have urged the industry to take the lead in this area. In June 1998 the national trade associations issued a proposed "U.S. Banking Industry Privacy Principles" that could be adopted and tailored to suit the needs of each institution. (See **attachment C**).

The federal banking regulators have begun offering guidelines for self-regulation. Most recently, the OCC, on May 4, 1999, issued AL 99-6 addressing the development of good web privacy practices. This guidance does not set new regulatory standards, but offers examples of privacy practices currently used by national banks and "endorsed" by the OCC. (See **attachment D**).

The Administration is also taking a strong stance on this issue. On May 4, 1999, the Clinton-Gore Plan for Financial privacy and Consumer Protection in the 21<sup>st</sup> Century was unveiled. This package would require banks, among other things: a) to inform consumers of information sharing with affiliates and offer "opt outs;" b) give examiners additional powers to review privacy policies; and c) include additional disclosure requirements on credit transactions. (See attachment E).

An effort that is more tenuous, but may still effect financial institutions in Kentucky is the European Union's Directive on Data Protection (95/46/EC), which went into effect October 25, 1998. This directive requires institutions in the EU to adopt privacy policies and it provides to enforcement power. The part that may effect Kentucky institutions is that which prohibits the international sharing of information between institutions, or within an institution, if the recipient is located in a country that does not have equally strict privacy protections. The U.S. Department of Commerce on April 19, 1999 issued guidance on compliance with that directive. (See attachment F).

**C. Consumer Advocate Activities** – There is never a shortage of consumer and privacy advocates ready to take on the cause. Financial information privacy has received more attention than ever because of the Know Your Customer proposals. (See attachment G).

**D. Government Interests** – The sections above discuss, primarily, the conflicts that arise between the consumer and the holder of the information and their respective responsibilities. An even more interesting development is the conflict that arises between the industry, which wants to protect this information and retain consumer trust, and the government, which wants free access to this information as a means of law enforcement assistance. The Know Your Customer proposals and Bank Secrecy Act reporting requirements are just a few examples. More frequently, federal and state agencies are finding value in information maintained at financial institutions. This has primarily come about because of the accuracy of this information. In no other single database is there more likely to be such detail and accuracy as in the banks.

Other examples of efforts by the government to access this information include the data matching requirements mandated by federal law for the tracking of assets of delinquent non-custodial parents. Financial institutions are now required to match information from "delinquent support" rolls against account information and freeze funds for the government. Similarly, the Kentucky Department of Revenue attempted a similar activity, when it required sheriffs in certain counties to deliver distraint orders to all banks located in those counties. These distraint orders had attached copies of thousands of delinquent tax bills. They attempted to order the financial institutions to search their accounts and freeze any funds belonging to the

identified taxpayers. The financial institutions involved challenged the orders in court, and the Knox Circuit Court ruled, in Union National Bank, et al v. Sheriff of Knox County, Knox Circuit Court, Civil Action Number 98-CI-00503 (1/21/99), in favor of the banks, holding that the Revenue Cabinet did not have the legal authority to issue such orders.

There will undoubtedly be more attempts to access financial information by the government, which will result in further legislation or more developed case law.

#### **IV. OVERDRAFT REPORTS ON ATTORNEY TRUST ACCOUNTS**

Recently passed Supreme Court Rule KRPC 1.15 requires attorneys to maintain escrow or trust funds in an account with an institution that agrees to report overdrafts. The new rule has been discussed in detail earlier in this conference by Ben Cowgill, Chief Deputy Bar Counsel for the Kentucky Bar Association. In the March issue of the Bench & Bar an article appeared, written in the form of a letter, advising financial institutions in general terms of the requirements of the rule. The Kentucky Bankers Association also sent information regarding this rule directly to the financial institutions. The points emphasized to the financial institutions are the following:

- The Rule imposes responsibility and compliance requirements on the attorney, not on the institution. The institution can participate if you choose and enter into an agreement with the attorney customer. However, if an institution elects to not participate, attorney customers are required by this rule to take these accounts to a financial institution that will agree to participate.
- Although the attorney customer is required to obtain "agreement" by the financial institution, that can be done via a letter to the attorney customer. A sample form letter is included in the article and should be provided by the attorney customer.
- The attorney customer is required to identify the accounts that are subject to the Rule's requirements. The institution need not evaluate accounts to make that determination.
- No subjective evaluation of overdrafts needs to be made by the institution. The sole responsibility, should an institution agree to participate, is to send a notice to the Bar each time a properly payable instrument is presented which would cause an overdraft, regardless of whether or not it is actually paid. The Bar will investigate, with the attorney, the circumstances behind the overdraft. A duplicate copy of the overdraft notice that is normally send to customers, sent to the Bar, will fulfill the reporting duty.
- Financial institutions electing to participate are encouraged to work with corporate counsel regarding an indemnification agreement with the attorney customer. If structured correctly, this may be a clause inserted into the letter agreement.



## **V. FEES AND NSF FEES CASES**

The issue of bank fees has been and continues to be a subject of debate with the state legislature and, more recently, fodder for more lawsuits. In July 1998, several class action suits were brought by a single law firm, looking to challenge the non-sufficient funds (overdraft) fees and processing policies of several larger institutions in the Louisville area. Essentially, the named plaintiffs claimed that the fees charged bear no relationship to the cost of processing a returned check and that some of the banks process checks in order from highest to lowest, in order in order to collect the maximum fees. Two of the five cases filed have been dismissed. (98-CI-04238 and 98-CI-04051). Circuit Court Judge Edwin A. Schroering, Jr entered an Opinion and Order in each of the PNC and Fifth Third dismissing all claims of the plaintiffs, ruling that: 1) there was no deception regarding the method of processing or amount of fee charged; 2) NSF fees are not and cannot be liquidated damages; 3) the fees do not constitute a breach of any implied duty of "good faith;" and 4) the fees are not unconscionable.

This is only the beginning of a national trend of challenges against bank fees. This trend is also carrying over to the legislature. It is common for the Kentucky Bankers Association to receive several inquiries during the Session regarding legal bank fees. The industry's position has always been that fees are a competitive/market issue. The Kentucky Bankers Association has already received its first inquiry regarding fees for the 2000 Session.

## **VI. DEPARTMENT OF LIBRARIES AND ARCHIVES**

The Department for Libraries and Archives has issued a regulation regarding document standards for certain filings made with the county clerks' office. 725 KAR 1:070. The documents covered by the regulation include mortgages, deeds, and POAs. The effective date is July 1, 1999.

The regulations requires:

- Documents (except maps, plats, drawings, wills, and instruments which are required by state or federal law to be a certain size) that are to be recorded with the county clerk to be \*on 8 ½ x 11" paper, \*not permanently bound, \*not a continuous form, \*have 1" minimum margins on top, bottom and sides of inner pages, \*have minimum 2" top margin and 1" bottom and side margins of first page, and \*have minimum 2" bottom margin and 1" top and side margins for the last page.
- Maps, plats and drawings to have a 3 x 3" square space at the bottom right corner.
- Printed with dark (equal to Step 8 on a Stouffer Opaque Sensitivity Guide) ink on white, 20-lb. paper with no backgrounds, colors, images or writing. The type must be "crisp, clean, complete and legible" and no smaller than 8-point, non-cursive font. Certain non-essential information does not have to comply

with this provision. Documents may not contain "superfluous decorations" such as wax, seals or ribbons.

- Handwritten signatures to be in dark (black or dark blue) ink.
- That county clerks may accept for filing a document that has been created, certified or accepted for filing by the U.S. Government or the government of a state or nation. Documents executed prior to February 1, 1999 and documents governed by KRS Chapters 355 and 186A are specifically excluded.

The Kentucky Bankers Association continues to work with the Department to have this regulation amended or withdrawn.

**WEB SITE PAGE REGARDING "KNOW YOUR CUSTOMER" REGULATIONS  
AND THE BANK SECRECY ACT**

*American Civil Liberties Union - 1999*

**Defend Your Data**  
*What They DO Know CAN Hurt You*

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AMERICAN CIVIL LIBERTIES UNION FREEDOM NETWORK

DATA DEFENSE KIT

JOIN

Background Information

Information About You

Keep Informed

## Your Financial Privacy

Americans are infuriated when their privacy in banking is assaulted. Late last year, bank regulators proposed "Know Your Customer" regulations that would have required banks to profile their customers, monitor their financial transactions, and report certain unusual transactions as "suspicious" to the super-secret Financial Crimes Enforcement Network (FinCEN) at the Treasury Department. Over 250,000 people wrote to protest this massive invasion of privacy.

Even though the proposed "Spy on Your Customer" regulations have been withdrawn, 86 percent of the banks that are members of the American Bankers Association had already adopted "Know Your Customer" regulations of their own by 1990. That's because under the Bank Secrecy Act, banks are required to report their customers as "suspects" to FinCEN whenever the banker has "reason to suspect" that a large transaction is unusual for the customer and the "bank knows of no reasonable explanation for the transaction."

Financial institutions reported their customers to the government as "suspects" approximately 100,000 times last year alone.

### KNOW YOUR BANKER

Banks are prohibited from disclosing to their customers the content of any "Suspicious Activity Reports" they send to FinCEN about their "suspect" customer. But there is nothing that prohibits a bank from disclosing whether it has adopted a Know Your Customer policy under pressure from the bank regulators or the number of Suspicious Activity Reports it filed last year.

Is your bank spying on you? Ask your banker!

Copy this letter, customize it, and mail it to your banker.

- Don't present it in person when you conduct a large financial transaction. Inquiring about your bank's practices of reporting customers to the government may be deemed "suspicious," particularly when tied to a large transaction.
- Don't settle for a form-letter or a vague, unenforceable financial privacy policy from your banker. Get the facts. Does your bank have a "Know Your Customer" policy, and how many "Suspicious Activity Reports" did it file last year?
- Every inquiry puts bankers on notice that their customers do not want to be spied upon.

If you get a response, you can let us know what your banker said about its spying practices by sending a copy of the reply to:

Field Department - Banker  
American Civil Liberties Union

122 Maryland Ave. NE  
Washington D.C. 20002

And if you haven't already done so, you can also protect your financial privacy by sending a FREE FAX to your Representative urging him or her repeal the Bank Secrecy Act. Finally, join the ACLU's new privacy email list so we can keep you up-to-date about this issue and other threats to your privacy.

### Sample Letter

[your bank's name and address]

[date]

To the Bank Manager:

I am concerned about the privacy of my financial transactions.

I have heard that banks report many large transactions to the federal government's Financial Crimes Enforcement Network (FinCEN) on "Suspicious Activity Reports," and that almost 100,000 such reports were filed with FinCEN last year.

It has also come to my attention that even though there is no requirement to do so, many banks have voluntarily adopted "Know Your Customer" policies. Under these policies, banks keep a profile of their customers, monitor their financial transactions, and report unusual transactions to FinCEN on Suspicious Activity Reports.

Please answer these two questions to reassure me about your commitment to my financial privacy.

1. Has this bank adopted a "Know Your Customer" policy or practice?
2. How many Suspicious Activity Reports did this branch of the bank file with FinCEN during 1998?

I understand that you are prohibited from disclosing the content of any Suspicious Activity Reports to me, but no regulation prohibits you from answering these simple questions. Your responses will help me measure your commitment to my financial privacy.

Sincerely,

[your name]

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<http://www.aclu.org/privacy/financial.html>

**GUIDELINES REGARDING THE FINANCIAL SERVICES INDUSTRY'S  
ABILITY TO COLLECT AND SHARE INFORMATION**

*Office of the Comptroller of the Currency - March 29, 1999*

AL 99-3

Subject: Fair Credit Reporting Act

Date: March 29, 1999

Purpose:

TO: Chief Executive Officers and Compliance Officers of all National Banks, Department and Division Heads, and all Examining Personnel

SUMMARY AND PURPOSE

Recent amendments to the Fair Credit Reporting Act ("FCRA") have enhanced the ability of various businesses, including banks, to exchange customer information among affiliated companies. At the same time, technological advances permit businesses to collect, store, analyze, and disseminate increasing amounts of customer data. Survey data indicate that consumers are sensitive to how businesses, including banks, maintain, use, and analyze information about them. These customer concerns about the accumulation and use of their personal information are likely to increase with the growing use of the Internet and electronic commerce.

The purpose of this advisory is to provide examples from a sampling of existing bank practices that represent effective approaches for complying with notice requirements under the FCRA regarding the sharing of customer information among affiliated companies. These examples are not examination standards and are not intended to be an exclusive description of the various ways in which banks can meet their existing legal obligations under the FCRA, nor do they impose any new obligations on banks. The examples are illustrative of approaches by some national banks that convey meaningful information to their customers about the treatment of personal data. Thus, national banks may find these examples helpful as they develop their own plans and programs to comply with the FCRA.

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BACKGROUND

Fair Credit Reporting Act Amendments of 1996

In 1996, Congress adopted amendments to the FCRA that, among other things, permit the efficient flow of customer information among affiliated companies. [Note 1: The Economic Growth and Regulatory Paperwork Reduction Act of 1996 substantially amended the Fair Credit Reporting Act effective September 30, 1997.] The amendments expanded the opportunity for companies "related by common ownership or affiliated by corporate control" to share, without restriction, transaction and experience information -- information that relates solely to an entity's own transactions or experiences with its customers. [Note 2: 15 U.S.C. 1681a (d) (2) (A) (ii).] This information could include, for example, a

customer's outstanding balance, whether the customer is delinquent in paying bills, [Note 3: See DiGianni v. Stern's, 26 F.3d 346, 348-49 (2nd Cir. 1994), cert. denied, 513 U.S. 897 (1994); Smith v. First National Bank of Atlanta, 837 F.2d 1575, 1578 (11th Cir. 1988), cert. denied, 488 U.S. 821 (1988); Rush v. Macy's New York, Inc., 775 F.2d 1554, 1556-57 (11th Cir. 1985). See also FTC Official Staff Commentary 603(d) item 7A(1) and (3) (May 1990).] and the length of time a customer has held a credit card. [Note 4: FTC FCRA Staff Opinion: Kane-Novak (September 9, 1998).] The law accomplishes this by exempting transaction and experience information from the definition of a consumer report. [Note 5: 15 U.S.C. 1681a(d)(2)(A)(ii). Generally, a "consumer report" is any communication, by a "consumer reporting agency," of any information that bears on a consumer's credit-worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living that is collected or used (or expected to be collected or used) as a factor in establishing the consumer's eligibility for credit, insurance, employment, or any other purpose permissible under the Act. Id. 1681a(d)(1). Reports limited to the consumer's name and address, with no connotations to credit worthiness or other characteristics, do not constitute a "consumer report." FTC Official Staff Commentary at 603(d) item 4F. The law also permits the sharing of transaction and experience information with unaffiliated third parties by exempting such information from the definition of a consumer report. 15 U.S.C. 1681a(d)(2)(A)(i).] Further, the amendments exempt from the definition of a consumer report, the communication among affiliated companies of other information about a consumer (that is, information in addition to transaction and experience information that would ordinarily be considered a consumer report), if certain conditions are met: (1) it is clearly and conspicuously disclosed to the consumer that information may be shared among affiliated companies; and, (2) the consumer is given the opportunity, prior to the time that the information is communicated, to direct that such information not be communicated among the entities. [Note 6: 15 U.S.C. 1681a(d)(2)(A)(iii).] This provision permits a bank to freely share customer information, such as consumer reports or information from a credit application, among affiliated companies if these conditions are satisfied. [Note 7: See Federal Reserve Regulatory Service, Questions and Answers about the Fair Credit Reporting Act, The Financial Institution as a Consumer Reporting Agency, FRRS 6-1605. See also FTC FCRA Staff Opinion: Kane-Novak, supra.]

Failure to comply with these conditions for affiliate information sharing can result in liability (including, administrative enforcement and/or civil action) and can make a bank a consumer reporting agency under the FCRA. A consumer reporting agency is subject to various legal obligations to maintain and safeguard consumer information, including limitations on the purposes for which information can be sold or distributed. [Note 8: 15 U.S.C. 1681b.] Consumer reporting agencies are also required to provide consumers an opportunity to review information maintained about them, as well as to establish particular error resolution procedures and consumer complaint mechanisms. [Note 9: Consumer reporting agencies are required to provide consumers access to all information, except credit scores, maintained in the consumer's file upon request. 15 U.S.C. 1681g(a)(1). In the event a consumer questions the accuracy or completeness of any information in the consumer's file, the reporting agency must conduct a reinvestigation. 15 U.S.C. 1681i.] Therefore, a bank that wishes to share customer information with its affiliates, that is not limited to transaction and experience information and that otherwise meets the definition of "consumer report," without the burden of complying with these requirements on consumer reporting agencies, must adhere to the FCRA opt-out conditions.

While banks may be subject to federal or state laws in other areas of consumer privacy, [Note 10: For example, the Electronic Funds Transfer Act and its implementing regulation, Regulation E, require a bank to

provide its customers a description of the circumstances in the institution's "ordinary course of business" in which it will disclose information about the consumer's account to third parties. 15 U.S.C. 1693c(a)(9); 12 C.F.R. 205.7(b)(9). This disclosure must address all information concerning the account that may be provided to third parties and whether it will be provided to affiliates. See FRB Official Staff Commentary 205.7(b)(9)-1.] those state laws that prohibit or limit the types of information affiliates may share are expressly preempted by FCRA until the year 2004. [Note 11: 15 U.S.C. 1681t (b) and (d)(2). State laws that were preempted by the FCRA do not automatically return in force after the sunset date. Each state must enact new legislation. Id. 1681t (d)(2).]

#### Developments in the Marketplace

Technological innovations and industry consolidation are increasing the magnitude and scope of information sharing in the financial services sector. Improvements in data processing and communications technology now allow more efficient storage, analysis, and rapid dissemination of vast amounts of information. Mergers among companies with the same or diverse lines of business are resulting in companies with the ability to assemble and use large databases of customer information. These developments create new opportunities for banks to use information to custom design products and services to match their customers' needs and preferences. Bank customers benefit from the improved quality of tailor-made goods and services, as well as the increased speed of obtaining financial services. But, while these developments may increase the quantity and quality of many bank services, the expanded use of customer information has also heightened consumer concerns about confidentiality and personal privacy.

Banks have a particular stake in addressing the privacy concerns of customers. Maintaining customer trust that the relationship will remain confidential is an essential component of banking relationships, and banks continually rely on the willingness of customers to provide extensive confidential information. Survey evidence indicates that much of the public's suspicion and concern about the privacy issue generally derives from a lack of knowledge about how a business handles consumer information. [Note 12: See Business Week/Harris Poll, "A Little Privacy, Please" Business Week, March 16, 1998.] The affiliate information sharing notice mandated by the FCRA can provide a convenient vehicle for banks to educate their customers about their information practices, and gives customers an opportunity to control the flow of their information. [Note 13: A recent survey of consumers indicated that 61 percent of the public believe that it is acceptable for companies to do profile marketing generally. The figure increases to 83 percent with prior notice about information uses and an opportunity to opt-out. See survey sponsored by Privacy & American Business, conducted by Louis Harris and Associates and Dr. Alan F. Westin, "Privacy, E-Commerce, and Financial Transactions" (November 1998). ]

#### EFFECTIVE PRACTICES

This section discusses examples of existing bank practices for complying with the affiliate information sharing notice provisions of the FCRA and addresses the contents of the notice, the appearance and prominence of the notice, and the convenience of a customer's opportunity to opt out. While the FCRA does not impose specific requirements for the placement or content of the notice, the following examples illustrate how some banks have used these notices to make their information handling practices more readily understandable to their customers. Likewise, the FCRA does not dictate that consumers be accorded convenient methods to opt out of information sharing. However, we have selected examples of existing practices to highlight how some banks, consistent with the spirit of the law, have made the opt out process easier for their customers to use.

Content of Affiliate Sharing Notice [Note 14: Some banks have selected a question and answer format to convey information about their usage of customer data. This is one method for conveying basic information to customers in a clear and easily understood format.]

#### What type of information is shared

A simple and concise description of the types of information that a bank intends to share among affiliates enables customers to make informed choices about whether to opt out of affiliate information sharing. For example, a number of banks inform their customers, when it is the case, that they share consumer reports in addition to other types of information, such as information from a customer's application, unless a customer opts out, rather than simply tell their customers they intend to share "other information" -- the terminology employed by the statute. Some banks provide additional disclosures to make their information sharing practices more transparent to their customers. For instance, some banks explain that they share the following types of information with affiliates: identification information (such as name and address), transaction and experience information (such as loan repayment history), and other personal information (such as information obtained from an application or consumer report). The banks explain that, unlike transaction and experience information that they may share among affiliates by law, customers may direct that certain other personal information (i.e., information contained in an application, information from consumer reports) not be similarly shared.

#### With whom is the information shared

Some banks inform customers of the names of their affiliated companies with which information will be shared and/or a description of their lines of business. In situations involving numerous affiliates, a generally stated description of the types of business they conduct is used instead. Other banks provide their customers with an expressly stated representative sample of the names or lines of business of their affiliates. (Banks that identify their affiliates by name or business type should be aware of the potential need to update their notices if there is a change in circumstances.) In describing their affiliates, some banks choose to use a term other than "affiliate" to avoid potential customer confusion, such as "members of the corporate family."

#### Purpose for the sharing

Notices may also contain basic information about the reasons why the bank shares personal data. Some banks describe specific ways in which information sharing benefits their customers. For example, certain banks explain that by knowing that a particular individual owns a home, the bank can direct that consumer to a home equity loan to finance a purchase because of the favorable tax consequences, rather than an unsecured installment loan. Other purposes for information sharing may be to reduce the customer's burden in having to provide duplicative information each time the customer applies for a new product or service from an affiliated company, or to identify customers for better pricing on products or services. Banks sometimes disclose these types of specific benefits in addition to more general disclosures that sharing customers' information enables a bank to design or improve products and services, such as new types of account or investment services. These types of disclosures also provide the bank a good opportunity to promote and distinguish its customer service.

#### Presentation of Notice

There are various ways that banks make FCRA notices clear and conspicuous



to customers. Some banks provide customers with the notice in a stand alone document. [Note 15: Banks must not only provide this notice to new customers, but must also provide notice to existing customers. Some banks have sent separate mailings, such as postcards, to their customers to provide the requisite notice. Other banks have sent this notice to existing customers in their regular customer statements.] Other banks have chosen to include the notice in a document containing additional information, such as an account agreement. Banks can employ a number of devices to highlight the notice, including (1) putting a box around it, (2) putting it in bold type, (3) putting it in type that is larger than other portions of the text, (4) putting the notice in a different color than other portions of the agreement, (5) captioning the notice to call attention to its contents, (6) underlining the notice, or (7) doing a combination of several of these steps. As part of its FCRA notice, one bank provides a telephone number its customers can call with questions about information sharing and opt out.

#### Convenience of Customer Opt Out

For bank customers who are concerned about maintaining the privacy of their personal information, being furnished with a convenient mechanism for opting out of affiliate information sharing is a value-added service. Banks have many options to provide customers convenient opportunities to opt out of information sharing, including providing their customers with detachable opt out forms as part of the affiliate information sharing notice or self-addressed opt out postcards. Additionally, some banks allow for opt out by telephone or by electronic means (for instance, by personal computer via the bank's Web site). [Note 16: If a bank chooses to permit opt out by means other than in writing, the bank should create a record of the opt out.] One bank provides a check-off box in a prominent position on its credit applications -- within the box containing the signature line -- that customers can mark to elect to opt out of information sharing.

#### CONCLUSION

Banks that share particular personal information with their affiliates may use the notice requirements of the FCRA as an opportunity to inform their customers about their information handling practices and further provide their customers with convenient mechanisms for opting out of such sharing. At a time of growing public sensitivity and concern about the proper treatment of personal information, this type of meaningful communication may enhance customer confidence and trust in their financial institutions.

#### FURTHER INFORMATION

For further information or questions relating to this advisory, please contact Amy Friend, Assistant Chief Counsel, (202)874-5200.

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Julie L. Williams  
Chief Counsel



**MODEL U.S. BANKING INDUSTRY PRIVACY PRINCIPLES****- June 1998 -*****The American Bankers Association  
The Consumer Bankers Association  
The Bankers Roundtable*****BANKING INDUSTRY  
PRIVACY PRINCIPLES FOR U.S. FINANCIAL INSTITUTIONS  
INTRODUCTION**

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Financial institutions in the United States are well aware of the need to protect privacy in all forms of commerce. With the advent of electronic banking, consumers are more attuned than ever to the need to protect personal information. The American Bankers Association (ABA), Consumer Bankers Association (CBA) and the Bankers Roundtable (BRT) have developed joint industry privacy principles for the benefit of bankers and consumers.

**INDUSTRY PRIVACY STATEMENT**

The membership of the participating understand the special duty that financial institutions have with safeguarding their customers' sensitive information. Though this information may be required to be obtained by law or sought by the institution for proper business purposes, such personal information is also vital to each bank's ability to provide its customers with quality service.

Our members recognize the reasonable expectation of privacy for all their customers and the importance of protecting that privacy. Bankers subscribe to these principles as one method to protect customer privacy. These principles may also serve as a foundation upon which individual banks can build their own privacy principles, either as a separate document, or in their institution's code of conduct, tailored to their particular needs and circumstances.

***U.S. BANKING INDUSTRY  
PRIVACY PRINCIPLES*****1. Recognition of a Customer's Expectation of Privacy**

Financial institutions should recognize and respect the privacy expectations of their customers and explain principles of financial privacy to their customers in an appropriate fashion. This could be accomplished, for example, by making available privacy guidelines and/or providing a series of questions and answers about financial privacy to those customers.

**2. Use, Collection and Retention of Customer Information**

Financial institutions should collect, retain and use information about individual customers only where the institution reasonably believes it would be useful (and allowed by law) to administering that organization's business and to provide products, services and other opportunities to its customers.

**3. Maintenance of Accurate Information**

Financial institutions should establish procedures so that a customer's financial information is accurate, current and complete in accordance with reasonable commercial standards. Financial institutions should also respond to requests to correct inaccurate information in a timely manner.

**4. Limiting Employee Access to Information**

Financial institutions should limit employee access to personally identifiable information to

those with a business reason for knowing such information. Financial institutions should educate their employees so that they will understand the importance of confidentiality and customer privacy. Financial institutions should also take appropriate disciplinary measures to enforce employee privacy responsibilities.

#### **5. Protection of Information via Established Security Procedures**

Financial institutions should maintain appropriate security standards and procedures regarding unauthorized access to customer information.

#### **6. Restrictions on the Disclosure of Account Information**

Financial institutions should not reveal specific information about customer accounts or other personally identifiable data to unaffiliated third parties for their independent use, except for the exchange of information with reputable information reporting agencies to maximize the accuracy and security of such information or in the performance of bona fide corporate due diligence, unless 1) the information is provided to help complete a customer initiated transaction; 2) the customer requests it; 3) the disclosure is required by/or allowed by law (i.e. subpoena, investigation of fraudulent activity, etc.); or 4) the customer has been informed about the possibility of such disclosure for marketing or similar purposes through a prior communication and is given the opportunity to decline (i.e. "opt out").

#### **7. Maintaining Customer Privacy in Business Relationships with Third Parties**

If personally identifiable customer information is provided to a third party, the financial institutions should insist that the third party adhere to similar privacy principles that provide for keeping such information confidential.

#### **8. Disclosure of Privacy Principles to Customers**

Financial institutions should devise methods of providing a customer with an understanding of their privacy policies. Customers that are concerned about financial privacy will want to know about an institution's treatment of this important issue. Each financial institution should create a method for making available its privacy policies.

GUIDANCE TO NATIONAL BANKS ON WEB SITE PRIVACY STATEMENTS*Office of the Comptroller of the Currency - May 4, 1999*

AL 99-6

Subject: Guidance to National Banks on Web Site Privacy Statements

Date: May 4, 1999

TO: Chief Executive Officers of all National Banks, Department and Division Heads, and all Examining Personnel

PURPOSE

This guidance provides national banks with examples of effective practices for informing consumers who access bank Internet sites about bank privacy policies for the collection and use of personal information. The guidance also discusses examples of effective practices for the development of bank privacy policies and for ensuring adherence to those policies.

BACKGROUND

Banks increasingly are using the Internet as a medium for communicating with their customers, and, to a lesser extent, as a vehicle for enabling their customers to conduct financial transactions. The success of banks in expanding the amount and type of business they and their customers conduct on line will depend largely on customer acceptance of this medium for making financial transactions. Survey data indicate that consumers are sensitive to how businesses, including banks, maintain, use, and analyze information about them. These consumer concerns about the accumulation and use of their personal information are likely to increase with the growing use of the Internet and electronic commerce.

Because a fundamental component of the bank/customer relationship is a customer's trust in the institution to respect the privacy and confidentiality of that relationship, it becomes even more important for banks to reassure customers about the safeguarding of their personal information when it is communicated in a remote, on-line environment. Indeed, informing customers about bank policies for handling of personal information may well increase consumer confidence in transacting business electronically. [Note: A recent Harris-Westin survey found that the majority of Internet users who purchased goods or services on line said that it was very important for businesses to post notices on their Web sites explaining how they will use the personal information customers provide when making purchases over the Internet. Further, the survey found that of consumers not likely to access the Internet in the next year, greater privacy protection was the factor that would most likely convince them to use the Internet. E-Commerce and Privacy: What Net Users Want, a survey conducted by Louis Harris and Associates, Inc. and Dr. Alan F. Westin, June 1998.] The Internet, thus, presents banks with both new business opportunities and new challenges for addressing legitimate expectations of customers about the privacy and security of their personal information.

A number of institutions have recognized the growing importance of privacy to their customers and have developed, implemented, and communicated privacy policies. [Note: A number of the banking trade associations -- the American Bankers Association, the Consumer Bankers Association, the Banking Industry Technology Secretariat of the Banker's Roundtable, American's Community Bankers, and the Independent Community Bankers of America -- have adopted a core set of banking industry privacy policies. These industry-wide policies have been used by many banks as a starting point for developing privacy policies tailored to their individual

corporate practices. ] Generally, these policies encompass one or more of the following five areas: (1) notice to consumers about the institution's information practices; (2) consumer choice about the disposition of personal information; (3) accuracy of personal information maintained by the institution; (4) security measures to protect consumers' personal information; and (5) mechanisms to handle consumer questions or complaints about the handling of personal information. [Note: For a discussion of widely accepted principles concerning fair information practices see Privacy Online: A Report to Congress, Federal Trade Commission, June 1998 (posted at [www.ftc.gov/reports/privacy3](http://www.ftc.gov/reports/privacy3)). ] This guidance provides examples from a sampling of these existing bank practices that represent effective approaches for the development and implementation of privacy policies and their posting on bank World Wide Web (Web) sites.

Although this guidance is targeted at banks that operate Web sites, the examples of practices and procedures for developing and implementing privacy policies are pertinent to any national bank considering establishing or revising a privacy policy and related procedures. Thus, national banks may find these examples helpful as they develop their own privacy policies and implementation procedures. These examples are not examination standards, do not impose new regulatory requirements on banks, and are not intended to be an exclusive description of the various ways banks can devise and communicate effective privacy policies.

#### EXISTING LEGAL REQUIREMENTS

Financial institutions, historically, have taken special care to protect the privacy and security of confidential customer information and have long been subject to a number of federal and state laws that govern the handling of such customer information. These laws and regulations may apply to aspects of the operation of bank Web sites. [Note: Banks offering PC banking were reminded to be familiar with applicable privacy rules that could restrict their ability to share information with third parties that they obtain from their customers. See Technology Risk Management: PC Banking, OCC Bulletin 98-38, August 24, 1998. The OCC also recently issued an Advisory Letter alerting bankers to the practice of "pretext phone calling," which is a means of gaining access to customers' confidential account information by organizations and individuals who call themselves "account information brokers." This letter was also intended to enhance institutions' awareness regarding the confidentiality and sensitivity of customer information generally, and identify some appropriate measures for the safeguarding of such information. See OCC Advisory Letter 98-11. ] For example, banks operating Web sites that permit customers to transfer funds electronically into and out of their accounts [Note: An "account" for the purposes of the Electronic Funds Transfer Act (EFTA) is defined as a demand deposit, savings deposit or other consumer asset account held directly or indirectly by a financial institution, established primarily for personal, family or household purposes. 15 U.S.C. .1693a(2); 12 C.F.R. 205.2(b)(1).] must inform these customers, among other things, about the situations in which the bank, in the "ordinary course of business," will disclose information about the customers' accounts to third parties. [Note: Id. .1693c(a)(9); 12 C.F.R. 205.7(b)(9). This disclosure must describe the circumstances in which any information concerning the account may be provided to third parties, including affiliates. See FRB Official Staff Commentary 205.7(b)(9)-1.

Banks may make this disclosure by mail, or, for a discussion of how banks may satisfy the EFTA's disclosure requirements by electronic means, see the interim rule currently in effect at 12 C.F.R. 205.4(c)(2), 63 Fed. Reg. 14528 (March 25, 1998).

Additionally, if a bank permits customers to apply for credit over its Web site, the Fair Credit Reporting Act's conditions for sharing certain customer information outside of the bank may apply. [Note: The Fair Credit Reporting Act (FCRA) provides that certain consumer information that is shared among affiliates is not a "consumer report" if there is clear and conspicuous notice to the consumer that the information may be shared and the consumer is given an opportunity to direct that the information not be shared ("opt out" notice). 12 U.S.C. .1681a(d)(2)(A)(iii). For a further discussion about the FCRA, the different types of consumer information that it covers, and examples of effective practices for satisfying the notice and opt out requirements related to sharing of information among affiliates, see OCC Advisory Letter 99-3.

#### EFFECTIVE PRACTICES

This section discusses examples of existing bank practices that the OCC considers effective means for communicating a bank's privacy policies, developing a bank's policies for handling customer information, and ensuring adherence to stated policies.

##### Communication of Privacy Principles

The most effective disclosures of privacy principles are clear, prominent, and easy to understand. In general, effective disclosures avoid communicating complicated information in a complex and technical way. Many banks that post privacy notices on their Web sites acknowledge their customers' privacy expectations and indicate how the bank will safeguard and handle personal information. In many instances, banks inform their customers that the bank takes measures to limit employee access to confidential information and to maintain accurate and up-to-date consumer records. Some banks also describe the general circumstances under which the bank will share information with third parties. Some banks explain that customers have a choice about how their information is shared and provide a convenient way to "opt out" of mail or telephone solicitations. Additionally, some Web site privacy policies explain the bank's collection and usage of customer information that is unique to the online environment, such as "cookies." [Note: A "cookie" is a piece of information that a Web site stores on a visitor's Web browser that is retrieved when the visitor logs onto the site again. ] To ensure that these stated principles are readily understood, some banks have supplemented their privacy principles with a series of questions and answers about the handling of customer information. [Note: Many banks use their Web sites as the only medium for communicating their privacy policies to customers. Some banks, however, provide customers with written copies of their privacy policies as a stand alone document or in conjunction with other written materials.

Banks have used a number of different devices to feature their privacy statements prominently. Banks with effective communication practices have posted privacy policies at specific locations on their Web sites where they may be most meaningful to the consumer. For instance, a bank that permits customers to submit on-line credit applications displays its privacy policy at the point at which the customer is asked to submit personal information. Many banks place "hypertext" links or "hotlinks" to privacy statements on their Internet home pages and/or on Web site transactional pages (e.g., on-line banking or small business pages) that automatically present disclosures to customers when the option is selected. Several banks place links to their privacy policies in the footer of each of their Web site pages.

### Developing an Effective Privacy Policy

Banks with effective privacy policies also take steps to ensure that their internal policies and procedures are consistent with and support stated privacy promises.

#### Senior Management Involvement

Effective policies and procedures often involve senior management's knowledge of, and involvement in, the planning process. Senior management can provide a broad perspective on the issues, dedicate appropriate resources to accomplish the task, and create the necessary culture to ensure that privacy matters are addressed comprehensively and consistently across the organization. In a number of banks, the teams or personnel responsible for developing privacy policies and procedures report directly to senior officials.

#### Interdisciplinary Working Groups

A number of banks, particularly large banks, have formed privacy working groups, teams, or task forces consisting of members from various departments in the bank (e.g., legal, marketing, compliance, retail, systems, security, and human resources) to either update or develop their privacy policies and procedures for handling customer information. The multi-disciplinary team approach has enabled banks to centralize efforts, while ensuring that diverse interests and perspectives in the company are represented. One institution that used the team approach to develop an institution-wide privacy policy is relying on individual business units to develop appropriate implementation plans to support the policy. Some smaller institutions, however, with different business considerations and personnel resources have found that an interdisciplinary team was not needed to develop privacy policies. In these cases, senior management appointed a particular division or employee to develop policies and procedures.

#### Review of Existing Procedures and Systems

Often the individuals or groups responsible for establishing policies and procedures reviewed existing systems, operations, and other internal policies to better understand current information practices, to assess risks associated with information handling, and to avoid promulgating privacy promises that could not be met. Additionally, reviews have involved an assessment of which, and the extent to which, existing systems and practices needed to be modified to accommodate a bank's new or revised privacy policy. [Note: Because of changes in bank systems, operations, and technology, banks expect these reviews will need to be ongoing or periodic.]

#### Review of Relationships with Third Parties

In addition to reviewing internal procedures and practices, many banks have reviewed their relationships with unaffiliated third parties to assess their adherence to the bank's privacy policies. Several banks that provide customer information to unaffiliated third parties for joint marketing purposes or operational support, such as data processing, have required the third party to execute a confidentiality agreement and agree to limit the use of information. Some banks also monitor these third parties for compliance with their agreements and/or give their customers prior opportunity to opt out of the information sharing where



feasible (e.g., joint marketing).

#### Enhancing the Effectiveness of the Bank's Privacy Policy

Banks with effective privacy policies take measures to enhance their employees' understanding of compliance with such policies. These banks have supported their policies with employee training and compliance mechanisms.

#### Internal Communication and Training

Banks with effective privacy policies take steps to ensure that their policies are understood by bank personnel involved in the handling of confidential customer information. These banks widely communicate the policies among appropriate bank employees and support them with employee training. For example, banks have informed their employees about their privacy policies through employee handbooks, codes of ethics, articles in company newspapers, Intranet postings, individual mailings from senior management, or the distribution of policy guidance. Some banks have supplemented communications with various forms of training -- live sessions, handbooks or videos. Many banks require employee acknowledgment of training, i.e., the staff must formally acknowledge their understanding of privacy/confidentiality policies, by signing a form. Where the bank's privacy policies have been incorporated into the bank's code of ethics, officers and employees have been required to certify their own compliance (annually or periodically) with the ethics code.

#### Compliance

A number of banks have established programs or procedures to enhance compliance with their privacy policies. Some banks require individual business unit compliance officers to establish appropriate compliance plans and/or require periodic self assessments by business lines to determine the adequacy of their adherence to procedures and internal controls. Others determine the adequacy of compliance through internal audits (the frequency of which is determined by the risk associated with the individual lines of business), or use audits to supplement the activities of business line managers or compliance officers. Depending on the size of the institution or the nature of the activity at issue, some institutions rely on periodic reviews rather than formal audits to monitor compliance with privacy policies.

Most banks have procedures designed to deter employee violations of their policies. An employee's failure to comply with a bank's privacy policy is often subject to the same disciplinary actions as any other breach of bank policy -- including termination where appropriate. These personnel procedures have been provided for in banks' ethics codes, codes of conduct, or human resource policies.

Additionally many banks have established mechanisms for handling consumer privacy complaints and inquiries. Some banks provide for a central point of contact within the bank to handle customer privacy issues. For instance, some banks provide an e-mail link on their Web sites for privacy related questions or complaints. Another bank has appointed an ombudsman to handle customer privacy complaints. Still, another bank catalogues privacy complaints, and depending on their nature, routes them to different centralized locations for handling. Each business line is expected to appoint a privacy officer and track and correct

privacy complaints in another bank. Some banks have determined that, because of their size or the nature of the activities they conduct, they can use established mechanisms or procedures within the bank designed to deal with customer complaints, generally, to handle customer privacy related complaints.

CONCLUSION

At a time of growing public sensitivity and concern about the treatment of personal information, bank privacy policies may enhance customer confidence and trust in their financial institutions. When posted on bank Web sites, privacy policies may increase customer acceptance of the Internet as a medium for conducting financial transactions. The most effective privacy policies found on bank Web sites are those that are posted prominently, contain clear and readily understandable disclosures about the handling of customer information, and are supported by consistent internal procedures and methods to enhance compliance by bank personnel.

FURTHER INFORMATION

For further information or questions relating to this advisory, please contact Amy Friend, assistant chief counsel at (202) 874-5200.

Julie L. Williams  
Chief Counsel

**THE CLINTON-GORE PLAN**  
**FOR FINANCIAL PRIVACY AND CONSUMER PROTECTION IN THE 21<sup>ST</sup> CENTURY**

*May 4, 1999*

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release

May 4, 1999

**THE CLINTON-GORE PLAN FOR**  
**FINANCIAL PRIVACY AND CONSUMER PROTECTION IN THE 21st CENTURY**  
May 04, 1999

**DETAILED PROPOSAL SUMMARY**

**INTRODUCTION**

Technology and competition in financial services give Americans more complex choices than ever before. Innovations in the financial marketplace offer millions of consumers new, ever increasing choices for investing their savings and obtaining credit. But new products have brought new risks and new abusive practices. We must update our consumer protection laws to give consumers the power, information and protection they need to profit from our 21st Century financial system.

Members of Congress, including Ranking Members Sarbanes and LaFalce, have sponsored important legislation to modernize our consumer financial protection laws. We applaud their leadership and look forward to working with Congress on a consumer protection agenda.

Set forth below is a series of actions that the Clinton Administration believes should be part of this agenda. The list is not exhaustive, and we will continue to look for constructive ideas in these and other areas. Among the issues deserving further scrutiny are lending practices such as "pay day" loans (short-term loans which can carry interest rates of 400%) and bank check processing practices that may be designed to maximize bounced check fees. We will work with the states and the FTC wherever possible. Secretary Cuomo is making important efforts to address abusive mortgage lending practices.

**PROTECT FINANCIAL PRIVACY**

Require institutions to inform consumers of plans to share or sell their financial information, and give the consumer the power to stop it. Although consumers put great value on the privacy of their financial records, our laws have not caught up to technological developments that make it possible and potentially profitable for companies to share financial data in new ways. Current law does provide some privacy protections: for example, the Fair Credit Reporting Act (FCRA) requires a form of notice and opt-out before certain information about consumers (e.g., information provided on an account application) can be shared. But there are no limits on the sharing of information about consumers' transactions (e.g., account balances, who they write checks to) within a financial conglomerate, or even on the sale of that information to a third party. We support legislation to give consumers control over the use and sharing of all their financial information.

Impose special restrictions on any sharing of medical information within a financial conglomerate. One of our greatest privacy concerns involve medical information. Yet, cross-industry mergers and consolidation have given banks unprecedented access to consumers' medical records. We support legislation requiring that medical information, such as that gathered from life insurance records, not be shared within financial services conglomerates (e.g., between banking and insurance affiliates) or with third parties, except for narrowly defined purposes. Consumers

who undergo physical exams to obtain insurance, for example, should not have to fear that the information will be used to lower their credit card limits or deny them mortgages.

Give bank regulators the authority they need to ensure compliance with existing privacy protections. Currently, bank regulators may not examine for compliance with existing privacy protections, but must wait for a consumer complaint. Congress should give regulators broader authority to monitor compliance.

Publicize best practices in the privacy area. Even in the absence of legislation, many responsible banks have begun posting their privacy practices on the Internet and otherwise informing customers about how their data is handled. The Office of Thrift Supervision has issued guidance in this area. Today, the Office of the Comptroller of the Currency is publishing best practices in this area, so that additional institutions can be encouraged to inform their customers and do so in the most effective way possible.

Coordinate privacy policy in the financial and other sectors. We must ensure that a proper balance is struck between information flows and personal privacy, for financial services and more broadly. To coordinate the Administration's privacy policy, we have created the new position of Chief Counselor for Privacy, in the Office of Management and Budget.

#### EXPANDING THE CONSUMER'S RIGHT TO KNOW

##### Credit Card Disclosures

Prevent Misleading Credit Card Marketing of "Teaser" Rates. Consumers frequently complain that they did not understand marketing materials on credit card interest rates and are shocked when rates skyrocket, whether because a "teaser" rate expired or they had a minor late payment. Some consumers are misled by mailings that promote a "low 3.9% initial rate" but fail to disclose as prominently that the rate doubles or triples in six months or with a single late payment. We support legislation requiring "teaser" rates for credit cards to be accompanied by equally prominent disclosure of the expiration date of the initial rate and the eventual APR.

Require Credit Card Minimum Payment Disclosures. In recent years, credit cards lenders have lowered minimum payments. Many consumers still assume, however, that, as with a monthly mortgage payment, repeated payment will eventually retire the debt. In reality, low minimum payment requirements and high interest rates often means that borrowers make little, if any, headway. We support legislation requiring clear and conspicuous notice of how long and how costly repayment would be if a consumer makes only the minimum payment.

Disclosure of Late Payment Fees. It can be hard to tell from a credit statement whether and when a late payment fee (in addition to interest on the unpaid balance) will be assessed. We support legislation requiring monthly statements to display prominently the date that payment is due, together with any late payment fee.

Disclosure of Security Interests. Increasingly, creditors take security interests in goods purchased on credit. While consumers should expect to lose such goods if they fail to repay, they ought to know if they are granting a lien. For goods with little resale value, such liens may be taken as a collection technique or to encourage reaffirmation of the debt if the consumer goes into bankruptcy. We support legislation requiring effective notice of liens taken.

Disclosure of Interest Rates and Fees on Credit Advances Through Third-Party Checks. Credit cards offer some card holders "convenience" checks that allow them to write checks against their credit account in places where credit cards are not honored. But card holders may not understand that rates and charges are typically higher than for their credit card. Currently, these charges are explained only in initial disclosures but not at the time that the checks are sent to the consumer. That law should be changed.

Apply Disclosure Rules to Internet Credit Card Solicitations. More and more, credit cards are marketed to consumers on the Internet, but current law does not specifically address the use of the Internet as it does for direct mail solicitations. We support legislation clarifying that all Internet credit card solicitations must include clear and conspicuous disclosure of the card's terms and conditions, updated regularly to reflect current terms and costs, consistent with direct mail disclosures.

#### Bank Disclosures

Provide Enforcement "Teeth" for Rules on Bank Sale of Non-Deposit Products. Increasingly, consumers buy securities, mutual funds, annuities, insurance on bank premises. Although none of these non-bank products are FDIC-insured, studies have shown that many customers believe that these products are FDIC-insured or that the bank would protect them from loss. Under current bank regulator guidelines, banks that sell non-deposit products must disclose that those products are not federally insured and limit their practices to avoid such confusion, for example by selling these products at a space physically separate from where banking transactions occur. However, a violation of these guidelines brings no penalties. We call on the banking regulators to adopt regulations that will be fully enforceable by civil money penalties and other sanctions.

#### Rent-to-Own Companies

Require Disclosure and Other Protection for Rent-to-Own (RTO). The attraction of obtaining a TV, refrigerator, or living room furniture with little down has spurred the rapid growth of firms offering to rent products with an option to buy. But an RTO firm can sell a customer a used product that looks new, and the consumer can pay many times the value of the product. The FTC is nearing completion of a study of the RTO industry. We look forward to its recommendations, and expect to support a legislative response. Adequate consumer protections, including disclosure so consumers can compare the cost of RTO to other alternatives, should be required. In addition, we will work with states to ensure that any federal rules do not interfere with or preempt state consumer protection efforts, including regulation of RTO under state credit sales and usury laws.

#### ATMs

Require ATMs to provide clear and conspicuous disclosures of surcharges on the machine and terminal screen. When customers use an ATM, the operator of the machine may impose a sizeable surcharge. Accordingly, most consumers shop around to avoid ATM fees or pay less. A conspicuous posting of the amount of any surcharge allows customers to walk past higher priced machines, or at least to begin the transaction with their eyes open. While ATM networks generally require members to post fee notices on the machine, a recent survey shows that nearly 25 percent of machines had either no posting or an inaccurate one. We support legislation requiring ATM owners to post a clear and conspicuous notice on the machine as well as on-screen, and subjecting ATM owners to

sanctions for failure to make the mandated disclosures.

#### Mortgages

Require Enhanced Disclosure for Mortgage and Settlement Services and Stem Abusive Practices. In July 1998, the Federal Reserve Board and the Department of Housing and Urban Development released a Congressionally mandated study of how best to streamline the statutory disclosure requirements for mortgage loans and settlement services, with the goal of simplifying and improving the quality of information provided to consumers to enhance their ability to shop and increase competition. The report calls for a series of statutory reforms to the Real Estate Settlement Procedures Act and the Truth in Lending Act to make the information provided to consumers more reliable, more timely, and more helpful in comparison shopping for all the services required to finance a home. Congress should adopt the report's recommendations. For example, the required annual percentage rate disclosure should include all costs the consumer is required to pay in order to receive credit, instead of the patchwork of costs currently disclosed. Creditors should be required to provide firm and reliable rate, fee, and closing cost information, and disclosures should be made early in the application process, before creditors impose substantial fees. It also is important to make sure that information provided to consumers is readily understandable.

#### Other Disclosures

Expand Truth in Lending Act (TILA) coverage for consumer loans and leases. TILA protections enacted in 1968 currently apply to all credit transactions secured by home equity and to other non-business consumer loans under \$25,000; the same cap was imposed on lease transactions in 1976. Originally, the \$25,000 limit was sufficiently high to ensure that most automobile, credit card, and personal loan transactions would come under TILA protections. Thirty years later, however, this is not the case, particularly for automobile loans. The limit should be raised to \$50,000 to cover most cars and other consumer loans.

Require Effective Disclosure of Exchange Rate and Fees for International Money Transfers. Consumers wiring money abroad often are confused or misled about fees and exchange rates. To prevent this confusion, we would amend the Electronic Fund Transfer Act to require additional disclosures relating to exchange rates for international transfers. Financial institutions or other businesses that initiate international money transfers on behalf of consumers would have to disclose, in both English and the language principally used by the business: (1) the exchange rate used in the transaction; (2) the prevailing exchange rate; and (3) all commissions and fees charged in connection with such transactions. Current law does not require such disclosure.

#### PREVENT FRAUD AND ABUSIVE PRACTICES

##### Devote Law Enforcement and Agency Resources to Financial Fraud.

"Identity Theft" Enforcement Initiative. Identify theft is the use of another's individual identifying information to commit an offense -- for example, using another's social security number to apply for a credit card.) Once, one had to forge or steal documents to impersonate another, but now one can easily use your identifiers to impersonate you over the phone or Internet. This type of crime is growing rapidly. Last year, Congress enacted new laws barring the use of another's identifying information. The Secret Service, in coordination with the Justice Department and regulatory agencies, will launch a vigorous identity theft enforcement and prevention strategy that includes referral of cases among federal, state and local law enforcement;

developing a public-private partnership to educate consumers on how to protect themselves; and proposing sentencing enhancements. They will cooperate with the American Bankers Association and others in the banking industry that have worked to combat this problem.

Combat Internet Securities Risk and Fraud with Investor Education and Enforcement. More and more Americans are investing in the stock market; 5.6 million are now trading on-line. The technology opens up great opportunity, but the rewards are not without risks. Complaints to the SEC were up 330% in one year, and new securities fraud schemes are uncovered each day. SEC Chairman Levitt is launching a stepped-up SEC effort to arm investors with the information they need to understand and manage the risks and protect themselves against fraud. In addition, President Clinton's budget provided \$11 million in new funds for SEC enforcement; however, the rate of growth in Internet trading and abuse has exceeded expectations. To meet this need, President Clinton will work with Congress and Chairman Levitt to provide an additional \$5.5 million for SEC enforcement, beyond what was requested in the FY 2000 balanced budget. These funds will help the SEC better investigate and prosecute Internet securities fraud. It will specifically help the Commission increase Internet surveillance, enhance the SEC's Enforcement Complaint Center, augment training for law enforcement on how to recognize and prosecute Internet securities fraud and continue its efforts to educate investors about the risk and rewards of investing over the Internet.

Internet Fraud Initiative: Federal, state and local law enforcement officials and regulatory agencies are receiving a growing number of complaints from consumers about Internet fraud. Many of the same features of the Internet that make it a powerful tool for legitimate e-commerce (global reach, instant and often anonymous communications, ability to reach millions of consumers) -- also make it attractive for fraud schemes. The Internet Fraud Initiative will crack down on Internet fraud by, for example, stepping up training for federal, state, and local prosecutors and agents; developing information on the nature and scope of Internet fraud; and keeping the public better informed about current fraud schemes and how to handle them. The initiative will also help coordinate the efforts of federal (Department of Justice, the FBI, the U.S. Secret Service, the Postal Inspection Service, the Federal Trade Commission, and the Securities and Exchange Commission), state and local law enforcement agencies.

Criminalize "Pretext Calling." There are widespread reports of private investigators and data brokers tricking financial institutions into providing confidential customer information. We support legislation that would criminalize this practice and protect the privacy and security of consumer financial information.

Fully Implement FTC-HELP and Consumer Sentinel. The Year 2000 will be the first full year of operation for FTC's toll-free consumer hotline, part of the Commission's Consumer Response Center. The hotline will give consumers fast and easy access to information they need to protect themselves -- from tips about credit and debt collection to advice on how to avoid becoming a victim of fraud. Complaints to the hotline become part of the Consumer Sentinel, the FTC's fraud database, which is shared only with other law enforcers in the U.S. and Canada. By 2000, the Consumer Sentinel database is expected to be a primary tool in the fight against consumer fraud. The President's FY2000 budget funds Consumer Sentinel.

Improve Consumer Protections Against Fraudulent or Abusive Practices.

Expand Disclosures for High LTV Mortgages. Consumers with high credit card debts are frequently offered second mortgages to consolidate their

debts, extend the time for repayment, and reduce the interest rate. These mortgages can result in debt levels of 125% to 150% of the home's value. Consumers may not understand the consequences of these refinancings -- especially that the failure to repay these consumer debts could lead to losing their home -- and recent studies show that many such homeowners promptly incur new consumer credit debts. We support legislation requiring lenders on high loan-to-value second mortgages to disclose that: (1) interest payments may not be fully deductible; (2) the consumer may be unable to resell the house unless the loan amount is significantly repaid; and (3) default can result in foreclosure.

**Increase Civil Liability Limits for the Truth in Lending Act (TILA) Violations.** TILA provides an individual right of action for violations under which a consumer can recover actual damages, additional statutory damages, and court costs. The amount of damages, however, is limited to a range of not less than \$100 nor greater than \$1,000 for non-mortgage loans or leases, and to a range of \$200 to \$2000 for mortgage loans. These damage limits may be too low to deter TILA violations, particularly at unregulated institutions not subject to systematic and regular examinations. We support raising the statutory cap to a level sufficient to deter violations.

**Improved Reporting on Race, Income and Other Data.** Financial institutions are required under the Home Mortgage Disclosure Act (HMDA) to report the race, income and other data about home mortgage borrowers, but a separate Federal Reserve regulation prohibits them from collecting such information for non-mortgage borrowers. Experience suggests that publicizing such data helps to reduce discrimination, increase access for minority borrowers, and foster innovation, and the current prohibition inhibits self-testing under the fair lending laws and makes fair lending enforcement more difficult. The Treasury Department has asked the Federal Reserve to amend the regulation to allow increased reporting.

**Clear Reporting.** HMDA regulations do not require financial institutions to report separately on sub-prime loans, such as for manufactured housing. If these loans were identified separately, banking regulators and enforcement agencies could better analyze the data for potential fair lending problems. In addition, financial institutions should be required to report on the reasons for loan denials. The Treasury Department has asked the Federal Reserve to determine if these regulatory changes can be made.

**Limitations on HMDA.** Institutions, other than banks and thrifts, do not have to report under HMDA if fewer than 10% of their loans are made for home purchase. The effect of this rule is to exclude from reporting some of the largest and fastest growing mortgage providers in the country, whose consumer loan portfolio is also large. We are asking the Federal Reserve to bring such providers under HMDA coverage.

**End Coercive Sales of Insurance Products.** Borrowers buy credit insurance to ensure repayment of their mortgages in the event of death, injury or job loss. However, the economic value to the consumer of these products is dubious. Moreover, credit insurance is frequently marketed in a way that is either explicitly or implicitly coercive -- that is, consumers are told or left with the impression that their chances of getting the loan or getting it more quickly would improve if they purchased the insurance. Some creditors collect up-front lump-sum insurance premiums for the policy term, so consumers cannot cancel. Required disclosures appear to be ineffective at deterring these practices. We support legislation barring the advance collection of lump-sum insurance premiums, so that consumers can pay for the insurance one month at a time, and so loan termination automatically cancels both



coverage and liability for insurance payments. In addition, Congress should bar the solicitation of credit life insurance until the lender has approved the loan application and communicated approval to the borrower.

Limit Consumer Liability for Non-PIN Protected Debit Cards. "Off-line debit cards" allow consumers to pay for products through an electronic transfer at the point of sale. These "check cards" differ from "on-line" ATM cards because there is no PIN or other security feature (other than a signature) to authenticate the transaction. Although credit cards also carry no PIN protection, the consumer is generally only liable for no more than \$50 of unauthorized charges. But with debit cards losses can be much higher unless the customer quickly notices and reports the loss. Thus, consumers can get the worst of both worlds: higher exposure to loss without security protections. Consumer liability for these cards should be limited as it is currently limited for credit cards -- a step that VISA and Mastercard have already taken voluntarily.

Prohibit Unsolicited Mailing of Loan Checks. Loan checks are credit products for which the consumer need only sign and cash the check to obtain a loan. Because these unsolicited checks are "live," however, the consumer is also at risk for fraudulent endorsement of the check. For the same reasons that Federal law prohibits unsolicited mailing of credit cards -- protecting consumers from the hassle of contesting liability for stolen card purchases -- we support legislation prohibiting unsolicited mailing of loan checks. Consumers should not feel they have to shred their daily mail.

Reform Accounting Rules for Consumer Installment Loans. We support legislation to eliminate the use of the "rule of 78," an outmoded accounting rule that disadvantages borrowers, for all consumer credit transactions. In 1992, Congress barred the rule's use in loans with terms over 61 months; our proposal would finish the task. Creditors would have to use an accounting method at least as favorable to the consumer as the actuarial method.

#### Take Action Against "Sub-prime" Lending Abuses.

Expand Protections in the Home Equity Market. The Fed/HUD Report on RESPA and TILA documented continued problems with abusive practices in some segments of the mortgage market, including evasions of the Home Ownership Equity Protection Act (HOEPA), which provides protections for borrowers with high-cost loans. The study recommended targeting abusive practices. For example: to reduce the occurrence of loan flipping -- recurrent refinancings that may make it difficult for a home owner to pay off a loan or to sell her home -- financing fees in high cost loans covered by HOEPA should be regulated; prepayment penalties and balloon payments should be further restricted; and the HOEPA threshold should be lowered. Creditors should be required to provide additional data on HOEPA loans. All amounts paid by a borrower should be counted under the HOEPA trigger. Creditors should be required to inform high-cost-loan applicants of available home counseling programs prior to closing. We will work with Congress to increase protections in this area.

Expand Enforcement Tools Against Abusive Practices. Congress should eliminate the requirement for a showing of "pattern or practice" of asset-based lending to establish HOEPA violations. The definition of "creditor" should be expanded to include individuals that control the lending practices of a company to deal with the problem of small, thinly capitalized sub-prime lenders who escape HOEPA liability by dissolution or bankruptcy. Finally, Congress should strengthen RESPA enforcement and remedies, consistent with the recommendations in the Fed/HUD Report.

Improve HMDA Reporting. There is a current imbalance in reporting requirements and enforcement under HMDA as between regulated depository institutions and other mortgage lenders. Some unregulated lenders face no sanctions if they fail to report when required. We support legislation providing HUD with enforcement authority to assure compliance by all lenders with HMDA reporting, unless banking regulators are already enforcing HMDA with respect to such lenders. These legislative changes will help level the playing field on reporting and compliance between regulated and unregulated financial institutions, and will improve disclosure in a growing segment of the mortgage lending market.

The Banking Regulators Should Continue to Improve Guidance on Sub-prime Lending. The Federal Financial Institutions Examination Council is improving guidance on fair lending compliance. The FFIEC issued fair lending examination procedures for banking regulators in January 1999 and focused particular attention on the problem of "steering" loan applicants on a prohibited basis to a sub-prime lender within a financial institution's organization. In March, the FFIEC released additional guidance focused on safety and soundness issues and fair lending problems. The OCC recently issued guidance warning of the risks in this area. Today, the President is directing the Office of the Comptroller of the Currency and the Office of Thrift Supervision, in consultation with HUD, the FTC, the Justice Department, and the other banking regulators, to study whether further actions are necessary to halt abusive practices in the sub-prime area.

#### EXPAND ACCESS TO FINANCIAL SERVICES

Provide Low-Cost Banking Services to All Americans. Too many Americans cannot afford, or do not have access to, basic banking services. The Administration will increase and strengthen its efforts -- working with banks and consumer groups -- to increase access to low-cost banking services to all Americans. The Treasury Department will pay set-up costs to encourage private banks to offer low-fee banking accounts for those who receive federal benefits like Social Security.

Provide Individual Development Accounts (IDAs) To Make It Easier for Low-Income Families to Save. IDAs allow low-income households to save not just for retirement but also for education, emergencies, home ownership, or business investment. Individual contributions can be matched to encourage more savings. (The FY 2000 budget doubles funding for IDAs.)

Bolster the Community Development Financial Institutions (CDFI) Fund. Treasury's CDFI Fund provides grants, loans, and equity investments to locally-based, specialized financial institutions and mainstream banks and thrifts serving low and moderate income communities. The CDFI Fund is helping to expand the reach of these institutions to under served communities. The Administration is seeking \$125 million for the Fund in FY 2000 and Fund reauthorization.

#### IMPROVE CONSUMER FINANCIAL EDUCATION

Launch a Campaign to Promote Education on Credit, Savings, and Investment. One of the best protections for consumers is education. Yet evidence suggests that consumers often find credit and investment opportunities confusing, and are carrying greater levels of debt, filing bankruptcy more often, not saving as much as they would like for retirement, and investing without full comprehension of the risks involved. The President today directed his National Economic Council to convene a high level interagency task force to present him with a plan to raise financial literacy levels, and to expand the Administration's commitment to public and private consumer financial education programs.

Elements of this plan will include:

Identify and Publicize Successful "Best Practices" for High School and Other Financial Education Programs. Nonprofit groups, such as the National Council on Economic Education and JumpStart, as well as government agencies including the Department of Agriculture and the Department of Defense, have developed educational modules and course materials that not only improve students' understanding of complex financial topics but also have been shown to improve their long-term financial status. Working with the interagency task force, the Department of Education will help publicize proven educational programs, to make it easier for teachers, professors, and other educators to adopt financial education programs that work.

Promote Effective Financial Planning. Studies show that families who are able to develop and follow a financial plan are much more successful in achieving major financial goals, such as saving adequately for retirement, their children's education, or a new business venture. A growing number of public, nonprofit, and corporate initiatives have begun to educate Americans about effective financial planning, such as the campaigns sponsored by the American Savings Education Council, the Securities and Exchange Commission, and the Department of Labor. The Administration will participate in joint initiatives with these and other groups to highlight the benefits of personal financial planning and the steps that all Americans can take to make financial planning easier.



**GUIDANCE ON COMPLIANCE WITH THE EUROPEAN UNION'S DIRECTIVE  
ON DATA PROTECTION IN ELECTRONIC COMMERCE**

*U. S. Department of Commerce - April 19, 1999*



OFFICE  
OF THE  
SECRETARY

FOR IMMEDIATE RELEASE  
Contact: Morrie Goodman, 202/482-4883  
Ross Brown, 202/482-3809

April 19, 1999

**Department of Commerce Releases New Proposal for Data Privacy  
Protection  
Draft Will Form Basis for Next Round of Discussions with EU**

Washington, D.C. - The U.S. Department of Commerce today released new documents developed to provide clear and predictable guidance to U.S. organizations seeking to comply with the European Union's Directive on Data Protection in electronic commerce.

"We have achieved a substantial level of consensus on both the content of the privacy principles themselves, and on the practices and procedures that will govern transatlantic data transfers," said David L. Aaron, Under Secretary of Commerce for International Trade. Aaron has been the United States' principal negotiator on data privacy.

The newly released documents include the revised safe harbor principles, as well as "frequently asked questions and answers" (FAQs) on access and a draft of the European Union's document on complaint procedures. Within a week, the Department will issue additional FAQs addressing certain sectoral concerns, other procedural issues, and several clarifications requested by interested U.S. organizations. The Commerce Department's new draft proposal will provide the basis for the next round of discussions between the two sides on the privacy issue. The public is invited to comment on both sets of documents, which will also be provided to the EU Member States for review.

Since last fall, when the European Union's Directive on Data Protection became effective, the Commerce Department has been working to develop clear and predictable guidance for U.S. organizations that would enable them to comply with the directive and avoid data flow disruptions. An earlier version of the safe harbor principles was published in November 1998.

"Since then, we have received extensive comments and held lengthy discussion with interested parties," Aaron said. "Access to and onward transfer of data have been particular concerns. We have also received many questions about how the broad safe harbor principles would be applied in specific cases. These latest documents address many of these concerns."

The Department and the Commission have also agreed on the key benefits for safe harbor participants. They include:

- All 15 Member States (MS) will be bound by US/EC understanding;
- The understanding will create the presumption that companies within the safe harbor provide adequate data protection (rather than the opposite) and data flows to those companies will continue;
- Claims against U.S. organizations will for the most part be limited to claims of non-compliance with the principles. European consumers will be expected to exhaust their recourse with the U.S. organization first, and due process will be assured for U.S. organizations that are subject to complaints;
- Generally, only the European Commission, acting with a committee of Member State representatives (the Article 31 Committee) will be able to interrupt personal data flows from an EU country to a U.S. organization; and
- US companies will have a grace period to implement safe harbor policies.

The Department is now requesting additional public comment to determine whether the solutions devised sufficiently satisfy the concerns raised. The deadline for comments is May 10, 1999.

The discussions were prompted by the EU's directive, issued last year, which requires EU member countries to enact laws prohibiting the transfer of personal data to non-member states that fail to ensure what the EU deems to be an "adequate" level of privacy protection. The United States has favored industry-led, market driven privacy protection principles to ensure consumer trust in electronic commerce.

Participation in the safe harbor is entirely voluntary, and is intended solely for use by U.S. organizations receiving personal data from the EU under the safe harbor. Since some of the definitions and exceptions contained within the agreement are based on European Union Law, the safe harbor principles have limited applicability. They are not intended to affect domestic privacy protections which are being addressed by other government and private sector efforts.

In the next few weeks, Under Secretary Aaron will continue to meet with interested parties and will conduct another round of talks with his EU counterpart in Washington late this month. The Department hopes to finalize the texts in May and reach a final conclusion on the safe harbor by the U.S.-EU Summit, scheduled for June 21.

These documents are available on the ITA's web site by [Clicking Here](#).

<http://www.ita.doc.gov/media/419data.htm>

**WEB SITE DIRECTORY TO SOURCES**  
**RELATING TO THE ISSUE OF CONSUMER PRIVACY**

*American Civil Liberties Union - 1999*

**Privacy**

American Civil Liberties Union  
**Freedom Network**

The following sites provide comprehensive or unique resources relating to the work of the ACLU in this issue area. While some of these sites are operated by organizations that work frequently in coalition with the ACLU, the sites may also include materials on positions we do not share.

To report a broken or relocated link, or to suggest a site for inclusion on this page, use the feedback button at the bottom of this page.

**Electronic Frontier Foundation**

This site provides a large amount of information on the organization itself. Users can browse past Newsletter Issues, read frequently updated Action Alerts and Special Announcements, and access an archive (over 1,000 files) of topically-organized documents. There are also a Links to Other Noteworthy Sites and Net Resources section (about 100 links in total), and an icon prompting users to Click This Button to Change the World.

**Privacy International**

Vast resource of information on various privacy issues. The website also provides users with the most recent privacy news from different sources.

**Voters Telecomm Watch**

The ACLU is a coalition member of this volunteer organization which tracks legislation as it relates to telecommunications and civil liberties. VTW monitors elected officials' performances and reviews elections as they occur. VTW, also publishes Bill Watch, a weekly newsletter which tracks federal legislation; Bill Watch is published only while Congress is in session.

**Electronic Privacy Information Center**

EPIC was established in 1994 to focus not only on such cyberspace topics as the Clipper Chip, but also on the broader privacy issues raised by "national ID cards, medical record privacy, credit records, and the sale of consumer data." The all-text site provides an organized introduction to both the Center and its key issues, including access to its on-line newsletter The Epic Alert, a look at Congressional bills affecting privacy, and a series of document collections on such topics as cryptography and free speech on the Internet.

**Benton Foundation's Communications Policy Project**

Established to "promote public interest values and non-commercial services for the National Information Infrastructure." Aside from the usual Publications and Projects sections, the site also includes a list of around 100 links, focused on nonprofits and electronic communications. Users can debate issues in the Forum section, maneuver around the site using the tool bar, or sign-up to receive regular site updates via the Foundation's electronic mailing list.

### **Computer Professionals for Social Responsibility**

This "public-interest alliance of computer scientists and others interested in the impact of computer technology on society" provides membership information, articles on current 'hot topics,' conference information, and some links to other sites.

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### **Legal Beat**

Legal Beat covers a wide range of issues relating to cyberliberties, with a short summary of some of the more major events thus far.

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### **Privacy and American Business**

Privacy & American Business is the activity of the non-profit Center for Social & Legal Research. Since its launch in 1993, P&AB has become the leading authoritative source for tracking new business-privacy issues and for promoting voluntary, balanced consumer privacy policies and practices, nationally and internationally.

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### **Michigan Telecommunications and Technology Law Review**

This site contains material related to the landmark Jake Baker/censorship of obscene material case. The full transcript of a debate at Michigan Law revolving around Baker is provided, as are links to other sources of information on the Internet.

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### **The Internet PRIVACY Forum -- list archives**

The web site of this electronic mailing list includes subscription information, a message archive, and a collection of relevant papers and reports.

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### **Communication and the Constitution in Cyberspace**

This hypertexted 'essay' examines, among other issues, "the First Amendment, privacy, and intellectual property issues of communication on the Internet."

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### **Prof. David F. Linowes' web site: workplace privacy**

David F. Linowes is Boeschstein Professor of Political Economy and Public Policy Emeritus, University of Illinois at Urbana-Champaign. Among other issues his webpage deals with the issues of privacy in the workplace. Users will find a number of research articles on workplace privacy.

[ [Censorship](#) | [Privacy/Encryption](#) | [ACLU v. Reno](#) | [Cyber-Liberties Updates](#) | [Cyber-Liberties Home](#) ]

<a href="#">INDEX</a>	<a href="#">JOIN</a>	<a href="#">HOME</a>	<a href="#">SEARCH</a>	<a href="#">FEEDBACK</a>
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**ISSUES BEFORE**  
**THE DEPARTMENT OF FINANCIAL INSTITUTIONS**

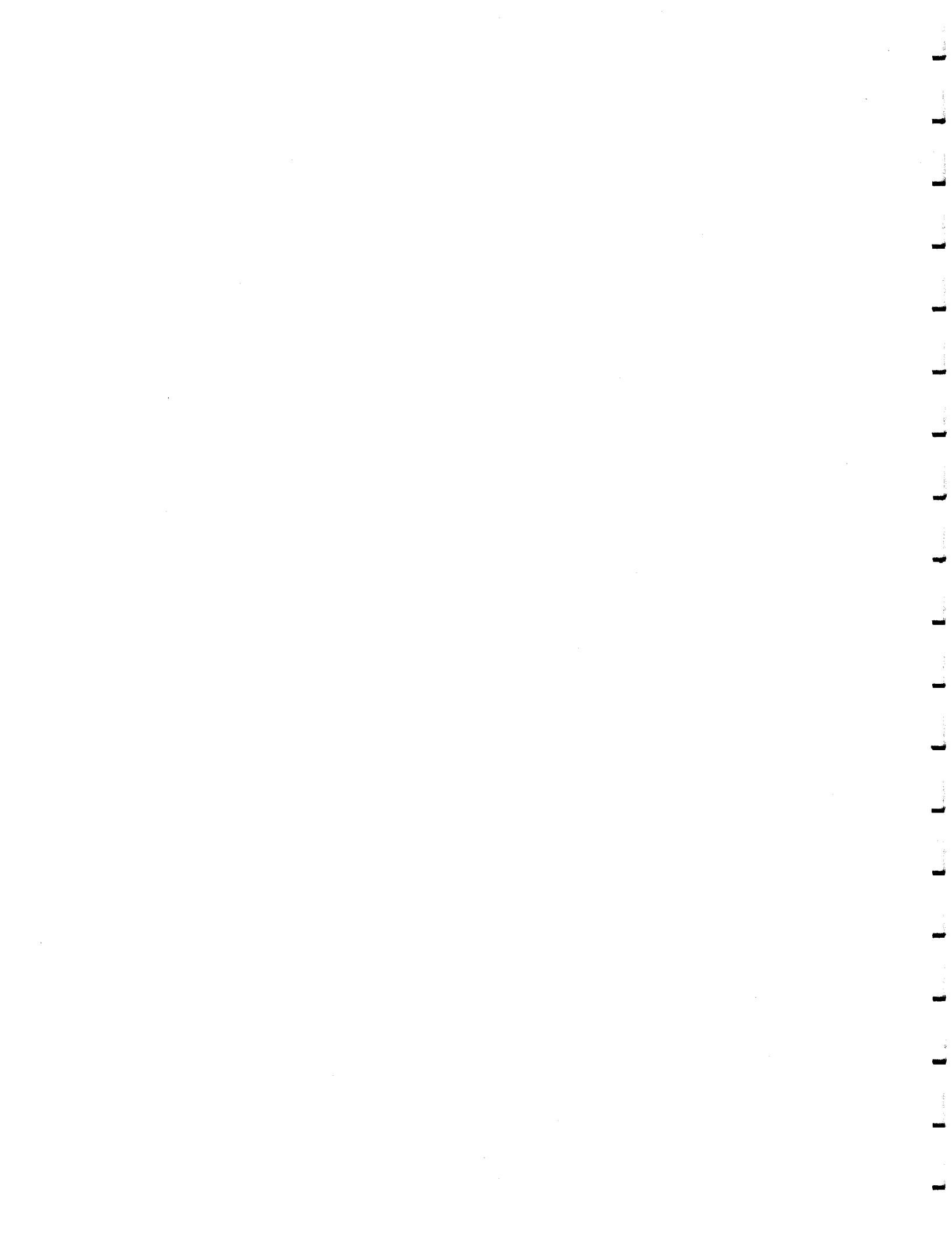
**J. Rick Jones**  
**Kentucky Department of Financial Institutions**  
**Frankfort, Kentucky**



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**NO REQUIREMENT FOR BOARD OF DIRECTOR'S QUALIFYING SHARES****Kentucky Revised Statutes, Section 287.065****287.065 Majority of directors to be residents -- Duties of directors.**

- (1) A majority of the directors of any board must be residents of Kentucky during their term of office.
- (2) Each director shall exercise such ordinary care and diligence as necessary and reasonable to administer the affairs of the bank in a safe and sound manner. In this regard, the bank shall furnish each director with a copy of an appropriate publication outlining the duties of a bank director and an updated copy of the Kentucky banking law, and maintain in the bank updated copies of federal banking laws, as determined by administrative regulations.

**Effective:** July 15, 1998

**History:** Amended 1998 Ky. Acts ch. 196, sec. 7, effective July 15, 1998. -- Amended 1986 Ky. Acts ch. 444, sec. 4, effective July 15, 1986. -- Amended 1982 Ky. Acts ch. 251, sec. 6, effective April 1, 1982. -- Amended 1970 Ky. Acts ch. 209, sec. 3. -- Created 1946 Ky. Acts ch. 141, sec. 10.



**INSURANCE POWERS OF BANKS**

**Kentucky Revised Statutes, Section 287.030**

**287.030 Limitation on right to engage in business -- Authorization for Kentucky chartered banks and subsidiaries to sell insurance.**

- (1) As used in this section, "person" includes a natural person, partnership, corporation, association, business trust, voting trust, or similar organization.
- (2) No persons, except corporations, shall engage in the business of private banking in this state.
- (3) No bank incorporated under the laws of another state or national bank having its principal place of business outside this state shall transact any banking business in this state except to lend money, unless specifically authorized by law or administrative regulation, or except as permitted following a merger transaction within the meaning of Section 44 of the Federal Deposit Insurance Act pursuant to 12 U.S.C. sec. 1811 et seq., approved after June 1, 1997.
- (4) Kentucky chartered banks, or their subsidiaries, are specifically authorized to engage in the sale of insurance.
- (5) No bank incorporated under the laws of the Commonwealth of Kentucky shall make any loan or discount on the security of the shares of its own capital stock, or the shares of stock of a bank holding company which controls the bank to the extent that such loan or discount secured by such shares exceeds the amounts permitted by Section 23(A) of the Federal Reserve Act (12 U.S.C. sec. 371c) as that section reads on July 15, 1986, nor be the purchaser or holder of any such shares, except that a bank may take property of any kind to satisfy or protect a loan previously made in good faith and in the ordinary course of business; and stock so purchased or acquired, shall, within six (6) months from the time of its purchase or acquisition, be sold or disposed of at public or private sale. This subsection shall not affect or modify in any way KRS 386.025, but said section shall remain in full force and effect.
- (6) Any state or national bank with branch offices in Kentucky shall use at all times the same name for all its branch offices in Kentucky.

**Effective:** July 15, 1998

**History:** Amended 1998 Ky. Acts ch. 196, sec. 4, effective July 15, 1998; and ch. 312, sec. 1, effective July 15, 1998. -- Amended 1996 Ky. Acts ch. 254, sec. 35, effective July 15, 1996; and ch. 338, sec. 8, effective July 15, 1996. -- Amended 1986 Ky. Acts ch. 444, sec. 1, effective July 15, 1986. -- Amended 1984 Ky. Acts ch. 130, sec. 2, effective July 13, 1984. -- Amended 1972 Ky. Acts ch. 174, sec. 1. -- Amended 1956 Ky. Acts ch. 80, sec. 1. -- Recodified 1942 Ky. Acts ch. 208, sec. 1, effective October 1, 1942, from Ky. Stat. secs. 581, 598b-4 (1938 Supp.), 602a-1, 609.

**Legislative Research Commission Note (7/15/98).** This section was amended by Ky. Acts chs. 196 and 312 which do not appear to be in conflict and have been codified together.





**PARITY LETTER 98-1 REGARDING PRINCIPAL OFFICE RELOCATIONS  
OF STATE CHARTERED BANKS**

**Kentucky Department of Financial Institutions, October 12, 1998**



DEPARTMENT OF FINANCIAL INSTITUTIONS  
477 VERSAILLES ROAD  
FRANKFORT, KENTUCKY 40601  
TELE. 502/573-3390  
FAX 502/573-8787

ARTHUR L. FREEMAN  
COMMISSIONER

PAUL E. PATTON  
GOVERNOR

**MEMORANDUM**

TO: All Kentucky State Chartered Banks

FROM: Arthur L. Freeman  
Commissioner

RE: Parity Letter 98-1  
Principal Office Relocations

DATE: October 12, 1998

Attached is a copy of Parity Letter 98-1 relating to the relocation of a Kentucky state chartered bank's principal office. The effective date of Parity Letter 98-1 is October 12, 1998.

If you have any questions, please feel free to contact me at (502) 573-3390.

**PARITY LETTER 98-1**

**PRINCIPAL OFFICE RELOCATIONS**

**EFFECTIVE DATE: October 12, 1998**

## PARITY LETTER 98-1

### PRINCIPAL OFFICE RELOCATIONS

**EFFECTIVE DATE:**           **October 12, 1998**

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#### HISTORICAL PERSPECTIVE

On June 24, 1996, under the authority of KRS 287.020(3), then Commissioner Larry D. Lander issued Parity Letter 96-1. That Parity Letter allowed a Kentucky state chartered bank to take advantage of the principal office relocation powers that 12 USC §30(b) grants to a national bank.

At the time Commissioner Lander issued Parity Letter 96-1, the Office of the Comptroller of the Currency, based on its interpretation of 12 USC §30(b) and its rulings concerning intrastate relocations, permitted a national bank to:

- 1) relocate its principal office up to thirty miles across state and county lines,
- 2) retain former branches,
- 3) establish a branch at the location of its former principal office under 12 USC §36(c), and
- 4) establish additional branches in the Kentucky counties where the bank could have established branches prior to the relocation under 12 USC §36(c).

Parity Letter 96-1 applied only to a request for a principal office relocation to a new county and permitted a state bank, upon a vote of the shareholders owning two-thirds of the stock of the bank and upon approval of the Commissioner, to:

- 1) relocate its principal office to a site in another county that was within thirty miles of the city, town, or village of its existing principal office;
- 2) retain its former branches;
- 3) establish a branch at the location of its former principal office under KRS 287.180; and
- 4) establish additional branches in the Kentucky counties where the bank could have established branches prior to the relocation under KRS 287.180.

While permitting the above, Parity Letter 96-1 contained certain restrictions limiting the ability of some state banks to relocate their principal office. It provided that a state bank, which was not in existence on or before May 31, 1996, must have been in existence for a minimum of five years before it could apply to relocate its principal office to another county. In addition, it

provided that a state bank which had relocated its principal office to another county must wait at least five years before it could apply to again relocate its principal office to another county.

## **PARITY STATEMENT**

The Department believes that competitive inequalities have arisen since Commissioner Lander issued Parity Letter 96-1. These inequalities have resulted because the Office of the Comptroller of the Currency has not placed the same restrictions on principal office relocations by national banks as the Department has placed on principal office relocations by state banks. Because the Department no longer believes that public policy requires these restrictions, Parity Letter 96-1 is nullified.

Consequently, to eliminate the competitive inequalities and increase parity with national banks, the Department will permit a Kentucky state chartered bank to:

- 1) file an application to relocate its principal office to a site in another county that is within thirty miles of the city, town, or village of its existing principal office,
- 2) file an application for a branch in any county where it has a principal office or an existing branch, and
- 3) file an application for a branch simultaneous with the closure of its former principal office if the bank has an existing branch in the county of its former principal office.

A state bank may file an application regardless of the date that the bank was chartered or the bank's length of existence. Further, a state bank which has relocated its principal office may, at any time, file a subsequent application to again relocate its principal office.

## **PUBLIC COMMENT**

On July 24, 1998, the Commissioner issued Proposed Parity Letter 98-1 and invited public comments on the Proposed Finding of Permissible Activities, Services, or Products contained in the Letter. The comment period ended on August 14, 1998. A number of financial institutions submitted comments both in favor of and opposed to the Proposed Finding. The Commissioner has considered all the comments.

A number of institutions expressed concerns with multiple relocations that might occur under this Parity Letter. To address these concerns, the Finding of Permissible Activities requires that the Commissioner make a determination that a relocation will serve the public convenience and advantage and that the principal office will have a reasonable probability of successful operation in the new location. In addition, to avail itself of the branching activities permitted by the Finding, a bank that relocates its principal office to another county must have an existing branch office in the original county. If the bank has no branch in the original county then the bank may not establish a branch at its former principal office after the relocation nor may it establish a new branch in the original county.

## FINDING OF PERMISSIBLE ACTIVITIES, SERVICES, OR PRODUCTS

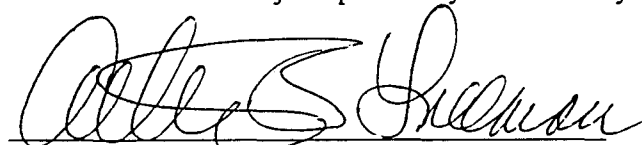
Under KRS 287.020(3), the Commissioner of the Department of Financial Institutions issues this Finding of Permissible Activities, Services, or Products.

On and after the effective date of this Finding, a state bank may, through a resolution of its board of directors, adopt the provisions of 12 USC §30(b). Then, upon a vote of the shareholders owning two-thirds of the stock of the bank and upon approval of the Commissioner, the state bank may:

- 1) relocate its principal office to a site in another county that is within thirty miles of the city, town, or village in which its principal office was originally located;
- 2) retain its former branches;
- 3) establish a branch at the location of its former principal office; and
- 4) establish additional branches in the Kentucky counties where the bank could have established branches prior to the relocation.

A bank may engage in the permissible activities regardless of the date that the bank was chartered or the bank's length of existence. However, the Commissioner, when considering an application for relocation, shall determine that the relocation will serve the public convenience and advantage and that the principal office will have a reasonable probability of successful operation in the new location. In addition, to avail itself of the branching activities permitted by this Finding, a bank that relocates its principal office to another county must have an existing branch office in the original county. If the bank has no branch in the original county then the bank may not establish a branch at its former principal office after the relocation nor may it establish a new branch in the original county.

In accordance with this Finding, Parity Letter 96-1 is nullified and Parity Letter 98-1 shall control those subjects previously controlled by Parity Letter 96-1.



Arthur L. Freeman, Commissioner

October 12, 1998



**KENTUCKY ADMINISTRATIVE REGULATIONS REGARDING**  
**AUTOMATIC TELLER MACHINES**

**808 KAR 1:060, as amended to January 19, 1999**

**808 KAR 1:060. Automated teller machines.**

RELATES TO: KRS 287.180, 289.061, 290.055

STATUTORY AUTHORITY: KRS 287.020, 289.702, 290.070

NECESSITY, FUNCTION, AND CONFORMITY: This administrative regulation provides for the use of an automated teller machine by a financial institution and specifies that an automated teller machine is not a branch of the financial institution.

Section 1. Definitions. (1) "Financial institution" means a state-chartered bank, savings and loan association, or credit union.

Section 2. A financial institution may receive and act upon a communication from a customer transmitted through an automated teller machine. The communication may:

- (1) Request the withdrawal of funds either from the customer's deposit account or from a previously authorized line of credit;
- (2) Instruct the institution to receive funds or to transfer funds for the customer's benefit;
- (3) Make a balance inquiry;
- (4) Instruct the financial institution to receive cash or a check; or
- (5) Request the financial institution to dispense cash to the customer at the location of the automated teller machine.

Section 3. A transaction initiated by an automated teller machine shall be subject to verification by the financial institution.

Section 4. The commissioner may require information from a financial institution concerning the operation of an automated teller machine or other information that the commissioner believes to be in the public interest.

Section 5. A financial transaction effected by use of an automated teller machine shall be deemed to be transacted at the institution and not at the automated teller machine. The automated teller machine shall not be considered to be a branch or branch office. (2 Ky.R. 140; Am. 266; eff. 11-12-75; 8 Ky.R. 19; eff. 8-5-81; 12 Ky.R. 40; eff. 8-13-85; 25 Ky.R. 1182; eff. 1-19-99.)





RESPONSIVE LETTER REGARDING INTERSTATE TRUST ACTIVITIES

Department of the Treasury, Office of Thrift Supervision; 1996

1996 OTS LEXIS 22

August 8, 1996

SUBJECT: [\*1] Interstate Trust Activities

Dear Text Omitted:

This responds to your inquiry submitted on behalf of Text Omitted (the "Company") concerning interstate trust activities. The Company is interested in acquiring Text Omitted ("Target Institution"), and transferring the assets and liabilities to a newly-formed institution to be known as Text Omitted (the "Association"). Specifically, you have asked: (i) whether the Association will be deemed "located," as that term is used in the federal trust laws, in states where it markets its trust services and where it performs certain activities incidental to serving as a testamentary trustee or trustee holding real estate, but performs no other trust activities; and (ii) whether federal law preempts specific state laws that would prohibit or restrict the Association from engaging in those marketing and other incidental activities.

In brief, the Office of Thrift Supervision ("OTS") concludes that: (i) for trust purposes, the Association will not be deemed located in a state where its only trust-related activities are marketing its trust services and performing the specified incidental duties pursuant to its appointment as testamentary trustee or [\*2] trustee holding real estate; and (ii) federal law would preempt state laws that prohibit or restrict an out-of-state federal thrift from engaging in these activities in the state.

I. BackgroundA. Factual Background

The Company is a provider of financial services. The Company owns broker-dealer subsidiaries, Text Omitted ("Affiliates"). The Company also currently owns a state-chartered trust company, Text Omitted ("Trust Company"), licensed to provide trust and other fiduciary services in Text Omitted ("State A"). You have told us that the Trust Company currently solicits trust business in a majority of states. The Trust Company also serves customers domiciled outside of State A in several ways. For example, the Trust Company currently holds real estate as trustee in at least one other state, in accordance with applicable state law, and believes it may be able to hold real estate under the laws of many other states, although it is just beginning to expand this aspect of its trust business. The Trust Company also acts as an inter vivos or testamentary trustee in a majority of states, in accordance with applicable state law.

The Company plans to acquire the Target Institution [\*3] and establish the Association. The Company has filed an application with OTS to authorize the Association to exercise the full range of fiduciary powers available to corporate fiduciaries in State A. The Company intends to use the Affiliates and the Affiliates' employees ("account executives") to solicit customers nationwide for the Association's trust services, in the manner described below. You also have informed us that the Association would like to act as a testamentary

trustee and hold real estate in trust for customers domiciled in all the states where it solicits its trust services, in the manner described below.

#### Marketing Activities

You have represented that the marketing activities of the Association through its Affiliates in states other than State A would typically consist of: (i) distributing materials and advising customers of the availability of, and describing, the Association's fiduciary services; (ii) answering prospective customer's questions concerning the nature of fiduciary services; (iii) assisting prospective customers in completing forms used by the Association's trust department; (iv) forwarding forms and funds received from customers to the Association's [\*4] home office; and (v) obtaining information from customers for the Association's home office, such as type of assets, amount of assets and cost basis of assets.

#### Liaison Services

Once a trust account is established, a trust officer will be assigned to the account. The trust officer will be an employee of the Association and will be located in State A. The trust officer will be the primary contact for the grantor and the beneficiaries of the trust. The Association will send out periodic trust statements and tax forms directly to its customers from State A. The Affiliates may provide administrative support services for the Association with respect to its trust accounts by acting as a liaison between the trust officer and the grantor and beneficiaries. This may involve: (i) answering ministerial questions and providing information regarding the trust account to the client; (ii) forwarding requests for distribution and requests for changes in the investment objectives of the trust account to the Association in State A; and (iii) forwarding forms and funds received from customers who wish to add funds or engage in other transactions affecting their trust accounts.

Thus, the Affiliates' [\*5] role in the trust operations will be strictly limited to soliciting customers for the Association's trust services and providing liaison services in support of the Association's trust services.

#### Holding Real Property

You have described the Association's intended operating method for holding real property in trust in states other than State A as follows: (i) the trust account will be accepted in State A; (ii) all decisions regarding disposition of the real estate will be made in State A; (iii) communications with the grantor and beneficiaries will be from the Association in State A; (iv) property tax bills will be sent to the Association in State A and the Association will mail out payment from State A; (v) property and casualty insurance bills will be sent to the Association in State A and the Association will mail out payment from State A; (vi) decisions regarding whether to use local counsel, and if so which counsel to use, will be made in State A; (vii) if the property is rental or commercial, a local independent contractor or rental agent will be used, and the decision as to which contractor or agent to use will be made by the Association in State A; (viii) the deed to the [\*6] property identifying the Association as trustee must be recorded in the state where the property is located and will be recorded by local counsel or a local title insurance company; and (ix) inspections, repairs, preventive maintenance and other functions necessary to maintain the property will be performed in the state in which the property is

located. The Association anticipates that the property maintenance functions will be done by the grantor, if mentally competent, or by an independent contractor hired by the Association. All decisions regarding inspections, maintenance, repairs or similar functions regarding property will be made by the Association in State A and payment to third parties for these services will be made by the Association from State A. In some unusual circumstances, the Association may send an employee to the location of the property to inspect it or to ensure that proper actions are taken with respect to the property.

#### Serving as Testamentary Trustee

You have described the Association's intended operating method for acting as a testamentary trustee for testators domiciled in states other than State A as follows: (i) the trust account will be accepted by [\*7] the Association in State A (the testator usually obtains prior approval of the Association that it will act as trustee); (ii) all decisions regarding investment of assets will be directed, supervised and managed by the Association in State A; (iii) distributions to beneficiaries will be decided by the Association in State A, and if approved, will be paid by the Association in State A and sent out by check or by wire; (iv) preparation of trust accounting and tax forms will be done by the Association in State A; (v) communications with beneficiaries will be from the Association in State A; (vi) the executor will transfer the trust assets to the Association in State A and the Association will work with the executor to ensure proper transfer; (vii) if required, periodic accountings will be mailed by the Association in State A to the probate court of the state of the testator's domicile; n1 and (viii) if required, local counsel will be hired by the Association to make appearances in the probate court of the state of the testator's domicile. You have informed us that the Company's current policy is generally not to accept personal property, other than stocks, bonds and other liquid securities, [\*8] as trust assets.

n1 You have represented that such accountings seldom are required.

You represent that with respect to all the activities described above, neither the Association nor its Affiliates will engage in any of the following outside of State A: execute or approve documents on behalf of the Association's trust department; accept or manage customer trust accounts; provide investment advice to customers; n2 exercise investment discretion over trust department accounts; make decisions with respect to implementation of the Association's trust agreement; or establish a trust office. n3

n2 Likewise, the Affiliates will not provide investment advice to the Association's trust department. The Association may execute specific brokerage transactions for individual accounts through Affiliates and its account executives. Such transactions will be subject to 12 U.S.C.A. § 1468 (West Supp. 1996), Sections 23A and 23B of the Federal Reserve Act, 12 U.S.C.A. §§ 371c and 371c-1 (West 1989), and 12 C.F.R. Part 550 (1996).

n3 Of course, the Association could return to OTS at a later date and apply to exercise trust powers in additional states. Any such approval would not affect the ability of the Association to continue its marketing and other incidental activities in the remaining states. [\*9]

#### B. State Statutes At Issue

You have asked us to review statutes in five representative states that might prohibit or restrict the Association, as an out-of-state fiduciary, from engaging in the above described activities. You have inquired whether federal law would preempt these statutes.

The statutory provision you cite for the State of Louisiana provides that "[a] trustee must be . . . a bank or trust company organized under the laws of Louisiana or of the United States domiciled in this state . . ." n4 The statutory provision you cite for the State of Oregon provides that a foreign institution "shall not hold real or personal property in trust in this state or act in a fiduciary capacity" except under special circumstances. n5 The statutory provision you cite for the State of Virginia provides that "no foreign corporation . . . shall do a . . . trust business in this Commonwealth." n6

n4 La. Rev. Stat. § 9:1783 (West 1996).

n5 Or. Rev. Stat. § 713.012 (1995). The special circumstances include "geographic reciprocity" in conjunction with other criteria.

n6 Va. Code Ann. § 6.1-5 (1995).

The statutory provision you cite for the State of Texas prohibits out-of-state [\*10] trust companies from acting as a trustee or in any other fiduciary capacity in the state unless the foreign trust company's state permits Texas-chartered fiduciaries to act in such fiduciary capacity. n7 Authorized foreign fiduciaries must register in order to serve in a fiduciary capacity in Texas. n8 The Texas statute also provides that "no foreign bank or trust company shall establish or maintain any branch office, agency office or other place of business within this state; or shall in any way solicit, directly or indirectly, any fiduciary business in this state . . ." n9

n7 Tex. Probate Code Ann. § 105A(a) (Vernon 1995).

n8 Tex. Probate Code Ann. § 105A(b) (Vernon 1995).

n9 Tex. Probate Code Ann. § 105A(c) (Vernon 1995).

The statutory provision you cite for the State of Wisconsin prohibits out-of-state trust companies from acting in any fiduciary capacity in Wisconsin, unless the foreign trust corporations's home state permits Wisconsin-chartered fiduciaries to act in such fiduciary capacity. n10 The Wisconsin statute further provides that a foreign corporation authorized to act as a trustee in the state shall not "establish or maintain directly or indirectly [\*11] any branch office or agency office in this state or shall in any way solicit directly or indirectly any business as executor or trustee therein." n11

n10 Wis. Stat. Ann. § 223.12(1) (West 1996).

n11 Wis. Stat. Ann. § 223.12(3) (West 1996).

## II. Discussion

The trust powers of federal thrifts are defined by section 5(n) of the Home Owners' Loan Act ("HOLA"). n12 Section 5(n)(1) authorizes the Director of OTS to permit federal thrifts that meet the standards specified in section 5(n) to

act in any fiduciary capacity that is permissible for corporate fiduciaries under the laws of the state where a thrift's trust business is "located" ("location state"). n13 If a thrift is located in more than one state for purposes of section 5(n), then the scope of fiduciary services the thrift can provide from offices located in those states will vary depending upon the law of each location state.

n12 12 U.S.C.A. § 1464(n) (West Supp. 1996).

n13 See, e.g., OTS Op. Chief Counsel (June 21, 1996) ("June 1996 Op."); OTS Op. Chief Counsel (March 28, 1996) ("March 1996 Op."); OTS Op. Acting Chief Counsel (June 13, 1994) ("June 1994 Op."); OTS Op. Chief Counsel (December 24, 1992) ("December 1992 Op."). [\*12]

Under this statutory scheme, the fact scenario you present raises two basic questions: (a) where will the Association be deemed located when engaging in the activities in question; and (b) does federal law preempt the laws of non-location states that purport to bar marketing and the performance of other incidental trust activities in those states?

#### A. Location

The term "located" is not defined by the HOLA. Thus, it falls to OTS, the federal agency charged with implementing HOLA section 5(n), to determine what types of trust activities are sufficient to cause a federal thrift to be deemed located in a state for purposes of section 5(n).

When opining in this area, the OTS has been mindful that, in analogous contexts (i.e., venue and most favored lender determinations under the National Bank Act), the Supreme Court has indicated that the term "located" should be interpreted flexibly so as to take account of modern developments in banking. n14 As the Supreme Court has noted, "there is no enduring rigidity about the word 'located'." n15 Noting that modern financial transactions frequently involve contacts with multiple states, n16 the Court indicated that the standards for determining [\*13] location should not be so sensitive or subjective that an institution "could never be certain whether its contacts with residents of foreign states were sufficient to alter its location . . . ." n17 An overly broad interpretation of "location," the Court indicated, could "throw into confusion the complex system of modern interstate banking." n18

n14 *Marquette National Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978), 311-312; *Citizens & Southern National Bank v. Bougas*, 434 U.S. 35, 44-45 (1977).

n15 *Citizens & Southern National Bank*, 434 U.S. at 44.

n16 Given the highly mobile nature of our society, a single trust can easily have contacts with multiple states. For example, with respect to a testamentary trust, a testator who resided in the State of V at his death and contributed real property located in State W and personal property located in State X, may appoint a trustee licensed and operating in State Y and provide in the trust agreement that the laws of State Z, his former residence, will govern the administration and construction of the trust.

n17 Marquette, 439 U.S. at 312.

n18 Id.

The Supreme Court's concerns are also [\*14] consistent with OTS's overarching statutory duty to regulate thrifts in a manner that furthers "the best practices of thrift institutions in the United States," n19 and with the legislative history of HOLA section 5(n), which indicates that the federal thrift regulator "is expected by regulation to tailor permissible trust powers to those that enhance the ability of thrifts to offer complete financial services to the consumer." n20

n19 12 U.S.C.A. § 1464(a) (West Supp. 1996).

n20 S. Rep. No. 368, 96th Cong., 2d Sess. 13, reprinted in, 1980 U.S. Code Cong. & Admin. News 236, 248. We are aware that one of the objectives of HOLA section 5(n) is to preserve a measure of parity between federal thrifts and state fiduciaries in federal thrifts' location states. See S. Rep. No. 368, 96th Cong., 2d Sess. 13, reprinted in, 1980 U.S. Code Cong. & Admin. News 236, 248. See also St. Louis County National Bank v. Mercantile Trust Co., N.A., 548 F.2d 716, 720 (8th Cir. 1976). cert. denied, 433 U.S. 909 (1977); Blaney v. Florida National Bank, 357 F.2d 27, 30 (5th Cir. 1966). Congress implemented this objective by expressly subjecting federal thrifts to certain state law requirements applicable to corporate fiduciaries chartered by federal thrifts' location states. For example, a federal thrift must conform to the requirements of location states regarding scope of fiduciary powers, capital requirements, security deposits, and oaths. 12 U.S.C.A. § 1464(n)(1), (5), (6), and (8). Beyond this, however, Congress did not mandate that the trust operations of federal thrifts be tied to state law. Instead, as indicated above, OTS is directed to implement § 5(n) in a manner that enhances the ability of thrifts to meet consumers' trust needs and is consistent with "best practices." Although the OTS may elect to incorporate additional elements of state law if deemed appropriate to meet these objectives, it is not required to do so. [\*15]

Consistent with the foregoing, OTS has interpreted the term "located" as it appears in HOLA section 5(n) in a manner that is predictable, stable, and consistent with the nature of the modern banking business. The beginning point for prior OTS interpretations has been the implementing regulations, which "are based on the premise that a federal thrift will be deemed located . . . in each state where it operates a trust office." n21 We have indicated that a trust office can either be in the form of a brick and mortar trust office or, alternatively, a fiduciary presence within a state that is the functional equivalent of operating a brick and mortar trust office -- a so-called de facto trust office. n22

n21 June 1996 Op., at 5.

n22 Id.

When assessing whether a thrift's trust-related activities in a state rise to the level of being characterized as a de facto trust office, we have indicated that we will focus on the nature of the thrift's contacts with the state, not their frequency. n23 Our objective has been to identify where the thrift is actually managing its trust accounts, i.e., entering into binding commitments, making discretionary decisions, and rendering [\*16] advice. We have

distinguished these core fiduciary functions from activities that are merely incidental to the exercise of trust powers.

n23 June 1996 Op., at 4-6.

For example, in our June 1996 Op., we concluded that marketing activities alone do not cause a thrift to be deemed located in a state for trust purposes. n24 Accordingly, the June 1996 Op. concluded that federal thrifts may market their duly authorized fiduciary services in any state, regardless of state laws that might attempt to bar marketing activities by foreign fiduciaries. The June 1996 Op. addressed mail and telephone solicitations. There we also reviewed a proposal to conduct informational seminars and to have employees of the association's trust department visit the offices of its affiliates to meet with trust customers to describe its trust services. We drew a distinction between these activities and other activities more closely associated with core conduct of a trust office, e.g., executing trust documents, approving new accounts, rendering investment advice, and making fiduciary decisions regarding investments and distributions.

n24 June 1996 Op., at 4-6.

This analytical approach to determining [\*17] location under section 5(n) is consistent with the approach that the OTS has used to determine location under NOLA section 4(g) (most favored lender). We have previously noted that the term "located" as it appears in both provisions should be interpreted in a consistent manner. n25 This does not mean that an association is "located" for section 4(g) purposes in every state where it is "located" for section 5(n) purposes. For example, under section 4(g) we examine the substance of an association's lending activities in various states, whereas under section 5(n) we examine the substance of trust activities. Nevertheless, the mode of analysis employed under section 4(g) (where the body of precedent is more developed) at least provides a point of reference for analyses conducted under section 5(n).

n25 June 1994 Op., at 4-5; December 1992 Op., at 8-9.

When confronted with location questions under section 4(g) we have, in prior opinions, looked to case law interpreting a virtually identical most favored lender provision for national banks. n26 The seminal case in this area is *Marquette Nat'l Bank v. First Omaha Service Corp.* n27 There, the Supreme Court conducted a location analysis [\*18] similar to that described above for NOLA section 5(n) to determine whether a national bank's credit card activities should be deemed to be located in Minnesota. The Court determined that the following activities were not of a type that would establish location in Minnesota: advertising the credit card; soliciting applications; soliciting participating merchants; remitting payments to merchants for goods purchased there; and sending periodic statements to and receiving payments mailed by cardholders living there. n28 Instead, the Court concluded that the national bank was located in Nebraska, where, inter alia, the bank reviewed, approved and issued credit cards, accepted charges, disbursed funds, received payments, originated communications to card holders, and had its main and branch offices (i.e., lending offices).

n26 December 1992 Op., at 2-4.

n27 439 U.S. 299 (1978).

n28 439 U.S. at 311-12.

The types of lending activities the Supreme Court found persuasive in establishing location for most favored lender purposes are analogous to the trust activities that the OTS has found significant in determining location for purposes of HOLA section 5(n).

With the [\*19] foregoing as background, we will now turn to the specific questions raised by the Association. The Association proposes to engage in three principal types of activities outside its location state: (i) marketing; (ii) activities incident to serving as a testamentary trustee or trustee of real estate; and (iii) certain liaison activities. We will examine each in turn.

### 1. Marketing

The Association's proposed marketing activities are quite similar to those previously considered by the OTS. The only activity you propose not specifically addressed in our June 1996 Op. is collecting information that is required for trust applications from potential trust customers concerning the type, amount and cost basis of their assets. In our view, assisting customers in completing the Association's trust application forms is part of the marketing and solicitation process.

Neither the OTS nor the Supreme Court in Marquette has deemed marketing and solicitation to be indicative of location. As explained above, when determining where a thrift's trust business is located, we look to where it conducts those activities associated with core conduct of a trust office, e.g., executing trust documents, [\*20] approving new accounts, rendering investment advice, and making fiduciary decisions regarding investments and distributions. If we were to adopt the view that a thrift is located wherever a potential customer happens to be situated when coming into contact with the Association's marketing materials or when filling out a trust application, the thrift's location would become unpredictable -- a result the Supreme Court clearly sought to avoid in Marquette. n29

n29 439 U.S. at 312.

Therefore, we conclude that the Association will not be deemed "located" in a state under HOLA section 5(n) by virtue of engaging in the types of marketing activities described herein.

### 2. Actions Incident to Serving as Testamentary Trustee or Trustee of Real Estate

The Association also wishes to serve as a testamentary trustee without regard to where the testator is domiciled upon death and to hold real estate in trust regardless where the real estate is situated. You represent that acting as a testamentary trustee and holding real estate are permissible activities for a State A corporate trustee.

You have indicated that acting as a testamentary trustee would not require the Association to perform [\*21] any functions outside of State A, except perhaps filing an accounting with a probate court or making an appearance in



probate court through local counsel. You have also told us that holding real estate outside of State A would not require the Association to perform any functions outside of State A, except to record title to the property through a local agent and to perform property management as previously described herein. The decisionmaking regarding the trusts would take place in State A. The Association will not execute trust documents, approve new accounts, provide investment advice or make decisions with respect to the maintenance and disposition of real or personal property outside of State A. n30

n30 You have also indicated that the Association will not be performing any of these functions indirectly through its Affiliates, since the activities of the Affiliates will be strictly limited to soliciting customers for the Association's trust services and providing liaison services in support of the Association's trust services.

On these facts, it is reasonable to conclude that the testamentary trusts and trusts holding real estate will genuinely be managed from State A and [\*22] that the incidental activities proposed for other states do not rise to the level of operating a de facto trust office in those states. None of the incidental activities proposed by the Association are the type of discretionary acts found significant in our prior location determinations.

This conclusion is also consistent with Marquette. The types of lending activities the Supreme Court found persuasive in establishing location for most favored lender purposes are analogous to the trust activities that the Association proposes to conduct exclusively in State A. Here, as in Marquette, accounts will be approved in offices in the location state, charges will be remitted to and funds disbursed from those offices, management decisions affecting the accounts will be made in those offices, all substantive communications from customers will be directed to personnel located in those offices; and all substantive communications to customers will be conducted by personnel located in those offices.

Accordingly, we conclude that the Association will not be deemed to be located outside of State A simply because it serves as a testamentary trustee for a testator who resided outside [\*23] State A at death or holds real estate as trustee outside State A, provided the activities conducted outside of State A are limited in accordance with the Association's representations as set forth herein. n31

n31 In *American Trust Company v. South Carolina State Board of Bank Control*, 381 F. Supp. 313 (D.S.C. 1974), the court held that a South Carolina statute prohibiting national banks domiciled in North Carolina (and other North Carolina fiduciaries) from serving as testamentary trustees for South Carolina citizens did not violate the commerce clause of the U.S. Constitution. The court's conclusion was based largely on its interpretation of the statement in the National Bank Act that national banks may exercise trust powers "when not in contravention of state or local law," which the court read to include South Carolina law. 12 U.S.C.A. § 92a (West 1989). The Office of the Comptroller of the Currency has criticized and refused to follow the court's interpretation. OCC Interpretive Letter No. 695, at 16-17 (December 8, 1995). In any event, the quoted language that was the basis of the court's decision was removed from HOLA section 5(n) by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Pub. L. 101-73, Aug. 9, 1989; 103 Stat. 183, 297. As indicated above, federal thrifts are authorized to act in any fiduciary capacity permissible

for corporate fiduciaries of their location state. "Non-location" states play no role in defining the scope of a federal thrift's fiduciary powers. [\*24]

### 3. Liaison Services

You have also indicated that, once a trust relationship is established, the Affiliates and their account executives will provide administrative services for the Association's trust department by acting as a liaison between grantors and beneficiaries and trust officers, in the manner described above. Consistent with the analysis set forth above, these functions are of an incidental, purely ministerial nature and thus do not establish location. We nevertheless believe it would be inadvisable for the Affiliates to relay orally any discretionary advice from the trustee. Our concern is not the simple act of relaying the advice (which is purely ministerial), but rather the danger that the Affiliate may be drawn into the role of adviser during the give and take of such conversations. Subject to this precautionary qualification, the Association will not be deemed to be located in a state for trust purposes by virtue of the Affiliates performing the liaison services described herein.

Accordingly, the OTS concludes that the Association will not be located in a state, within the meaning of HOLA section 5(n), merely because it engages in some or all of the marketing, [\*25] liaison, and other incidental activities described herein.

### B. Preemption

You also ask whether federal law preempts the application to federal thrifts of several state statutes you have cited that prohibit out-of-state corporations from marketing or from performing other incidental trust activities in that state.

In our June 1996 Op. we concluded, and here reaffirm for the reasons stated in that opinion, that "non-location" states may not prevent federal thrifts from marketing their duly authorized trust services. n32 Thus, the only new preemption question raised by your inquiry concerns state laws that purport to prohibit the above-described incidental in-state activities by out-of-state federal thrifts that are managing testamentary trusts or real estate they hold in trust.

n32 June 1996 Op., at 6-9.

It is well established that the authority of a federal thrift to engage in the trust business is solely a matter of federal law, governed by HOLA section 5(n). This provision determines when and where federal thrifts may engage in trust activities. Under section 5(n), the OTS is authorized to issue a special permit to a federal thrift to engage in the trust business, provided, [\*26] inter alia, the thrift meets certain standards drawn from the laws of the state in which the trust powers will be exercised, i.e., the location state. For example, location state law determines: (i) the scope of permissible trust powers; (ii) minimum capital requirements; and (iii) the amount of securities that must be deposited with the state. n33

n33 The securities deposit provision that appears in HOLA section 5(n)(5) refers variously to the deposit requirement of the state "involved" and the state where the thrift is "acting in a fiduciary capacity." 12 U.S.C.A. @

1464(n)(5) (West Supp. 1996). The OTS and its predecessor have always interpreted paragraph (n)(5) as referring back to the federal thrift's state of location. See 12 C.F.R. § 550.4 (1996); and December 1992 Op., at 11-13. The reference in paragraph (n)(5) to the state where a thrift is "acting in a fiduciary capacity" ties back into the requirement in (n)(1) that a thrift restrict its "fiduciary capacities" to those permissible in its location state. This interpretation is also consistent with OTS's objective of establishing a workable, internally consistent regulatory scheme under HOLA § 5(n).

Thus, [\*27] we have previously opined that any law in a federal thrift's location state that purports to require it to obtain a license from the state before exercising trust powers is preempted. n34 In that context, we noted that:

where [in section 5(n)] Congress intended to incorporate certain substantive standards from state law, Congress clearly spelled out what those requirements were. Thus, it follows that Congress, if it desired to subject the OTS's authority to state action, would have also made this requirement part of the statute. To subject OTS's authority to state review would, in fact, render the authority granted by the statute largely illusory. n35

n34 June 1994 Op. See also, OTS Op. Principal Deputy Chief Counsel -- Legal (Jan. 9, 1990) (imposition of annual license fee by a state authority is preempted). The OCC has taken the position that state securities licensing requirements are preempted as applied to national bank trust activities. OCC IL No. 628, 1993 OCC Ltr. LEXIS 35 (July 19, 1993).

n35 June 1994 Op., at 10 (citations omitted). The OCC reached a similar conclusion regarding its authority to grant national banks the power to engage in the trust business. OCC IL No. 695 (December 8, 1995), at 12. [\*28]

Numerous other opinions have reached similar conclusions under similar circumstances. For example, we have concluded that the states have no right to require federal thrifts to obtain a license to engage in lending activities authorized by the HOLA or in money order activities authorized by OTS regulations. n36 The power to license is the power to prohibit, and the states cannot prohibit what federal law has authorized.

n36 OTS Op. by Solomon (December 14, 1994) (state statute requiring license to enter into the money order business does not apply to federal thrifts); and OTS Op. Chief Counsel (November 30, 1990) (state statutes restricting the lending operations of out-of-state federal thrifts and requiring them to obtain state mortgage banker licenses are preempted).

This principle -- that a state may not impede federally authorized activities -- applies with equal force to "non-location" states that attempt to erect access barriers to the incidental trust activities of out-of-state federal thrifts. As is explained in detail in Part II.A. of this opinion, under the HOLA scheme no special permit is required before a federal thrift engages in incidental trust activities outside [\*29] its location state. These activities are conducted under the auspices of the location state permit issued by OTS, pursuant to a federal regulatory program devised by OTS in accordance with its "best practices" mandate n37 and Congress' directive to implement section 5(n) in a manner that enhances the ability of thrifts to provide effective trust services to consumers. n38

n37 12 U.S.C.A. § 1464(a) (West Supp. 1996).

n38 S. Rep. No. 368, 96th Cong., 2d Sess. 13, reprinted in, 1980 U.S. Code Cong. & Admin. News 236, 248.

The states have no power to augment or impede this federal licensing scheme. The role of location states in the licensing process is limited to contributing those state law standards expressly incorporated by HOLA section 5(n). Non-location states are assigned no role. Any location or non-location state that attempts to circumvent this federal licensing scheme by requiring federal thrifts to meet standards other than those specified by section 5(n) or by prohibiting federal thrifts from engaging in trust activities authorized by a permit issued under section 5(n) acts in direct conflict with the HOLA. It is well established that state laws that conflict [n30] with federal law are preempted. n39 The states have no power to prohibit activities authorized by the HOLA.

n39 See, e.g., *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 248 (1984); *Pacific Gas and Electric Co. v. State Energy Resources Conservation and Development Com.*, 461 U.S. 190, 203-04 (1983); *Fidelity Federal Savings and Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 152-53 (1982). For a detailed analysis of federal preemption theories, see, e.g., June 1994 Op., at 8-9; and OTS Op. Principal Deputy Chief Counsel - Legal, at 2-4 (January 9, 1990).

The particular state laws you have identified would prohibit federal thrifts from engaging in trust activities authorized under section 5(n) and, if allowed to stand, would effectively transfer licensing authority from OTS to the states. Therefore, the laws of Texas and Wisconsin that purport to prohibit marketing and advertising of trust services by out-of-state fiduciaries are preempted. In addition, the statutes you have cited for Louisiana, Virginia and Oregon that would prohibit the Association, an out-of-state fiduciary, from performing the incidental activities described herein pursuant to its appointment as a [n31] testamentary trustee or trustee of a trust holding real estate are preempted. Likewise, the reciprocity statutes of Texas and Wisconsin are preempted to the extent that they would prohibit the Association from engaging in these incidental activities in the state or would require registration with the state.

In reaching the foregoing conclusions, the OTS has relied upon the factual representations made in the material you submitted to us and in subsequent discussions, as summarized herein. Our conclusions depend upon the accuracy and completeness of those facts. Any material difference in facts or circumstances from those described herein could result in different conclusions.

If you have any questions regarding these matters, please feel free to contact Dorene Rosenthal, Counsel (Banking and Finance) (202) 906-7268.

Very truly yours,

(signed)  
Carolyn J. Buck  
Chief Counsel

cc: All Regional Directors  
All Regional Counsel