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Kentucky Law Survey: Commercial Law

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Commercial Law

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Introduction

Recent developments in Kentucky in the area of commercial law demonstrate the growth of two national trends—the continuing spread of a judicial gloss on the Uniform Commercial Code, and the rapid expansion of the law designed to protect consumers. The recent efforts of the Kentucky courts and legislature in these two areas provide the focal point for this year's survey of Kentucky commercial law.

I. Decisions Under the Uniform Commercial Code

A. *Sales of Goods*

1. *Franchise Agreements*

The parties in *Leibel v. Raynor Manufacturing Company*[1] entered into an oral agreement providing for an exclusive dealer-distributorship of garage doors. Raynor agreed to sell and deliver its garage doors and parts at factory prices to Leibel who, in turn, agreed to sell, install, and service these products exclusively. After two years of dealing under this agreement, Raynor notified Leibel in writing that the relationship was to be terminated forthwith due to decreasing sales. Leibel brought suit against Raynor to enforce the contract, alleging that he was entitled to reasonable notification of termination and that he had borrowed substantial sums of money for the purpose of performing his contract obligations. In its motion for summary judgment, Raynor argued that since the franchise agreement was of indefinite duration, either party could terminate it at will. Leibel insisted that Article Two of the Uniform Commercial Code governed the agreement and required Raynor to give Leibel reasonable notice of its intention to terminate the agreement. Raynor's motion for summary judgment was granted by the circuit court, which concluded that Article Two was not

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[1] No. CA-1800-MR (Ky. App. June 23, 1978).

applicable and that, even if it did apply, only actual, as opposed to reasonable, notice of the termination was required.[2]

On appeal, the court first considered whether a distributorship agreement is a sale of goods subject to the provisions of Article Two of the Uniform Commercial Code.[3] In resolving this issue, the court relied on *Buttorff v. United Electronic Laboratories, Inc.*,[4] which examined the nature and purpose of the agreement and the true intentions of the parties to determine whether a particular transaction fell within the scope of Article Two. In *Buttorff*, a camera salesman compensated on a commission basis was held to be a party to a contract for personal services and not a contract for the sale of goods.[5] The *Leibel* court did not clearly define the difference between a distributor and a salesman,[6] but found that the agreement in question involved primarily a sale of goods rather than services.[7] This decision is consistent with the weight of pertinent authority, which distinguishes distributors and commissioned salesmen on the basis of the presence of an agreement to purchase goods. "[T]he sales agent derives his income or compensation primarily from commissions on sales promoted and does not purchase the manufacturer's products, while, on the other hand, the distributor does make substantial purchases from the manufacturer for resale to retailers. . . ."[8]

Having determined that Leibel was a purchaser of goods, the court of appeals held that a distributorship agreement for the sale of goods is governed by Article Two.[9] In reaching this result, the court did not analyze specific Code provisions or consider whether exclusive dealership, service and installation

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[2] *Id.* at 1-3.

[3] *Id.* at 3.

[4] 459 S.W.2d 581 (Ky. 1970).

[5] *Id.* at 585.

[6] Leibel v. Raynor Mfg. Co., No. CA-1800-MR at 4 (Ky. App. June 23, 1978).

[7] *Id.* at 5.

[8] Annot., 19 A.L.R.3d 196, 208 (1968). In Louis De Gidio Oil & Gas Burner Sales & Service, Inc. v. Ace Eng'r Co., 15 U.C.C. Rep. Serv. 801 (Minn. 1974), for example, the court held that, even though the representative agreement referred to commissions, the relationship was one of buyer and seller rather than principal and agent, since the seller had no dealings with ultimate purchasers; the seller billed the dealer, who paid the seller directly at fixed price; the dealer was never paid on a commission basis; and the seller did not restrict the dealer's relation with his customers. *Id.* at 806-07.

[9] Leibel v. Raynor Mfg. Co., No. CA-1800-MR at 5 (Ky. App. June 23, 1978).

provisions of an agreement constitute a "transaction in goods."[10] Rather, the court relied on the statement of a noted Code commentator that "'[w]hen a manufacturer sells its product to the public through a local dealer, the transaction is a sale'"[11] regardless of the labels attached by the parties.

Since goods are defined by the Code as "all things . . . which are movable at the time of identification to the contract for sale,"[12] the court could have held that Article Two applied to the sale of the garage doors but did not govern the exclusive dealership provision and the agreement to install and service the goods. However, the preferred approach, which comports with the court's holding in *Leibel,* employs the "rule of a reasonable characterization of the transaction as a whole."[13] This rule provides an objective test for determining whether "the essential bulk of the assets to be transferred qualify as 'goods' . . . ."[14] If the sale of goods is the dominant part of the agreement, the inclusion in the agreement of provisions for servicing of the goods or a lease of realty will not preclude application of Article Two to the entire contract.[15] Treating the agreement as divisible would be inconsistent with the intentions of the parties and would require the court to rewrite the contract.[16] "To insist that all assets [or aspects of the agreement] qualify as 'goods' would substantially thwart the intentions of the drafters of the Uniform Commercial Code; it would sanction the absurd."[17]

Since Article Two was held to be applicable to the distributorship agreement in *Leibel,* the court next addressed whether

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[10] *See* KY. REV. STAT. §§ 355.1-102(1), (2), 355.2-102, and 355.2-105(1) (1971) [hereinafter cited as KRS].

[11] 1 R.A. ANDERSON, ANDERSON ON THE UNIFORM COMMERCIAL CODE § 2-101:5 (2d ed. 1971) [hereinafter cited as ANDERSON].

[12] KRS § 355.2-105(1) (1971).

[13] De Filippo v. Ford Motor Co., 516 F.2d 1313, 1323 (3d Cir.), *cert. denied,* 423 U.S. 912 (1975).

[14] *Id.*

[15] *See* Ashland Oil, Inc. v. Donahue, 223 S.E.2d 433, 434-35 (W. Va. 1976); Division of Triple T. Serv., Inc. v. Mobil Oil Corp., 304 N.Y.S.2d 191 (Sup. Ct. 1969); Warner Motors, Inc. v. Chrysler Motors Corp., 5 U.C.C. Rep. Serv. 365, 367 (E.D. Pa. 1968); *but see* Foster v. Colorado Radio Corp., 381 F.2d 222, 226 (10th Cir. 1967).

[16] Division of Triple T. Serv., Inc. v. Mobil Oil Corp., 304 N.Y.S.2d 191, 199-201 (Sup. Ct. 1969).

[17] De Filippo v. Ford Motor Co., 516 F.2d 1313, 1323 (3d Cir.), *cert. denied,* 423 U.S. 912 (1975).

the Code required reasonable notice of Raynor's intent to terminate the agreement. The court found that Subsections (2) and (3) of Kentucky Revised Statutes § 355.2-309 did require reasonable notice.[18] Subsection (2) of Section 355.2-309 provides that "[w]here the contract . . . is indefinite in duration, it is valid for a reasonable time but unless otherwise agreed may be terminated at any time by either party."[19] Subsection (3) of Section 355.2-309 provides that "[t]ermination of a contract by one (1) party except on the happening of an agreed event requires that reasonable notification be received by the other party and an agreement dispensing with notification is invalid if its operation would be unconscionable."[20] Applying Subsection (3), the court concluded that reasonable notification of termination was required and that the actual notice given was insufficient as a matter of law.[21]

Since Leibel was appealing a summary judgment, the court attempted to give the lower court some guidance, to apply on remand, as to what constitutes "reasonable notice." The appellate court suggested that the dealer should be given sufficient time to sell his inventory,[22] that the notice should give "'the other party reasonable time to seek a substitute arrangement,'"[23] or that the dealer should be given enough time to recoup his investment.[24] In making these suggestions, however, the court failed to recognize the differing applicability of Subsections (2) and (3).[25] Subsection (2) provides for reasonable duration of an agreement that is indefinite as to duration, whereas Subsection (3) requires reasonable notice of termination. Most courts have recognized that the period of time which constitutes a "reasonable duration" may be significantly different from the amount of advance notice required prior to termination of an agreement.[26]

[18] No. CA-1800-MR at 5-7 (Ky. App. June 23, 1978).
[19] KRS § 355.2-309(2) (1971).
[20] KRS § 355.2-309(3) (1971).
[21] No. CA-1800-MR at 5 (Ky. App. June 23, 1978).
[22] *Id.*
[23] *Id.* at 6.
[24] *Id.* at 7.
[25] The requirement of Subsection (2) may not have been satisfied in *Leibel*, since the agreement lasted a mere two years; however, the appellant only raised the reasonable notice of termination issue which is governed by Subsection (3). *Id.* at 2.
[26] *See* notes 27-43 *infra* and accompanying text.

McGinnis Piano and Organ Company v. Yamaha International Corporation,[27] in which the length of a "reasonable duration" was discussed, was cited in the *Leibel* opinion for the proposition that a distributorship agreement terminable at will "must be allowed to continue for a sufficient period to enable the franchisee to recoup his investment."[28] The *McGinnis* court also held that reasonable notice of termination "is that period of time necessary to close out the franchise and minimize losses."[29] In *McGinnis,* the conclusion was reached that a contract duration of six years was insufficient, as a matter of law, to permit the franchisee to recoup his investment.[30] One commentator has noted that 16 months has been held not to constitute a reasonable duration, while other courts have established a one- or three-year minimum.[31] On the other hand, notice periods of 60 days and three months have been held to be "reasonable."[32]

Measuring "reasonable duration" by the amount of time necessary to allow a dealer to recoup his investment is not an uncomplicated task. The period will vary "depending on the significance of the contract relationship to each party and on the potential harm each may suffer from requiring or not enforcing a minimum period."[33] In addition, reasonableness should be determined in the context of the circumstances existing at the time of termination rather than at the time the agreement was executed.[34] The *McGinnis* court found that six years' duration was not reasonable by examining "[t]he evidence with respect to the difficulty in building sales in early years, the losses during those early years, and the investment

[27] 480 F.2d 474 (8th Cir. 1973).

[28] No. CA-1800-MR at 7 (Ky. App. June 23, 1978).

[29] McGinnis Piano and Organ Co. v. Yamaha Int'l Corp., 480 F.2d 474, 479 (8th Cir. 1973).

[30] *Id.* at 480.

[31] Gellhorn, *Limitations on Contract Termination Rights—Franchise Cancellations,* 1967 DUKE L.J. 465, 480 n.54. Although this article addressed termination rights implied by law, at least one court has stated that the Uniform Commercial Code has codified such rights in Section 2-309. *See* McGinnis Piano and Organ Co. v. Yamaha Int'l Corp., 480 F.2d 474 (8th Cir. 1973).

[32] Gellhorn, *Limitations on Contract Termination Rights, supra* note 31, at 481 n.60.

[33] *Id.* at 480.

[34] *Id.* at 480-81.

by McGinnis in time and money in building the franchise . . . ."[35] When an agreement has been terminated prematurely, recoupment has traditionally "been confined to the recovery of preliminary expenses incurred in setting up a distributorship system, such as sums expended for initial promotion and renting a facility"[36] and cannot include recovery of "damages incurred after termination including lost profits."[37]

Reasonable notice, on the other hand, is measured by the time necessary to make "substitute arrangements."[38] The circumstances of each case will be material factors in determining what constitutes reasonable notice.[39] For example, in the case of an exclusive dealer-distributorship, the "manufacturer should receive reasonable notice of termination in order to locate another distributor in the area . . .; the distributor should have reasonable notice in order to make the transition from an exclusive distributor to a non-exclusive distributor."[40] If the distributorship is not exclusive, "the notice period may be less significant."[41] In addition, reasonable notice, or the amount of advance warning required to terminate an agreement, should be determined as in the case of reasonable duration, taking into account the circumstances existing at the time of termination, rather than at the time the agreement was executed.[42]

The reasonable notice provision of KRS § 355.2-309(3) may be circumvented by an agreement expressly providing for no advance notice of termination. If, however, the court finds the agreement unconscionable at the time it was executed, the contract will be rewritten to require advance warning.[43] Never-

[35] 480 F.2d at 480.

[36] Ag-Chem Equip. Co. v. Hahn, Inc., 480 F.2d 482, 487 (8th Cir. 1973).

[37] *Id.* at 492.

[38] Leibel v. Raynor Mfg. Co., No. CA-1800-MR at 6 (Ky. App. June 23, 1978). The court also stated that the dealer should be given "sufficient time to sell his remaining inventory." *Id.* at 5.

[39] *See* Hamilton Tailoring Co. v. Delta Air Lines, Inc., 14 U.C.C. Rep. Serv. 1310 (S.D. Ohio 1974); KRS § 355.1-204(2) (1971).

[40] Gellhorn, *Limitations on Contract Termination Rights, supra* note 31, at 481 n.61.

[41] *Id.* at 482 n.61.

[42] *Id.* at 482.

[43] *See* Division of Triple T. Serv., Inc. v. Mobil Oil Corp., 304 N.Y.S.2d 191, 201 (Sup. Ct. 1969); Sinkoff Beverage Co. v. Joseph Schlitz Brewing Co., 273 N.Y.S.2d 364, 367 (Sup. Ct. 1966).

theless, an argument based on unconscionability will generally be unsuccessful in a franchise case since "the doctrine of unconscionability is seldom applied in a commercial context."[44]

2. *Sale or Return*

A "sale or return" is a transaction in which goods are delivered to the buyer primarily for resale and may be returned to the seller if they are not sold, even though the goods conformed to the contract.[45] If the buyer maintains a place of business at which he deals in goods of the type purchased, the goods held by the buyer on "sale or return" are subject to the claims of the buyer's creditors even though title to the goods has been reserved by the seller.[46] Under the provisions of KRS § 355.2-326(3), goods belonging to a seller, but in the hands of a buyer on a "sale or return" basis, will not be subject to the claims of the buyer's creditors if the seller: (a) complies with a local law protecting his rights as a consignor by posting a sign on the buyer's premises,[47] (b) "establishes that the person to whom the goods are delivered is generally known to his creditors to be substantially engaged in selling the goods of others,"[48] or (c)

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[44] Gellhorn, *Limitations on Contract Termination Rights, supra* note 31, at 490.

[45] KRS § 355.2-326(1)(b) (1971).

[46] KRS § 355.2-326(2), (3) (1971).

[47] As a practical matter, compliance with a sign-posting act under Section 2-326(3)(a) of the Uniform Commercial Code will not be an alternative available to the seller. It has been held that this manner of notice to creditors of the buyer may be used only when it is expressly authorized by an "applicable state law." *See, e.g.,* In re Levy, 3 U.C.C. Rep. Serv. 291 (E.D. Pa. 1965). Currently, such laws are in force in only two states, Mississippi and North Carolina. MISS. CODE ANN. § 15-3-7; N.C. CON. & BUS. CODE § 66-72.

[48] KRS § 355.2-326(3)(b) (1971). The "general knowledge" exception provided by Section 2-326(3)(b) may be of little assistance to a seller whose goods, while in the hands of a buyer, are claimed by the buyer's creditors. The burden of showing "general" knowledge has been difficult to meet. It has been held, for example, that the seller-consignor must show that "most of the consignee's creditors knew that a considerable amount of the consignee's business was selling the goods of others;" moreover, "most creditors" does not mean "most of the indebtedness represented." *See, e.g.,* In re Webb, 13 U.C.C. Rep. Serv. 394 (S.D. Tex. 1973) (15 creditors, representing more than one-half of the total claims, had the requisite knowledge, but there were 84 creditors in all); *see also* In re International Mobile Homes, 14 U.C.C. Rep. Serv. 1150 (E.D. Tenn. 1974).

The "general knowledge" alternative in Section 2-326(3)(b) is a remedial device rather than a planning provision. A merchant-consignor who has the option of either filing a financing statement under the provisions of UCC Article Nine, Sections 9-408 has a perfected security interest in the goods pursuant to Article Nine of the Uniform Commercial Code.[49]

The "sale or return" provisions of Article Two were recently reviewed and interpreted by the Kentucky Court of Appeals in *Founders Investment Corporation v. Fegett.*[50] Unlike the ordinary "sale or return" case, *Fegett* addressed the applicability of Section 2-326 to a buyer's return of a chattel to the seller for resale. Thus, an analysis of this fact situation in terms of Section 2-326 requires that the original buyer of the chattel be characterized as the "seller" or "consignor" and the original seller as the "buyer" or "consignee." The *Fegett* case involved the purchase of a mobile home financed by appellee Indiana National Bank. Six months after the purchase, the buyer moved the mobile home back to the seller's commercial lot, claiming that, due to the ill health of his wife, he was unable to pay for lot rental expenses. Under the terms of an oral agreement between the parties, the seller was authorized to receive and transmit purchase offers on the mobile home to the buyer, who had sole discretion to accept or reject them. While the mobile home was in the possession of the seller-consignee, the buyer-consignor continued to make payments to the appellee Bank and the mobile home remained legally registered in his name. Founders Investment Corporation, which had a recorded security interest in the seller's after-acquired inventory, subsequently attached and removed a number of mobile homes from the seller's lot, including the mobile home of the buyer, as a result of a commercial dispute with the seller. Although the attachment was later declared void, the buyer's mobile home was sold and was never returned to him. The appellee Bank perfected its security interest in the buyer's mobile home after the attachment had been declared void.[51]

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and 9-114, or relying on Section 2-326(3)(b), should always choose the former. Such a filing is not burdensome; moreover, even if "general knowledge" is assured, a change in the identity of the buyer's creditors may again jeopardize the interests of the consignor if a filing has not been made. Coogan, *Leases of Equipment and Some Other Unconventional Security Devices: An Analysis of UCC Section 1-201(37) and Article 9,* 1973 DUKE L.J. 909, 952-54 (1973).

[49] KRS § 355.2-326(3)(c) (1971).

[50] No. 76-52 (Ky. App. Apr. 14, 1978), discretionary review granted, 25 Ky. Law Summ. 13 at 16 (Ky. 1978).

[51] *Id.* at 1, 2.

The appellant, Founders Investment Corporation, contended that when the buyer placed the mobile home in the seller's possession, he had delivered the chattel to the mobile home dealer on a "sale or return" basis, even though he did not intend to convey any ownership interest to the seller.[52] Thus, it was argued, the buyer occupied the position of a "seller" whose goods might be claimed by the creditors (including Founders Investment) of his "buyer," the dealer, if one of the three exceptions to this rule did not apply. Rejecting the appellant's argument, the court held that the transaction between the purchaser and the mobile home dealer was not a "sale or return."[53] Consequently, Founders acquired no interest in the buyer's mobile home under the after-acquired property clause of its security agreement with the mobile home dealer.[54] *Allgeier v. Campisi*[55] was cited as controlling precedent in the *Fegett* case, while the appellant's authorities dealing with transactions between commercial dealers were dismissed as inapposite.[56] In *Allgeier*, an automobile was delivered to a dealer by the individual owner with an understanding that the dealer would secure offers of purchase and sell the automobile upon approval of the owner. The *Allgeier* court held that the parties had not engaged in a "sale or return" transaction.[57]

The *Fegett* court justified its decision on the grounds that "it would be an unjust and unwise policy to impose"[58] the sale or return provisions of KRS § 355.2-326 "upon an *individual* owner, as distinguished from a *commercial* one."[59] The *Fegett* and *Allgeier* decisions were thus regarded by the court as statements of a judicially-created exception to the sale or return provisions of the Code, in that they protect an otherwise unprotected group:[60] "the private individual vis-a-vis the commercial

[52] *Id.* at 3.

[53] *Id.* at 3, 4.

[54] *Id.* at 4.

[55] 159 S.E.2d 458 (Ga. App. 1968).

[56] Founders Inv. Corp. v. Fegett, No. 76-52 at 4 (Ky. App. Apr. 14, 1978), discretionary review granted, 25 Ky Law Summ. 13 at 16 (Ky. 1978).

[57] 159 S.E.2d at 459.

[58] No. 76-52 at 4.

[59] *Id.* (emphasis in original).

[60] This group does not fall within any of the exceptions listed in KRS § 355.2-326(3) (1971).

financier when such owner merely attempts . . . to utilize the marketing or sales services of a commercial dealer with no intention of transferring any ownership interest to such dealer."[61] Commercial dealers and financiers would not be unduly harmed, according to the court, since transactions such as that in *Fegett* are "relatively few" in number.[62] By contrast, individual owners would suffer considerable loss if the Code's sale or return provisions were applied to them.[63]

A different method of analysis was used in a New York case, *Cosgriff v. Liberty National Bank & Trust Co.*[64] Although the facts in *Cosgriff* were similar to those in the *Allgeier* case, the *Cosgriff* court focused on the security agreement of the seller-consignee's creditor to determine whether it covered the automobile delivered to the seller by the buyer for the purpose of finding a purchaser. The court held that a security interest in "inventory, now owned or hereafter acquired" gave the secured creditor an interest in only those automobiles actually owned by its debtor, and thus "did not cover any cars owned by third persons . . ., which were merely in the temporary possession of the dealer, as an agent, for sales purposes in which the dealer's only interest was in a commission in the event that a sale was consummated."[65]

The result in *Fegett,* favoring the individual "buyer-consignor," is consistent with the Official Comments to the Uniform Commercial Code. The comments state that Section 2-326 "presupposes that a contract for sale is contemplated by the parties . . . ."[66] In the *Fegett, Allgeier,* and *Cosgriff* cases, the "buyer-consignor" did not deliver the chattel to the "seller-consignee" with an intent to sell to the dealer. Consequently, the creditor of the seller-consignee had no claim to the goods of the buyer-consignor under the "sale or return" provisions of Section 2-326. The exception to Section 2-326 created by the court in *Fegett,* and the *Cosgriff* analysis of the security agree-

[61] No. 76-52 at 4.

[62] *Id.*

[63] *Id.*

[64] 296 N.Y.S.2d 517 (Sup. Ct. 1969).

[65] *Id.* at 519.

[66] U.C.C. § 2-326, Comment 1 (1962 version); *see also* 1 ANDERSON, *supra* note 11, at § 2-326:1(1).

ment between the seller-consignee and his creditor, are therefore unnecessary to reach the conclusion that the sale or return provisions are inapplicable when the private individual merely relinquishes possession of goods to utilize the marketing or sales services of a commercial dealer with no intention of entering into a contract for sale with the dealer-consignee.

3. *Voidable Title and the Good Faith Purchaser for Value*

Under certain circumstances, a party may obtain good title to goods even though his transferor did not have legal title. *United Road Machinery Co. v. Jasper*[67] demonstrates the power of a good faith purchaser for value to defeat the claims of the original owner under the voidable title provisions of the Uniform Commercial Code.[68] United Road and Consolidated Coal entered into a lease-purchase agreement for truck scales, which provided for a 24-month payment period with an option to purchase. The truck scales were delivered to Consolidated Coal, but United Road never received any payments on the lease. About two months after the delivery, Consolidated Coal sold the truck scales for $8,500. Before purchasing the scales, the buyer examined the pertinent county records for possible notations of encumbrances on the scales but none were found. Two days later, the purchaser sold the scales for $8,500, after the purchaser's transferee had again searched the county records for encumbrances without result. United Road brought an action against the two purchasers, both of whom denied any knowledge of the dispute between United Road and Consolidated Coal.[69]

The Kentucky Court of Appeals affirmed a judgment for the purchasers and noted that there were three means by which the purchasers-appellees could have received good title to the truck scales.[70] The appellees could have acquired good title if the seller, Consolidated Coal, possessed good title to the scales.[71] This, of course, was not the case, since Consolidated

[67] No. CA-1868-MR (Ky. App. June 23, 1978).
[68] KRS § 355.2-403(1) (1971).
[69] No. CA-1868-MR at 1-3.
[70] *Id.* at 3.
[71] *Id.; see* KRS § 355.2-403(1) (1971).

Coal failed to tender any consideration for the scales to United Road. If, however, Consolidated Coal had voidable title to the scales, then the appellees would acquire good title by purchase if they were "good faith purchasers for value."[72] A transfer by an original owner (e.g., United Road) to a vendor (e.g., Consolidated Coal) will confer voidable title upon the vendor, even though the vendor does not receive "good title" as against the original owner:[73] (1) when the vendor has deceived the original owner as to his identity;[74] (2) when the vendor acquired possession from "the original owner under circumstances constituting larcenous fraud;"[75] (3) when the vendor paid the original owner with a bad check;[76] or (4) when the vendor bought the goods "from the original owner under a 'cash sale' but in fact did not pay for the goods."[77] The court assumed that one of the above four situations applied to the transaction between United Road and Consolidated Coal. United Road had argued that the transaction was a lease rather than a purchase and that Consolidated Coal could not have transferred good title, since a transaction of purchase is necessary to trigger application of the voidable title doctrine. The court held, however, that the dominant intention of the parties was to consummate a sale, and that the transaction was thus a purchase for purposes of applying the voidable title doctrine.[78] Moreover, the court concluded that each appellee qualified as a "good faith purchaser for value," defined by the court "'as one who takes by purchase getting sufficient consideration to support a simple contract, and who is honest in the transaction of the purchase.'"[79] Therefore, the appellees could obtain good title from a transferor with voidable title.

Finally, the court stated that the doctrine of estoppel would protect the appellees even if Consolidated Coal pos-

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[72] No. CA-1868-MR at 3.

[73] *Id.* at 4.

[74] KRS § 355.2-403(1)(a) (1971).

[75] 2 ANDERSON, *supra* note 11, at § 2-403:8, *see also* KRS § 355.2-403(1)(b) (1971).

[76] KRS § 355.2-403(1)(b) (1971).

[77] 2 ANDERSON, *supra* note 11, at § 2-403:8; *see also* KRS § 355.2-403(1)(d) (1971).

[78] United Road Mach. Co. v. Jasper, No. CA-1868-MR at 4 (Ky. App. June 23, 1978). At the end of the 24-month lease agreement, Consolidated Coal would have paid $14,592 for a truck scales worth $13,133. *Id.* at 2.

[79] *Id.* at 3-4, quoting the circuit court.

sessed neither good title nor voidable title. Although, as a general rule, "'one who had no title could convey none,'"[80] an exception was created in equity when "the seller possessed indicia of ownership sufficient to indicate to the purchaser that he had power to convey."[81] United Road was estopped from asserting its title against the appellees since United Road enabled Consolidated Coal to represent itself to the appellees as the owner of the truck scales, no encumbrances were revealed by the appellees' search of county records, and the appellees were unaware of the dispute between United Road and Consolidated Coal. Consequently, the appellees were deemed bona fide purchasers in good faith and United Road was required to bear the loss since its "'initial conduct'" put Consolidated Coal in the position to cause the loss.[82]

B. *Bulk Transfers*

Article Six of the Uniform Commercial Code, governing bulk transfers, applies only to enterprises "whose principal business is the sale of merchandise from stock, including those who manufacture what they sell."[83] A transfer of "a major part" of the materials, supplies, merchandise or other inventory of the transferor's business must comply with the provisions of Article Six if the transfer is not made in the ordinary course of business.[84] In addition, a "transfer of a substantial part of the equipment . . . of such an enterprise is a bulk transfer if it is made in connection with a bulk transfer of inventory, but not otherwise."[85]

If the transfer falls within the scope of Article Six, four basic requirements must be satisfied: (1) The transferee must

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[80] *Id.* at 5, quoting 67 AM. JUR. 2D *Sales* § 259 (1973).

[81] No. CA-1868-MR at 5 (Ky. App. June 23, 1978).

[82] *Id.*, quoting Dudley v. Lovins, 220 S.W.2d 978, 980 (Ky. 1949).

[83] KRS § 355.6-102(3) (1971). "[F]arming . . . contracting . . . professional services, . . . such . . . as cleaning shops, barber shops, pool halls, hotels, restaurants, and the like whose principal business is the sale not of merchandise but of services" are not governed by Article Six. 3 ANDERSON, *supra* note 11, at § 6-102:1(3).

[84] KRS § 355.6-102(1) (1971).

[85] KRS § 355.6-102(2) (1971). "Transfers of investment securities are not covered by the Article, nor are transfers of money, accounts receivable, chattel paper, contract rights, negotiable instruments, nor things in action generally." 3 ANDERSON, *supra* note 11, at § 6-102:1(3).

require "the transferor to furnish a list of his existing creditors."[86] (2) Both the transferor and transferee must "prepare a schedule of the property to be transferred sufficient to identify it."[87] (3) The transferee must preserve the list of creditors and the property schedule for six months following the transfer and permit any creditor of the transferor to inspect or copy the list and schedule at all reasonable hours or file the same in the county clerk's office.[88] (4) The transferee must give a specified form of notice to the transferor's listed creditors and to all other persons known to the transferee to have claims against the transferor.[89] The purpose of these requirements is to protect the rights of those creditors of the transferor who may have an interest in the transferor's assets at the time of transfer.[90]

1. *Scope and the Statute of Limitations*

Fifth Third Bank v. Kentucky Club, Inc.[91] dealt primarily with determining when the bulk transfer limitations period may be tolled. Nevertheless, the preliminary issue of whether Article Six was applicable is also noteworthy, since *Fifth Third Bank* involved the transfer of a bar and restaurant business, a transfer specifically excluded from Article Six by its Official Comments.[92] Despite the unequivocal language of the Comments, "there is a split of authority over whether restaurants and bars are included."[93] The Kentucky Court of Appeals did not consider this issue, however. The court merely noted that Section 355.6-102(4) governs all bulk transfers except those exempted by Section 355.6-103.[94] Since none of those exceptions applied, the court held that the Kentucky Club transfer was governed by Article Six.[95] As a result of the court's failure

[86] KRS § 355.6-104(1)(a) (Supp. 1978).

[87] KRS § 355.6-104(1)(b) (Supp. 1978).

[88] KRS § 355.6-104(1)(c) (Supp. 1978).

[89] *See* KRS §§ 355.6-105, 355.6-107 (1971).

[90] Cornelius v. J & R Motor Supply Corp., 468 S.W.2d 781, 782 (Ky. 1971).

[91] No. CA-2234-MR (Ky. App. July 21, 1978), discretionary review granted 26 Ky. Law Summ. 2 at 29 (Ky. 1979).

[92] U.C.C. § 6-102, Comment 2 (1962 version); *see also* 3 ANDERSON, *supra* note 11, at § 6-102:1.

[93] J. WHITE AND R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 19-2 (1972).

[94] No. CA-2234-MR at 2.

[95] *Id.*

to consider the Official Comments to the Code, the "restaurant-bar" issue may still be legitimately contested in Kentucky. Practitioners may also question whether other enterprises engaged primarily in the sale of services rather than merchandise are now governed by Article Six in light of the decision in *Fifth Third Bank.*[96]

The statute of limitations issue arose in *Fifth Third Bank* because the appellant's amended complaint, alleging noncompliance with the bulk transfer notice provisions, was filed more than one year after the transfer of Kentucky Club's real and personal property.[97] Section 355.6-111 requires all bulk transfer suits to be brought not "more than six months after the date on which the transferee took possession of the goods unless the transfer has been concealed." Concealment of the transfer tolls the six-month limitations period until the transferor's creditors discover the transfer.[98]

The court held that the transfer in *Fifth Third Bank* had been concealed, thereby tolling the six-month statute of limitations. The parties to the bulk transfer had provided by written agreement that Article Six would not apply to the Kentucky Club transfer. Although Section 355.1-102(3) allows the parties to vary the Code by agreement in some situations, the court held that Section 355.6-102(4) precluded enforcement of this contract provision.[99] The parties cannot "seek to waive the application of the Bulk Sales Law on the one hand and then attempt to employ the statute of limitations as a protection against the law's application."[100]

Authorities interpreting Section 6-111 have concluded that there must be an affirmative concealment of the bulk transfer before the limitations period will be tolled.[101] Under this theory, "mere nondisclosure or failure to give public notice" does not constitute affirmative concealment.[102] Although the parties did not give the notice required by Article Six, the Kentucky Club

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[96] *See* 3 ANDERSON, *supra* note 11, at § 6-102:1.

[97] No. CA-2234-MR at 3.

[98] KRS § 355.6-111 (1971).

[99] Fifth Third Bank v. Kentucky Club, Inc., No. CA-2234-MR at 3.

[100] *Id.*

[101] *See* Aluminum Shapes, Inc. v. K-A Liquidating Co., 290 F. Supp. 356, 358 (W.D. Pa. 1968); 3 ANDERSON, *supra* note 11, at § 6-111:5.

[102] No. CA-2234-MR at 4.

transfer was recorded in the county clerk's office.[103] Nonetheless, the court held "that the attempt by the parties to avoid the notice provision of the law was tantamount to a concealment of a transfer of assets within the meaning of" Section 355.6-111.[104] By intentionally avoiding Article Six, "the parties took such affirmative action as to amount to an active concealment of the transfer."[105] Consequently, the transfer of Kentucky Club was ineffective against the creditor, Fifth Third Bank, the party Article Six was designed to protect.[106]

2. *Bulk Transfer Exemption*

A bulk transfer normally within the scope of Article Six may be exempted from its requirements by Section 355.6-103. One of these statutory exemptions was the subject of controversy in *Malone & Hyde, Inc. v. Maxwell.*[107] In this case, a businessman, Mr. King, obtained a loan to purchase and operate a grocery store by signing a promissory note and security agreement. The security agreement gave the secured party, Malone & Hyde, a security interest in the store's fixtures, appliances, present and after-acquired inventory, and proceeds. A "future advance" clause, providing that the value of the security interest would fluctuate to the extent of any subsequent advances made by the creditor, was also incorporated in the security agreement. Subsequent to the perfection of Malone & Hyde's security interest, Maxwell, the appellee, supplied merchandise to King's grocery store. Shortly thereafter, the note was declared in default and Mr. King agreed to assign the inventory, fixtures, cash, and bank accounts of the store to Malone & Hyde in exchange for forgiveness of the balance of the note and an open account in the amount of approximately $182,000. Maxwell brought this action against Malone & Hyde and King for nonpayment for the merchandise furnished and for failure to comply with the provisions of Article Six.

The parties agreed that the transfer to Malone & Hyde of the inventory, fixtures, cash, and bank account was a bulk

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[103] *Id.*
[104] *Id.* at 3.
[105] *Id.* at 4.
[106] *Id.*
[107] 557 S.W.2d 908 (Ky. App. 1977).

transfer.[108] However, such a transfer may be exempt from Article Six if it qualifies as a transfer "in settlement or realization of a lien or other security interest."[109] The unsecured "creditors of the transferor cannot be jeopardized"[110] by this type of transfer of inventory covered by a security agreement since the secured party has a superior interest in the goods. Consequently, Article Six notice to unsecured creditors would serve no useful purpose.[111] Had Malone & Hyde fully released King from his obligation to repay the amount he owed, there would have been no question that the transfer of inventory and other assets was in settlement of the security interest and therefore exempt from Article Six.[112] Although King was released from his obligation on the note, Malone & Hyde created a new obligation when an open account was established for King's benefit. Creation of the open account could not be considered a bulk transfer;[113] however, the open account triggered consideration of the *Starman* rule[114] that the security interest exemption is inapplicable when part of the transfer is made to satisfy unsecured obligations.[115] Unsecured creditors who have not received notice are prejudiced in this situation because the transferee did not have a superior interest in all of the goods transferred.[116] The *Starman* rule would apply in *Malone & Hyde* if the open account had not been covered by the future advance clause of the security agreement. But for the future advance clause, King would have been released from the obligation on the note and would have received a new line of unsecured credit; thus Maxwell would have had a valid claim against the inventory transferred. The only issue in *Malone & Hyde*, therefore, was

[108] *Id.* at 909.

[109] KRS § 355.6-103(3) (1971).

[110] Starman v. John Wolfe, Inc., 490 S.W.2d 377, 382 (Mo. App. 1973).

[111] The Section 355.6-103(3) exemption deals with "instances where the general creditors cannot be harmed because of a specific senior security interest covering the transferred items." *Id.*

[112] *See* American Metal Finishers, Inc. v. Palleschi, 391 N.Y.S.2d 170 (Sup. Ct. 1977); Midland Bean Co. v. Farmers State Bank, 552 P.2d 317 (Colo. App. 1976).

[113] Transfers of money are not covered by Article Six. *See* 3 ANDERSON, *supra* note 11, at § 6-102:1(3).

[114] *See* Starman v. John Wolfe, Inc., 490 S.W.2d 377, 382-83 (Mo. App. 1973).

[115] *Id.*

[116] *Id.*

whether a security agreement with a future advance clause secures an open account subsequently established between the parties. The court held that the open account was secured and therefore found that the transfer was within the security interest exception to Article Six.[117]

3. *Application of the Holder in Due Course Doctrine to Bulk Transactions*

In the recent case of *Henkin, Inc. v. Berea Bank & Trust Co.*,[118] the Kentucky Court of Appeals considered the application of the Article Three holder in due course doctrine to an Article Six bulk transaction. Henkin, Inc. purchased a radio station from Tinker, Inc., executing a promissory note as part of the purchase price. Henkin applied to the Berea Bank & Trust Company for a loan to take advantage of Tinker's offer to discount the note for full payment. Henkin advised the bank officers of the specific purpose of the loan, but the application was rejected. While pursuing financing from other sources, Henkin was informed by the majority stockholder of the Berea Bank that the Bank would "work something out"[119] on the proposed loan. Subsequently, the majority stockholder discussed with Tinker the possibility of purchasing the Henkin note at a discount without disclosing the fact that Henkin had applied for a loan to pay the note in full. The Bank's board of directors later authorized the purchase of the Henkin note from Tinker. As a result of the purchase, the Bank acquired the mortgage on Henkin's radio station which secured the promissory note. Foreclosure proceedings were thereafter instituted by the Bank when Henkin's first installment payment was not made on time.[120]

Prior to adjudication of the foreclosure proceeding, the State Commissioner of Banking closed the Berea Bank, and the Henkin note and other bank assets were transferred to the Federal Deposit Insurance Corporation. An intervening complaint was filed in the foreclosure action by the F.D.I.C., seeking the

[117] 557 S.W.2d at 909.
[118] 566 S.W.2d 420 (Ky. App. 1978).
[119] *Id.* at 422.
[120] *Id.*

sale of Henkin's property for the full amount of the note. A counterclaim for $535,000 was filed by Henkin against the Bank, alleging fraud and breach of a fiduciary relationship. This counterclaim was also asserted as a set-off on the amount due the F.D.I.C.[121] The F.D.I.C. invoked the holder-in-due-course doctrine, contending that Henkin's claim against the Bank could not be used as a defense to the collection of the note.

The court relied on Section 355.3-302(3)(c) to hold that the F.D.I.C. was not a holder in due course and was therefore subject to the defenses Henkin asserted against the Bank.[122] That Section provides that "[a] holder does not become a holder in due course of an instrument by purchasing it as part of a bulk transaction not in the regular course of business of the transferor." In such a situation, the holder "is merely a successor in interest to the prior holder and can acquire no better rights."[123] The court noted that Section 355.3-302(3)(c) "has particular application to the purchase by one bank of a substantial part of the paper held by another bank which is threatened with insolvency and seeking to liquidate its assets."[124] Furthermore, a bulk transaction "does not possess the characteristics of a sale for value, in good faith and without notice of defense."[125]

The issue of whether a confidential or fiduciary relationship exists between a bank and its customer was a question of first impression in Kentucky.[126] The trial court dismissed Henkin's counterclaim, stating that a bank is not "legally bound by morals, ethics or strictures of conscience except as may be imposed by legislation and that there is no 'confidential relationship' between a banker and its [*sic*] customers."[127] This decision was reversed by the court of appeals.[128] The court noted that Henkin had confidentially advised the Bank of its opportunity to discount the note solely to further consideration

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[121] *Id.*

[122] *Id.* at 424.

[123] 2 ANDERSON, *supra* note 11, at § 3-302:1(3).

[124] 566 S.W.2d at 424; *see also* 2 ANDERSON, *supra* note 11, at § 3-302:1(3).

[125] 566 S.W.2d at 424; *see also* 2 ANDERSON, *supra* note 11, at § 3-302:23.

[126] 566 S.W.2d at 423.

[127] *Id.*

[128] *Id.* at 425.

of its loan application.[129] Relying on a Massachusetts case[130] and on general equitable principles, the court held that Henkin had a valid cause of action against the Berea Bank for breach of a fiduciary duty.[131] Absent a finding of such a duty, a bank official could use the information furnished by a loan applicant to "purchase the property behind the back of the applicant,"[132] thereby impairing or destroying the public's confidence in banking institutions. "'A bank official to whom an application for a loan is made must act fairly and impartially toward the bank and toward the applicant. He is prohibited from deriving any personal gain at the expense[s] of the applicant.'"[133]

The issue whether a bank has a fiduciary duty to its customers with regard to confidential matters has not been widely addressed.[134] Notwithstanding the lack of precedent on this issue, and the trial court's exhortations that only the legislature could require banks to follow "morals, ethics or strictures of conscience,"[135] the court's decision to impose fiduciary responsibilities on a bank is consistent with longstanding legal and equitable principles. A bank, like a trustee, physician, attorney or corporate director, will at times occupy a position of trust and will be privy to information of a confidential nature. There is no justification in law or equity for a rule which would permit the bank to use such information to obtain an advantage at the expense of its customer. The *Henkin* decision thus provides a bank customer with necessary and appropriate protection.

C. *Secured Transactions*

Whether Article Nine of the Uniform Commercial Code

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[129] *Id.*

[130] Warsofsky v. Sherman, 93 N.E.2d 612 (Mass. 1950).

[131] 566 S.W.2d at 424.

[132] *Id.* at 423-24, quoting Warsofsky v. Sherman, 93 N.E.2d 612, 615-16 (Mass. 1950).

[133] 566 S.W.2d at 424, quoting Warsofsky v. Sherman, 93 N.E.2d 612, 615-16 (Mass. 1950).

[134] 566 S.W.2d at 423. An Illinois court has, however, concluded that the mere existence of a debtor-creditor relationship does not impose a fiduciary duty on the creditor bank. Funderburg v. Shappert, 165 N.E.2d 543 (Ill. App. 1960) (abstract opinion).

[135] 566 S.W.2d at 423.

governs the priorities to be accorded to parties with conflicting interests in aircraft has been the subject of considerable controversy.[136] Section 9-104 of the Code states that Article Nine does not apply "to a security interest subject to any statute of the United States . . . to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property . . . ."[137] The Federal Aviation Act[138] contains provisions which clearly govern the perfection of security interests in aircraft[139] and thus, at least with respect to such perfection, there is no dispute that Article Nine is inapplicable.[140] It is less widely accepted, however, that the remaining provisions of Article Nine, and in particular the rules governing the relative priorities of secured parties and purchasers of the collateral, may be applied to resolve competing claims to aircraft collateral.

In the recent case of *Cessna Finance Corporation v. Skyways Enterprises, Inc.*,[141] the Kentucky Court of Appeals adopted the favored position on this issue,[142] holding that Congress, in the Federal Aviation Act, preempted the field only with respect to *perfection* of security interests and that a priority conflict between a secured party and a subsequent purchaser of the aircraft collateral from the debtor was properly resolved with reference to state law:

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[136] *Compare* Dowell v. Beech Acceptance Corp., 91 Cal. Rptr. 1, 476 P.2d 401 (Sup. Ct. Cal. 1970), *with* State Securities Co. v. Aviation Enterprises, Inc., 355 F.2d 225 (10th Cir. 1966), *and* Feldman v. Philadelphia Nat'l Bank, 408 F. Supp. 24 (E.D. Pa. 1976).

[137] U.C.C. § 9-104(a) (1962 version).

[138] 49 U.S.C. § 1403 (1976).

[139] Under the Act, the Secretary of Transportation is required to establish and maintain a system for the recording of all interests in aircraft, including interests taken for the purposes of security. 49 U.S.C. § 1403(a)(3) (1976). Failure to file such an interest for recordation in the office of the Secretary of Transporation renders it invalid against all persons except the debtor. 49 U.S.C. § 1403(c) (1976).

[140] *See generally,* J. WHITE AND R. SUMMERS, HANDBOOK ON THE LAW UNDER THE UNIFORM COMMERCIAL CODE 942 (1972); *cf.* I G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 13.6 at 427 n.20 (1965).

[141] No. CA-1488-MR (Ky. App. Apr. 21, 1978), *aff'd*, 26 Ky. Law Summ. 4 at 20 (Ky. 1979).

[142] J. WHITE AND R. SUMMERS, HANDBOOK ON THE LAW UNDER THE UNIFORM COMMERCIAL CODE 942 (1972); *see also* R. BRAUCHER AND R. RIEGERT, INTRODUCTION TO COMMERCIAL TRANSACTIONS 447 (1977).

> While Congress may choose to regulate an aspect of interstate commerce, unless the clear intent of the legislation is to occupy the field entirely, the states have the power to continue to regulate in that area consistent with the federal law.
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> . . . .
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> *Congress did not intend, however, to displace and preempt all state law involving priorities of liens and title interests in aircraft.*[143]

Cessna Finance Corporation (CFC) had financed the sale of an airplane by Aviation Activities, Inc. to Central States Aircraft, Inc. The evidence adduced at trial established that Cessna knew that the buyer, a dealer, contemplated immediate resale of the aircraft and that, although the terms of the security agreement prohibited resale without CFC's consent, CFC had impliedly consented to such resale on other occasions.[144] CFC retained a security interest in the airplane and filed its notice of that interest in the manner and at the place required by the Federal Aviation Act.[145] The dealer transferred title to a sister corporation, which immediately sold the plane to Skyways. Subsequently, First National Security Bank was granted a security interest in the plane, and that security interest was also duly perfected.

In deciding that Skyways' purchase of the airplane extinguished CFC's security interest, and that First National Security Bank's security interest was therefore prior to that of CFC, the court applied Section 9-306(2) of the Code,[146] which provides that a security interest normally continues in collateral notwithstanding its sale or other disposition to a third party

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[143] Cessna Finance Corp. v. Skyways Enterprises, Inc., No. CA-1488-MR at 4 (Ky. App. Apr. 21, 1978), *aff'd*, 26 Ky. Law Summ. 4, at 20 (Ky. 1979), quoting Feldman v. Philadelphia Nat'l Bank, 408 F. Supp. 24 (E.D. Pa. 1976) (emphasis added) (citations omitted).

[144] No. CA-1488-MR at 2 (Ky. App. Apr. 21, 1978), *aff'd*, 26 Ky. Law Summ. 4 at 20 (Ky. 1979).

[145] *Id.* The files of the Federal Aviation Agency are maintained in Oklahoma City, Oklahoma. *Id.*, *cf.*, I G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 13.6 at 427 (1965).

[146] No. CA-1488-MR at 5 (Ky. App. Apr. 21, 1978), *aff'd*, 26 Ky. Law Summ. 4 at 20 (Ky. 1979). Section 9-306(2) states that "[e]xcept where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof by the debtor unless his action was authorized by the secured party in the security agreement or otherwise . . . ." U.C.C. § 9-306(2) (1962 version).

unless otherwise provided by applicable Code sections and unless such disposition was authorized. The court found that CFC's prior course of dealing, in which it had impliedly consented to resale of collateral by the debtor, sufficed to establish authorized disposition in *Cessna*. Moreover, Skyways was held to be a "buyer in ordinary course of business" within the meaning of Section 9-307(1) and thus, under the terms of that section, took the aircraft free of CFC's security interest.[147]

A "buyer in ordinary course of business" must purchase "in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party . . . ."[148] Although it was clear that Skyways lacked knowledge of CFC's security interest, CFC contended that Skyways did not purchase with the requisite good faith. "Good faith" is defined generally as "honesty in fact in the conduct or transaction concerned;"[149] however, a different standard is applicable to merchants[150] in cases involving sales of goods.[151] In this latter context, "good faith" means "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."[152] CFC argued that Skyways failed to observe reasonable commercial standards when it neglected to search the records of properly filed security interests prior

[147] Under Section 9-307(1), "[a] buyer in ordinary course of business . . . takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence." U.C.C. § 9-307(1) (1962 version). Skyways had purchased the aircraft from DuPage Aircraft, a corporation formed by one Robert Brooks, who had also formed Central States Aircraft, Inc., the original debtor of CFC. No. CA-1488-MR at 1-2 (Ky. App. Apr. 21, 1978). Although the court did not discuss the requirement of Section 9-307(1), that the security interest to be extinguished be created by the buyer's seller, it would appear that the court regarded the two corporations as a common entity for purposes of applying that section.

[148] U.C.C. § 1-201(9) (1962 version).

[149] U.C.C. § 1-201(19) (1962 version).

[150] A "merchant" is defined under the Code as

> a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.

U.C.C. § 2-104(1) (1962 version).

[151] *See* text accompanying notes 155-160 *infra*.

[152] U.C.C. § 2-103(1)(b) (1962 version).

to its purchase of the aircraft.[153] This argument was rejected by the court, which stated that negligence on the part of Skyways in failing to conduct a title search would not constitute "dishonesty" or "unfair dealings."[154] Thus, CFC was deemed to be divested of its security interest in the aircraft collateral.

Although the result reached in *Cessna* appears proper, the court's application of a good faith test based on "observance of reasonable commercial standards" and its interpretation of the meaning of that phrase are arguably unsound. It has been held that, for purposes of applying Article Nine of the Code, merchants need only meet the general test of good faith, "honesty in fact," and not the further burden of observing "reasonable commercial standards."[155] The latter definition appears to be limited in its application to cases arising under Article Two, dealing with sales of goods. Such a construction of the Code is supported by the scheme of Article Nine,[156] by language in Article Two,[157] and by the Official Comments to the Code.[158]

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[153] No. CA-1488-MR at 6 (Ky. App. Apr. 21, 1978) *aff'd*, 26 Ky. Law Summ. 4 at 20 (Ky. 1979).

[154] *Id.*

[155] Sherrock v. Commercial Credit Corp., 290 A.2d 648 (Sup. Ct. Del. 1972); Associates Discount Corp. v. Rattan Chevrolet, Inc., 462 S.W.2d 546 (Tex. 1970); *but see* Bank of Utica v. Castle Ford, Inc., 317 N.Y.S.2d 542 (1971).

[156] Article Nine contains an index of definitions applicable to that article, and includes a reference to the general definitions in Article One of the Code. U.C.C. § 9-105(4) (1962 version). The *Sherrock* court noted that no analogous reference is made to definitions contained in Article Two, in which the good faith standard applicable to merchants is set forth. Sherrock v. Commercial Credit Corp., 290 A.2d 648, 651 (Sup. Ct. Del. 1972). Similarly, the court noted that the definitional cross references appended to Section 9-307(1) refer to several of the definitions in Article One, but make no reference to those in Article Two. *Id.*

[157] The definition of good faith applied to merchants is preceded by the words "[i]n this Article." U.C.C. § 2-103 (1962 version). By negative implication, the definition is intended to have no effect on the interpretation and construction of provisions in other Articles of the Code. Sherrock v. Commercial Credit Corp., 290 A.2d 648, 651 (Sup. Ct. Del. 1972).

[158] In the 1962 Official Text of the American Law Institute, National Conference of Commissioners on Uniform State Laws, the drafters of the Uniform Commercial Code comment on "good faith" in Note 19 under Section 1-201 as follows:

> 'Good Faith', whenever it is used in the Code, means at least what is here stated. [i.e., honesty in fact] In certain Articles, by specific provision, additional requirements are made applicable. See e.g., Secs. 2-103(1)(b), 7-404. To illustrate, in the article on Sales, Section 2-103, good faith is expressly defined as including

If "honesty in fact," is the standard of good faith pertinent to Skyways' purchase, the court's conclusion in *Cessna* is a correct one. "Honesty in fact" refers to a subjective test of good faith, under which negligence or commercial unreasonableness are irrelevant; good faith in this context may be found when the actor has a "pure heart," albeit also an "empty head."[159] Conversely, if observance of reasonable commercial standards is necessary to a finding that Skyways acted in good faith in *Cessna,* and if, as is likely, the commercially reasonable merchant would definitely conduct a search of recorded security interests prior to the purchase of an aircraft, then Skyways could not be found to have acted in good faith. "Dishonesty" and "unfairness" would be inferred in this instance from the failure to act in accordance with reasonable commercial standards.[160]

> in the case of a merchant observance of reasonable commercial standards of fair dealing in the trade, so that throughout that article wherever a merchant appears in the case an inquiry into his observance of such standards is necessary [sic] to determine his good faith.'

It would thus appear that the draftsmen of the Uniform Commercial Code meant the definition of "good faith" set forth in Article 2-103(1)(b) be limited to the specific Article in which it appears: Sales Article 2 only.

290 A.2d at 651 n.2.

[159] Braucher, *The Legislative History of the Uniform Commercial Code,* 58 COLUM. L. REV. 798, 812 (1958). Under this definition, a party is found to have acted in good faith "only if he acted with innocent ignorance or lack of suspicion." Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code,* 30 U. CHI. L. REV. 666, 668 (1963).

[160] It would appear that the courts have little difficulty in finding that, if the objective standard of "good faith" is applied, a failure to act in a *commercially reasonable* manner is tantamount to a lack of good faith. *See, e.g.,* Sherrock v. Commercial Credit Corp., 277 A.2d 708 (Sup. Ct. Del. 1971), *rev'd,* 290 A.2d 648 (Sup. Ct. Del. 1972). "Only to the extent that the test is objective do commercial practices become vital in establishing the standards of good faith." Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code,* 30 U. CHI. L. REV. 666, 677 (1963).

The Code apparently does not impose an obligation on Skyways to conduct the title search which CFC would require. Even if Skyways had knowledge of CFC's security interest, Skyways would qualify as a "buyer in ordinary course of business" under Section 9-307(1), so long as Skyways had no knowledge that the sale of the aircraft was "in violation of" that security interest—*i.e.,* that the disposition was not authorized. *See generally* J. WHITE AND R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 940-42 (1972).

III. CONSUMER LAW

A. *Parking Garages and Bailments*

In Kentucky, a parking garage operator who requires automobile owners to relinquish their car keys when they leave their automobiles on his premises is, by statute, a bailee for hire.[161] In a recent Kentucky case, *Central Parking System v. Miller,*[162] the court of appeals considered the status of a parking garage operator who did not require the automobile owner to relinquish his car keys. Each customer of Central Parking System (CPS) took a ticket from an automatic ticket machine upon entering CPS's garage and a mechanical gate blocking the entry to the garage would rise. The customer then parked his car and removed his keys. The ticket, indicating the time when the customer entered the garage, was presented by the customer to the gate attendant at the exit, who would use it to determine the parking charges.[163] The appellee, Stephen Miller, parked his car at the CPS garage on several occasions over an eight-month period and, during the course of that period, seven wire wheels were stolen from his car while it was parked at the garage. Mr. Miller brought an action against CPS, wherein the only issue on appeal was whether a bailment relationship existed between the parties.[164]

The relationship between automobile owners and parking garage operators is usually one of bailment, lease or license, depending upon the circumstances of the case.[165] "Generally, a bailment is created where the operator of a garage or parking lot has knowingly and voluntarily assumed control, possession, or custody of the motor vehicle . . . ."[166] If a bailment relationship does not exist, the automobile owner will bear the burden of proving negligence on the part of the operator.[167] The court of appeals, however, did not discuss the existence of control, possession, or custody by CPS of Mr. Miller's automobile,

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161 KRS § 189.710 (1971).

162 No. CA-2091-MR (Ky. App. June 30, 1978), discretionary review granted, 25 Ky. Law Summ. 14 at 27 (Ky. 1978).

163 *Id.* at 1-2.

164 *Id.* at 2.

165 38 AM. JUR. 2D *Garages, and Filling and Parking Stations* § 28 (1968).

166 *Id.*

167 *See* Annot., 7 A.L.R.3d 927, 932 (1966).

choosing instead[168] to rely on a 1925 case, *Blackburn v. Depoyster.*[169] *Blackburn* involved a parking garage owner whose customers parked their own cars and took them out at will, apparently without relinquishing their car keys.[170] The *Blackburn* Court stated that "a garage keeper with whom an automobile is left for storage is [a] bailee for hire and as such he is under legal obligation to exercise such ordinary care as a man of reasonable prudence and discretion would exercise under like circumstances with respect to his own property."[171] The *Central Parking* court held that the *Blackburn* decision required the conclusion that CPS was a bailee[172] and as such "has the burden of overcoming the prima facie presumption of negligence which arose out of delivery of the car into its possession, and loss while in its possession."[173] The *Central Parking* decision was rendered notwithstanding a Kentucky statute,[174] enacted in 1954, which provides that parking garage operators who require automobile owners to leave their keys with their cars are bailees for hire and liable for thefts. This statute was held not to interfere with application of the principle announced in *Blackburn,* because the statute did not specifically state that garage owners who did not require drivers to relinquish their keys were not bailees.[175] Judge Gant, dissenting in *Central Parking,* distinguished *Blackburn* on the ground that it had involved an oral agreement between the plaintiff and the owner of the garage, and argued that "the necessary elements of surrender of control of the chattel and knowledge of possession of same by the bailee" were not present in the *Central Parking* case.[176]

It is possible to argue, as the court of appeals elected to do in *Central Parking,* that the 1954 statute is not applicable to this case, because it addresses only the status of parking garage

[168] No. CA-2091-MR at 2-3 (Ky. App. June 30, 1978).

[169] 272 S.W. 398 (Ky. 1925).

[170] *See* Central Parking Sys. v. Miller, No. CA-2091-MR at 2 (Ky. App. June 30, 1978), discretionary review granted, 25 Ky. Law Summ. 14 at 27 (Ky. 1978).

[171] 272 S.W. at 399, quoted in No. CA-2091-MR at 2-3 (Ky. App. June 30, 1978).

[172] No. CA-2091-MR at 2 (Ky. App. June 30, 1978).

[173] *Id.* at 4.

[174] KRS § 189.710 (1971).

[175] No. CA-2091-MR at 3 (Ky. App. June 30, 1978).

[176] *Id.* at 5.

operators who in fact require surrender of automobile keys. The statute, however, clearly erodes to some extent the general rule announced in *Blackburn* that "a garage keeper . . . is a bailee for hire." With the authority of *Blackburn* thus in question, the court of appeals might profitably have undertaken an independent analysis of the status of CPS, and considered the extent to which a parking garage operator who fails to retain a customer's keys may nevertheless be deemed to be a bailee for hire. In this context, whether CPS willingly assumed control of Mr. Miller's automobile must be the central issue.

Although there is no other authority in Kentucky on this point, the liability of parking garage operators who do not retain automobile keys has been considered in other jurisdictions; however, the pertinent decisions offer no clear consensus. In *Giles v. Meyers,*[177] for example, the court stated that custody of the automobile shifts to the garage owner and a contract of bailment is created "if once having received an identification ticket upon entering the lot the driver can only remove his car from the lot by relinquishing the ticket . . . ."[178] The garage owner was also held to be a bailee for hire in *Hale v. Massachusetts Parking Authority,*[179] a case in which the automobile owner had parked and locked his car and kept his keys. The parking facility was enclosed and an attendant, who was responsible for stopping each departing car and checking the tickets presented by the customers, was stationed at the sole means of egress. The garage owner was held to have exercised control over the automobiles by controlling their departure from the facility.[180]

Other courts, on similar facts, have refused to hold the parking garage operators liable as bailees for hire. *Equity Mutual Insurance Co. v. Affiliated Parking, Inc.,*[181] concerned the liability of the owner of an enclosed airport parking lot in which the automobile owners parked their cars and retained their keys. The lot was equipped with automatic ticket machines. In

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[177] 107 N.E.2d 777 (Ohio Misc. 1952).

[178] *Id.* at 778.

[179] 265 N.E.2d 494 (Mass. 1970).

[180] *Id.* at 495-96; *see also* Sewall v. Fitz-Inn Auto Parks, Inc., 330 N.E.2d 853, 855 (Mass. App. 1975).

[181] 448 S.W.2d 909 (Mo. App. 1969).

Equity Mutual, the court emphasized that the "tickets were not for the purpose of identifying the specific automobile bailed, for stating the terms of the bailment, or for any purpose other than determining the amount of time the car was on the lot and thus the amount owed defendant upon removal."[182] Consequently, the court found that "the tickets were not such as would constitute evidence of the control and delivery necessary to create a bailment."[183] In *Wall v. Airport Parking Co.,*[184] involving a similar self-service parking lot, the parking lot operator was also held not to be a bailee. The court noted that acceptance of the chattel is a necessary element of a bailment, and concluded that the operator did not accept any vehicle for bailment since he had no control over those who used the self-service lot.[185]

The differing results in the above cases reflect the conflicting policy considerations inherent in the underlying fact situation. On the one hand, a parking garage operator who is not present when an automobile is left on his lot and who does not accept the keys to that automobile arguably has exercised no dominion or control over it and should not be responsible for any loss or damage to it. Further, to subject such operators to the categorical rule of *Blackburn,* and label them bailees for hire by reason of their occupation alone, is to say that society will not accommodate absentee operation of a parking garage. Surely, the operators might contend, it is appropriate to permit individuals to contract to lease merely unattended and unguarded space, without incurring additional obligation.

The owner of an automobile, on the other hand, also merits concern. Presumably, the owner has parked his or her automobile in a parking garage either because there is no other place in which to leave it or because the garage appears to offer greater protection against loss than "on-the-street" parking. By holding that a bailment was not created, the *Equity Mutual* and *Wall* decisions place the burden of proving the negligence of the garage owner on the customer. As a practical matter, the

[182] *Id.* at 914.
[183] *Id.*
[184] 244 N.E.2d 190 (Ill. 1969).
[185] *Id.* at 193.

imposition of this burden of proof will often preclude recovery by an automobile owner who has sustained damage or loss to a vehicle, since evidence of exercise of care or the lack thereof is in the parking operator's control.[186] The *Giles* and *Hale* decisions, which place on the parking lot operator the burden of going forward with evidence explaining the loss, clearly offer greater protection to customers of parking garages and lots. It should be noted, moreover, that the operator may be better able to absorb the losses that occur to automobiles on his or her premises.[187]

The decisions discussed above may be distinguished to some extent by the character of the particular operations. In the first instance, it may be appropriate to concede that parking in an open lot, which is accessible to the public at all or most hours of the day and night, presents a discrete situation in which an automobile owner ought not to be entitled to expect that an unattended vehicle would be secure from harm. Under this analysis, the results in *Equity Mutual,* involving an airport parking lot, and *Wall,* involving a "self-service" lot, may be proper. Where, however, a particular parking facility creates the impression of offering some measure of security, because it is located in an enclosed building, locked after certain hours, or because, although it is not enclosed, it is of suffi-

[186] Although it has been stated that, as a general rule, the burdens of pleading and proof with regard to most facts are imposed on the plaintiff, who generally seeks to alter the status quo, MCCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE 786 (E. Cleary ed., 2d ed. 1972), courts have often applied the doctrine that, where the facts pertaining to a particular issue lie peculiarly in the knowledge of one party, that party should bear the burden of proof on that issue. *Id.* at 787. Thus, the natural tendency to place the burdens on the party desiring change are sometimes qualified by other factors, including special policy considerations, fairness, convenience, and the judicial estimate of the probability that a particular event has occurred. *Id.* at 787-89.

[187] Under the "risk-spreading" theory, which has to date received greatest attention in the area of products liability, it is contended that manufacturers and suppliers, as a group and as an industry, ought to bear the "inevitable losses which must result in a complex civilization from the use of their products, because they are in the better position to do so, and through their prices to pass such losses on to the community at large." Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer),* 69 YALE L.J. 1099, 1120 (1960); *see also* Prosser, *The Fall of the Citadel (Strict Liability to the Consumer),* 50 MINN. L. REV. 791, 800 (1966). Advocates of this theory suggest that allocation of risk in this fashion could be borne by means of liability insurance. *See* Prosser, *The Assault Upon the Citadel, supra* at 1121, for a discussion of the controversy surrounding the assignment of this role to the insurance structure.

ciently limited dimensions to permit continuous surveillance by an exit attendant stationed there, and where no conspicuous effort is made by the parking facility operator to disabuse potential patrons of this impression, imposition of liability for loss on the operator, absent a showing of exercise of reasonable care, would appear to be appropriate.[188]

The *Central Parking* decision is not the thoroughly reasoned opinion required to establish a rule on this issue in Kentucky. Nevertheless, the decision, which requires parking facility operators to prove that they exercised reasonable care with respect to automobiles bailed on their premises, offers considerable protection to the vulnerable consumer and is not without support in case law and in social policy.

B. *New Home Purchases and the Implied Warranty of Fitness*

Anderson v. Scholz Homes, Inc.[189] recounts the tragic tale of a consumer who should have won, but did not. The Andersons entered into a purchase agreement with Scholz Homes for a new house[190] and lot for $67,500. The purchase agreement provided that "[a]ll work shall be done to complete [the]

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[188] For an excellent discussion of the theories of liability for defective services rendered in a consumer transaction, see Greenfield, *Consumer Protection in Service Transactions—Implied Warranties and Strict Liability in Tort,* 1974 UTAH L. REV. 661, 662-83. A number of arguments have been made for an extension of application of implied warranty and strict tort liability to service transactions. It may be urged, for example, that the relationship between the seller and the buyer is the same whether chattels or services are sold; *i.e.*, the seller is clearly in a better position than the buyer to determine in advance whether a particular service is defective and, if it is, to alter it. Similarly, the seller may be in a better position to bear the loss caused by provision of a defective service, and to distribute the risk of that loss among all of his customers. Moreover, as in the case of a sale of goods, the consumer of services places a high degree of reliance on the seller's skill, care and reputation. This reliance is often explicitly encouraged by sellers, either via advertising or by other promotional devices. Greenfield, *Consumer Protection in Service Transactions, supra* at 688-89 & nn.117, 118. Parking garage operators may also implicitly foster such reliance by ostensibly offering a secure location for temporary storage of motor vehicles. The social and legal policy which favors giving some weight to consumer expectations, operative in imposing tort liability for sale of defective goods, is thus arguably applicable to the provision of services. Absent a clear and conspicuous warning or disclaimer of the effectiveness of the service—in this case, the security of a parking garage—loss should fall on the seller of the service, the parking facility operator.

[189] 558 S.W.2d 639 (Ky. App. 1977).

[190] *Id.* at 640.

house in new home condition."[191] About one week after the purchase agreement had been executed, the Andersons sent a letter to Scholz Homes specifying numerous items which they believed Scholz Homes was obligated to complete.[192] Approximately eight months later, the Andersons filed a complaint alleging that Scholz Homes had breached its contractual obligation to repair the sagging roof on the new home. The sagging roof was not one of the items mentioned in the earlier letter to Scholz Homes.[193] Nonetheless, the letter was attached as an exhibit to the Andersons' complaint.[194] The complaint did not allege ambiguity of contract, unfair representations, or breach of an implied warranty of quality.[195] Scholz Homes moved to dismiss the complaint for failure to state a claim upon which relief may be granted. The trial court sustained the motion and dismissed the complaint with prejudice.[196]

Notwithstanding the absence of an implied warranty claim in the Andersons' complaint, the court of appeals allowed the issue to be raised on appeal. The court stated that "Kentucky seems to still hold to the doctrine of caveat emptor."[197] This rule applies "'where no direct representation is made by the vendor concerning definite facts and the purchaser has sufficient opportunity to observe the condition of the premises . . . .'"[198] Applying the rule of caveat emptor, the court affirmed the trial court's decision, since the purchase agreement provided that the "Andersons took the home 'as is,' after an inspection."[199] The inspection by the Andersons revealed some problems which were corrected but did not disclose the sagging roof. The court determined that the contractual obligation of Scholz Homes did not include the repair of "later-discovered defects."[200] The result in this case is unfor-

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[191] *Id.*

[192] *Id.*

[193] *Id.*

[194] Brief for Appellee at 1-2, Anderson v. Scholz Homes, Inc., 558 S.W.2d 639 (Ky. App. 1977).

[195] 558 S.W.2d at 640-41.

[196] *Id.* at 640.

[197] *Id.* at 641.

[198] *Id.*, quoting Fannon v. Carden, 240 S.W.2d 101, 103 (Ky. 1951).

[199] *Id.*

[200] *Id.*

tunate, for it appears that both the attorney[201] for the Andersons and the court were unaware of the 1969 Kentucky case of *Crawley v. Terhune.*[202] In *Crawley,* the Court abandoned the majority rule "that there is no implied warranty of fitness, condition or quality in the sale of a new dwelling."[203] The Court announced that "the caveat emptor rule is completely unrealistic and inequitable as applied in the case of the ordinary inexperienced buyer of a new house from the professional builder-seller . . . ."[204] The minority view was thereafter adopted by the *Crawley* Court: "[I]n the sale of a new dwelling by a builder there is an implied warranty that in its major structural features the dwelling was constructed in a workmanlike manner and using suitable materials."[205]

C. *Statute of Limitations Under the Truth-in-Lending Act*

The Federal Truth-in-Lending Act[206] requires that creditors make certain enumerated disclosures to borrowers in connection with consumer credit transactions.[207] Creditors who

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[201] The Andersons' attorney raised the implied warranty issue on appeal, citing only the Texas case of Humber v. Morton, 426 S.W.2d 554 (Tex. 1968). Brief for Appellant at 4-5, Anderson v. Scholz Homes, Inc., 558 S.W.2d 639 (Ky. App. 1977).

[202] 437 S.W.2d 743 (Ky. 1969). One possible explanation for the omission of any reference to *Crawley* in the briefs or opinion in *Anderson* is that the indexing system of the *Kentucky Digest* is unreliable in the field of homeowners' remedies against builders. For example, the "key-number" category assigned to *Fannon v. Carden* is "Vendor & Purchaser: Application of doctrine of caveat emptor—37(1)." 18A KENTUCKY DIGEST 349 (1962). In *Anderson v. Scholz Homes* the assigned category is "Vendor & Purchaser: Subject Matter—Appurtenances—67." *Id.* at 17 (Supp. 1978). However, the category assigned to the implied warranty issue in *Crawley v. Terhune* is "Contracts: Warranties—205." 5 KENTUCKY DIGEST 155 (Supp. 1978). Consequently, research of the cases in the "Vendor & Purchaser" category indicates that the doctrine of caveat emptor is still applicable in Kentucky.

[203] 437 S.W.2d at 745.

[204] *Id.*

[205] *Id.*

[206] 15 U.S.C. §§ 1601-81 (1976).

[207] The disclosure requirements apply to both closed-end credit transactions, such as a single loan, 15 U.S.C. §§ 1638, 1639 (1976), and open-end credit plans, such as revolving charge accounts, 15 U.S.C. § 1637 (1976). The type of information required to be disclosed includes: the annual percentage rate of interest, the total amount of any finance charge, and the principal amount financed. Disclosures are regulated not only as to content, but also as to form: disclosures must be made clearly, conspicuously, in meaningful sequence and in the terminology prescribed by the Act and by Federal Reserve Board Regulation Z, 12 C.F.R. § 226.6(a) (1978).

fail to comply with these disclosure requirements are liable for a penalty, limited under the Act to twice the amount of the finance charge in connection with the transaction, but not less than $100 nor more than $1000.[208] A successful plaintiff is also entitled to recover the costs of the action together with reasonable attorney's fees.[209]

The Act expressly provides that an action based on a failure to comply with the disclosure requirements must be brought "within one year from the date of the occurrence of the violation."[210] Although the courts have had little difficulty in construing this provision to bar actions by a consumer plaintiff more than one year after a violation of the Act by a creditor,[211] there has been less agreement as to the applicability of this statute of limitations in other contexts. Specifically, when a creditor has sued in a state court to recover an unpaid debt, and the debtor has filed a counterclaim based on Truth-in-Lending Act violations which occurred more than one year prior to the suit, the courts have been divided on the issue whether the counterclaim should be barred by the Act's limitations statute.

Courts which have held that such counterclaims are barred have often done so summarily.[212] Other courts have emphasized the policy of the Truth-in-Lending Act, noting a manifested congressional intent to establish a uniform period

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[208] 15 U.S.C. § 1640(a)(2)(A)(ii) (1976).

[209] 15 U.S.C. § 1640(a)(3) (1976).

[210] 15 U.S.C. § 1640(e) (1974). As a general rule, when the violation occurs in a "closed-end" transaction, it is held to have "occurred" when the creditor fails to make the required disclosures at the time required, *i.e.* when the agreement is consummated, as opposed to the time the violation is discovered. *See, e.g.*, Stevens v. Rock Springs Nat'l Bank, 497 F.2d 307, 309 (10th Cir. 1974). The theory that the violation is a continuing one has been rejected by the majority of courts. *See, e.g.*, Wachtel v. West, 476 F.2d 1062 (6th Cir.), *cert. denied*, 414 U.S. 874 (1973); Munson v. Orrin E. Thompson Homes, Inc., 395 F. Supp. 152 (D. Minn. 1974); *see generally*, Annot., 36 A.L.R. Fed. 657, 670 (1978); *but see* Postow v. Oriental Bldg. Ass'n, 390 F. Supp. 1130 (D.D.C. 1975), for an example of the minority position. Moreover, repetitions of the violation, such as monthly billing statements, do not extend the period of limitations. *See* Fenton v. Citizens Sav. Ass'n, 400 F. Supp. 874 (W.D. Mo. 1975).

[211] *See, e.g.*, Stevens v. Rock Springs Nat'l Bank, 497 F.2d 307 (10th Cir. 1974); Wachtel v. West, 476 F.2d 1062 (6th Cir.), *cert. denied*, 414 U.S. 874 (1973); Fenton v. Citizens Sav. Ass'n. 400 F. Supp. 874 (W.D. Mo. 1975).

[212] *See, e.g.*, Phil Mechanic Constr. Co. v. Gibson, 226 S.E.2d 837 (N.C. App. 1976).

for enforcement of actions for violations,[213] and suggesting that it would be improper to extend the time limit merely because a state forum was involved.[214] It has been urged, moreover, that while the Truth-in-Lending Act was intended to protect consumers, it should not be used to thwart the valid claims of creditors.[215]

The Kentucky Court of Appeals considered this issue in the recent case of *Empire Finance Co. v. Ewing,*[216] and held that the one-year limitations period was not applicable to a consumer defense, based on TILA violations, in the nature of "recoupment."[217] Melvin Ewing, the debtor on an installment note executed to Empire Finance Company on September 25, 1975, was the defendant in Empire's action to recover the unpaid balance due on the note after default. Ewing alleged that Empire had failed to comply in numerous respects with the disclosure requirements of the Act, and claimed that he was entitled to a "set-off" of $398 against the $484.38 due on the debt. Ewing counterclaimed for the $398 and for attorney's fees and costs of the action.[218] The trial court found that Empire had violated the Truth-in-Lending Act, in failing to indicate on its disclosure statement that the security interest retained by

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[213] "Truth-in-Lending is a federal law which should be uniformly applied to consumers in all states." Ken-Lu Enterprises, Inc. v. Neal, 223 S.E.2d 831, 833 (N.C. App.), *cert. denied,* 225 S.E.2d 829 (N.C.), *cert. denied,* 429 U.S. 1002 (1976).

Congressional intent to maintain an inflexible one-year statute of limitations on TILA actions has also been inferred by some courts from a 1974 amendment to the Act. This amendment provides that a person may not offset any amount for which a creditor is potentially liable to him under the Act against a debt owed to such creditor "unless the amount of the creditor's liability to such person has been determined by judgment of a court of competent jurisdiction in an action to which such person was a party." 15 U.S.C. § 1640(h) (1974). Public Loan Co. v. Hyde, 390 N.Y.S.2d 971 (1977); Ken-Lu Enterprises, Inc. v. Neal, 223 S.E.2d 831 (N.C. App.), *cert. denied,* 225 S.E.2d 829 (N.C.), *cert. denied,* 429 U.S. 1002 (1976). Others have urged that this provision is intended only to preclude a debtor's "self-help" deduction of penalties not adjudicated against a creditor. *See* note 223 *infra* and accompanying text.

[214] In *Public Loan Co. v. Hyde,* 390 N.Y.S.2d 971 (1977), the court rejected counterclaims based on violations of the Truth-in-Lending Act, and noted that it was consistent, if federal courts lacked jurisdiction over such claims after one year, to similarly limit the jurisdiction of the state court.

[215] *E.g.,* Ken-Lu Enterprises, Inc. v. Neal, 223 S.E.2d 831 (N.C. App.), *cert. denied,* 225 S.E.2d 829 (N.C.), *cert. denied,* 429 U.S. 1002 (1976).

[216] 558 S.W.2d 619 (Ky. App. 1977).

[217] *Id.* at 622.

[218] *Id.* at 620.

Empire in Ewing's after-acquired property was limited to property acquired within ten days after the date the loan was made.[219] The set-off claimed by Ewing was allowed, and Empire appealed.

The appellate court, affirming the decision below,[220] rejected Empire's argument that the Truth-in-Lending Act established a one-year statute of limitation[221] applicable to both affirmative actions to recover a penalty for violation of the Act and to debtor defenses seeking to assert the penalty by way of set-off, counterclaim or recoupment.[222] The appellee, Ewing, had argued that the Act was intended to bar only affirmative actions under the Act more than one year after a violation had occurred and to preclude debtor "self-help" via unilateral deduction from the debt of a penalty the debtor deemed to be due him under the Act.[223] Noting that there was support for both

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[219] *Id.* at 621. Federal Reserve Board Regulation Z, 12 C.F.R. § 226.8(a)(5) (1978), requires that the disclosure statement contain a description or identification of the type of security interest retained by the creditor, if any. Although it is not improper to retain a security interest in after-acquired property of the debtor, if the debtor is a consumer such after-acquired interests are limited to property acquired within 10 days from the date that the loan is made. U.C.C. § 9-204(4) (1962 version); KRS § 355.9-204(4)(b) (1960). In light of this limitation, it has been held that a security interest in "all after-acquired property," without an indication of the restrictions on this interest, constitutes a violation of the Truth-in-Lending Act. *E.g.*, Tinsman v. Moline Beneficial Finance Co., 531 F.2d 815 (7th Cir. 1976); Johnson v. Associates Finance, Inc., 369 F. Supp. 1121 (S.D. Ill. 1974). This rule has been unofficially adopted in Kentucky, Stone v. Modern Loan Co., Inc., No. C75-0033L(B) (June 2, 1976), and was applied by the Court of Appeals in *Empire*. 558 S.W.2d at 621.

[220] Error was found, however, in the trial court's failure to award the creditor prejudgment interest, and interest after judgment at the statutory rate. The judgment for Empire (albeit reduced in amount to the extent claimed by Ewing) was amended to provide for such interest. 558 S.W.2d at 622.

[221] Empire based its claim that a one-year statute of limitations applied to all TILA claims upon a reading of sections 130(e) and 130(h) of the Act. 15 U.S.C. §§ 1640(e), (h) (1976).

[222] 558 S.W.2d at 621-22.

[223] *Id.*

> To hold otherwise, appellee contends, would seriously hamper the purpose of the penalty provision since in most instances borrowers would not become aware of a violation of disclosure provisions until some legal action was commenced by the lender to recover the money lent. Lenders could, therefore, avoid assertion of the penalty by a borrower by simply waiting more than one year to take action.

Id. It should be noted that, even if no such bad faith may be imputed to lenders, a construction of the limitations provision to bar *any* claim for a penalty more than one year from the violation would appear to reward debtors who default immediately in positions in the case law of other jurisdictions,[224] and that such decisions thus furnished little guidance for resolution of the issue, the court turned to Kentucky law. Controlling effect was given to the case of *Liter v. Hoagland*[225] and its progeny,[226] holding that, under Kentucky practice, limitations periods do not preclude the assertion of " 'mere defenses' arising out of the transaction connected with a plaintiff's claim."[227] To apply *Liter*, the court further found that the defense raised by Ewing was in fact one "arising out of" the transaction and not "extrinsic" thereto.[228]

The *Empire* decision is noteworthy primarily as a statement of Kentucky's position on an issue on which state courts have been sharply divided.[229] The refusal of the Kentucky Court of Appeals to bar claims for Truth-in-Lending Act violations asserted by defendants in debt collection actions, when the defense of recoupment is raised more than one year from the date the violation occurred, is clearly a boon to consumers. Because they often lack commercial sophistication, consumer debtors may be unaware of the protection afforded them under Federal law until well after the one-year period allowed for affirmative actions to enforce their rights has expired. Surely, it may be argued, the credit information to which such a consumer is entitled under the Act does not lose its relevance to

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their credit obligations and penalize those who make a good faith effort to pay their debts, but become unable to do so more than one year after the date of contracting.

Legislative history supports the argument that Section 130(h), 15 U.S.C. § 1640(h) (1976), was designed to prevent "self-help" deductions of penalties, and thus does not mandate exclusion of counterclaims or claims in the nature of set-off or recoupment. S. REP. No. 93-278, 93d Cong., 1st Sess. 16 (1973).

[224] 558 S.W.2d at 622. *Compare, e.g.*, Public Loan Co. v. Hyde, 390 N.Y.S.2d 971 (1977) (counterclaims barred), *with* Termplan Mid-City, Inc. v. Laughlin, 333 So.2d 738 (La. App. 1976) (time-barred claim of TILA violations may be asserted as set-off).

[225] 204 S.W.2d 219 (Ky. 1947).

[226] *See, e.g.*, Armstrong v. Logsdon, 469 S.W.2d 342 (Ky. 1971).

[227] 558 S.W.2d at 622, *citing* Liter v. Hoagland, 204 S.W.2d 219 (Ky. 1947).

[228] "The duties and resultant civil liability of a lender arise out of the loan transaction itself. They are imposed by law upon the lender in the making of such a contract and, in effect, they become a part of the contract." 558 S.W.2d at 622. A contrary result was urged in *Empire*, and had been adopted by other courts. *E.g.*, Ken-Lu Enterprises, Inc. v. Neal, 223 S.E.2d 831 (N.C. App.), *cert. denied*, 225 S.E.2d 829 (N.C.), *cert. denied*, 429 U.S. 1002 (1976).

[229] *See, e.g.*, notes 211-15 and 224 *supra* and accompanying text; notes 231-34 *infra* and accompanying text.

him simultaneously with the expiration of that period. Thus, to hold that even a defense in the nature of recoupment or set-off, based on TILA violations, is barred after one year is to permit a creditor to reap the benefits of an unlawful contract, and to frustrate the essential purpose and policies of the Act.[230]

It is interesting to note, however, that a number of state courts allowing TILA violations to be raised as defenses have, as in *Empire,* based their decisions upon a helpful peculiarity of state law. For example, in *Wood Acceptance Co. v. King,*[231] a state statute allowed the defendant to plead as a set-off or counterclaim a claim otherwise barred by the pertinent statute of limitations.[232] Similarly, in *First National City Bank v. Drake,*[233] the court was aided by a New York statute authorizing assertion of time-barred causes of action as a set-off or defense against an obligation out of which the defense arose.[234]

That courts have been compelled to look to state statutory or case law to reach the conclusion that TILA-based defenses are not barred explains the lack of uniform result in the decisions on this issue and illustrates the inadequacy and ambiguity of the TILA. Although there is little legislative history to illuminate the congressional purpose underlying the one-year

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[230] The intent of Congress in enacting the disclosure requirements under the Federal Consumer Credit Protection Act was to ensure full disclosure of credit charges in order to permit consumers to "comparison-shop" for credit and to make intelligent judgments as to the reasonableness of the credit charges imposed.H.R. REP. No. 1040, 90th Cong., 1st Sess. 1-2 (1967), *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 1962, 1962-63.

[231] 309 N.E.2d 403 (Ill. App. 1974).

[232] ILL. REV. STAT. ch. 83, § 17 (1971), *cited in* Wood Acceptance Co. v. King, 309 N.E.2d 403, 404 (Ill. App. 1974).

[233] [1969-1973 Transfer Binder] CONS. CRED. GUIDE (CCH) ¶ 98,939 (N.Y. Civ. Ct. 1973).

[234] By rule of civil procedure in New York, defenses or counterclaims arising out of the same transaction as that giving rise to the complaint are not barred by the pertinent statute of limitations in all instances:

> A defense or counterclaim is not barred if it was not barred at the time the claims asserted in the complaint were interposed, *except that* if the defense or counterclaim arose from the transactions, occurrences, or series of transactions or occurrences, upon which a claim asserted in the complaint depends, *it is not barred to the extent of the demand in the complaint* notwithstanding that it was barred at the time the claims asserted in the complaint were interposed.

N.Y. CIV. PRAC. LAW § 203(c) (McKinney) (emphasis added).

statute of limitations in the Truth-in-Lending Act,[235] the Act was clearly intended to safeguard consumers[236] and to be enforced by means of private actions for the civil penalty provided.[237] To further these policies and to avoid inequitable results and disparate holdings in different states, clarification of the Act is required. Pending that clarification, courts must continue to speculate on the proper application of the limitations provision, endeavoring with little guidance to realize the objective of fairness to consumers.

D. *Consumer Legislation*

Two acts of the Kentucky legislature, approved on March 30, 1978, provide significant protection for the interests of consumers by regulating the distribution and sale of "business opportunities,"[238] and the use of "negative option plans"[239] in the sale of merchandise.

1. *Business Opportunities*

A new section of KRS Chapter 367, an Act relating to business opportunities, defines a "business opportunity" as "an opportunity to offer, sell or distribute through a distribution device goods or services supplied in whole or in part by the offeror" when the offeror acquires an initial required investment of at least $500, and when the offeror has made certain specified representations to the consumer/investor concerning

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[235] "Although our research into the Congressional hearings on the enactment of the Federal Truth in Lending Bill fails to disclose the purpose behind the one year filing period, we note that the Act is intended to safeguard the consumer in connection with the utilization of credit . . . ." Wood Acceptance Co. v. King, 309 N.E.2d 403, 405 (Ill. App. 1974).

[236] *Id.*

[237] *Id.* "[T]he enforcement of the Act is accomplished largely through the institution of civil actions. For this reason, no provision was made for investigative or enforcement machinery at the federal level on the assumption that the civil penalty section would secure substantial compliance with the Act." *Id., citing* S. REP. No. 392, 90th Cong., 1st Sess. 9 (1967).

[238] KRS §§ 367.801-.990 (Supp. 1978). Legislation regulating the sale of recreation and retirement use land was also added to the Kentucky consumer protection laws in 1978. This legislation, not discussed in this article, may be found at KRS §§ 367.470-.486 (Supp. 1978).

[239] KRS §§ 367.570-.585 (Supp. 1978).

the anticipated profitability of the opportunity.[240] The sale of business opportunities is declared by the Act to be unlawful unless the seller-offeror first files a form of registration statement with the state division of securities, and furnishes $25,000 bond "to insure the veracity of all statements contained in the registration . . . ."[241] The filed registration must contain certain information specified in the Act, including disclosure of the offeror's trade names, and home addresses and home telephone numbers of the company offering the business opportunity, and of any directors, chief executive officers and sales representatives. Disclosure of additional information pertaining to the history of the offeror's business is also required, including, for example, the names, addresses and telephone numbers of all persons who have purchased business opportunities from the offeror within the preceding two years; a statement of any civil or criminal judgment against the offeror; a statement of any litigation to which the offeror or its officers, directors or agents have been a party within the past seven-year period; and whether the offeror has been adjudicated a bankrupt within that period.[242]

The Act requires an offeror to furnish and display to any potential consumer/investor a copy of the filed disclosure statement,[243] and to provide the prospective consumer/investor with a notice stating that registration does not imply, directly or indirectly, that the business opportunity or any of the activities

[240] KRS § 367.801(5) (Supp. 1978). Specifically, a "business opportunity" is brought within the scope of the Act when:

> (a) The offeror obtains an initial required consideration of not less than five hundred dollars ($500) from the purchase or lease of the business opportunity or inventory associated therewith; and
> (b) The offeror has represented that the consumer/investor will earn, can earn or is likely to earn a gross or net profit in excess of the initial required investment paid by the consumer/investor for the business opportunity; and
> (c) The offeror has represented that he has knowledge of the relevant market and that the market demand will enable the consumer/investor to earn a profit from the business opportunity; or the offeror has represented that . . . assistance will be given to the consumer/investor in finding locations for the use or operation of the business opportunity . . . or that the offeror will buy back or is likely to buy back any product . . . .

Id.

[241] KRS § 367.815(2) (Supp. 1978).

[242] KRS § 367.805(1) (Supp. 1978).

[243] KRS § 367.813(1) (Supp. 1978).

of representatives selling such business opportunities are approved by the Commonwealth of Kentucky.[244] Moreover, notice of a purchaser's right to cancel within 30 days after the assumption of any financial obligation must be provided in the form and manner specified by the Act.[245] In addition to this right of cancellation within 30 days, a purchaser of a business opportunity is entitled, under the Act, to cancel at any time if the offeror has failed (a) to provide locations as represented; (b) to deliver goods or merchandising materials as represented; or (c) "to comply with Section 5(1)" of the Act, pertaining to disclosure of the offeror's registration number in any advertising materials.[246] The Act specifies the manner in which cancellation may be accomplished[247] and sets forth the rights and obligations of the purchaser and offeror upon cancellation.[248]

The enforcement provisions of the Act are broad, designed to permit both governmental and private litigation to assure compliance. The attorney general is authorized to seek a restraining order or a temporary or permanent injunction prohibiting any offer or sale of a business opportunity whenever the attorney general "has reason to believe" that the offer or sale is being made in violation of the Act.[249] An offeror or seller of a business opportunity who makes false, misleading or deceptive representations is also civilly liable to the purchaser of the business opportunity for an amount "equal to the sum of [the purchaser's] actual damages or . . . ($1,500), whichever is greater, as well as the cost of the action together with reasona-

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[244] KRS § 367.813(2) (Supp. 1978).

[245] KRS §§ 367.819(1), (5) (Supp. 1978).

[246] KRS § 367.819(1) (Supp. 1978).

[247] Although a purchaser's notice of cancellation need not be in any particular form, it must be in writing and, if cancellation is made after more than thirty (30) days, it should specify the violation on the basis of which cancellation is demanded. KRS §§ 367.819(2), (4) (Supp. 1978). *See also* KRS § 367.819(3) (Supp. 1978) (notice of cancellation, when mailed, is deemed to be given when deposited in the mail, properly addressed and with postage prepaid).

[248] The seller must refund to the purchaser any payments made and must terminate all financial obligations created in connection with the transaction within 15 days after the date of the purchaser's notice of cancellation. KRS § 367.819(7) (Supp. 1978). A cancelling purchaser must return any products or inventory provided by the seller "in substantially as good condition as when received by the buyer." KRS § 367.819(9) (Supp. 1978).

[249] KRS § 367.817 (Supp. 1978).

ble attorney's fees . . . ."[250] Finally, the Act establishes a scheme of fines and penalties for violation of its various provisions.[251] Offerors who have "continuously operated a business from a physical location in Kentucky . . . for twelve (12) consecutive months prior to the time of the offer" and those who sell or offer to sell "package franchises"[252] are exempted from the provisions of the Act.[253]

2. *Negative Option Plans*

A second piece of consumer protection legislation regulates the use of "negative option plans," by which merchandise announced in advance is sent to a subscriber unless, within a specified period of time, the subscriber instructs the seller not to send it.[254] Such plans are used regularly by book clubs, record clubs, and collectors' societies which offer periodic opportunities to purchase stamps, coins or other special merchandise. This Act sets forth a number of detailed requirements and declares that a failure to comply with these requirements in connection with the use of any negative option plan is an "unfair, false, misleading and deceptive practice as prohibited by KRS 367.170 . . .,"[255] entitling the attorney general to resort to the remedies and enforcement powers provided for violation of the consumer protection laws generally.[256] The new Act re-

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[250] KRS § 367.815(1) (Supp. 1978).

[251] KRS § 367.990 (Supp. 1978).

[252] The term "package franchise" is defined as an agreement in which:

> (a) The franchisee sells goods or services which must meet the quality standards of the franchisor; and
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> (b) The franchisee is required by the franchisor to establish a retail business location, not to include the home or residence of the franchisee, to be used primarily for the sale of the goods or services under the trade name of the franchisor; and
>
> (c) The franchisor exerts or has authority to exert a significant degree of control over the franchisee's business organization, promotional activities, management marketing plan, or business affairs.

KRS § 367.801(7) (Supp. 1978).

[253] KRS § 367.807 (Supp. 1978).

[254] KRS § 367.570(1) (Supp. 1978). Solicitation and subscription sales of printed material such as magazines, encyclopedias, books and Bibles are also subject to regulation pursuant to 1978 amendment of the Kentucky consumer protection laws. *See* KRS §§ 367.510-.540 (Supp. 1978).

[255] KRS § 367.575(1) (Supp. 1978).

[256] KRS § 367.575(2) (Supp. 1978). The Kentucky consumer protection laws au-

quires clear and conspicuous disclosure, in any promotional material, of the material terms of any negative option plan, including:

> (a) That aspect of the plan under which the subscriber must notify the seller, in the manner provided for by the seller, if he does not wish to purchase the selection; (b) Any obligation assumed by the subscriber to purchase a minimum quantity of merchandise; (c) The right of a contract-complete subscriber to cancel his membership at any time; (d) Whether billing charges will include an amount for postage and handling; (e) A disclosure indicating that the subscriber will be provided with at least ten (10) days in which to mail any form, contained in or accompanying an announcement identifying the selection, to the seller; (f) A disclosure that the seller will credit the return of any selections sent to a subscriber, and guarantee to the postal service or the subscriber postage to return such selections to the seller when the announcement and form are not received by the subscriber in time to afford him at least ten (10) days in which to mail his form to the seller; (g) The frequency with which the announcements and forms will be sent to the subscriber, and the maximum number of announcements and forms which will be sent to him during a 12-month period.[257]

The Act specifies the contents of the announcement and the reply form to be sent to each subscriber before any selection is sent, and mandates that this information and form be mailed within a period allowing the subscriber at least ten days in which to reply by mailing the form.[258]

Finally, the Act contains a list of acts prohibited in

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thorize the attorney general to seek restraining orders and injunctions prohibiting unlawful methods, acts or practices, KRS § 367.190 (1972); to accept assurances of voluntary compliance with respect to any method, act or practice deemed to be unlawful, KRS § 367.230 (1972); and to make investigations, utilizing the subpoena power, to ascertain the existence of violations of the consumer protection laws, KRS §§ 367.240, 367.250 (1972). Courts may "make such additional orders or judgments as may be necessary to restore to any person in interest any moneys or property" acquired by unlawful methods, acts or practices. Such orders may include, for example, the appointment of a receiver or the revocation of a license or certificate authorizing the conduct of business in the state. KRS § 367.200 (1972). Finally, private actions to enforce the consumer protection laws are sanctioned. KRS § 367.220 (1972).

[257] KRS § 367.580(1) (Supp. 1978).

[258] KRS §§ 367.580(2), (3) (Supp. 1978).

connection with the use of a negative option plan. Refusal to credit a subscriber with the return of a particular selection and to guarantee postage adequate to permit such return violates the Act when, under the statutory language, a right to return the merchandise exists.[259] Failure to notify a subscriber of the existence of a right to return a selection,[260] unexcused failure to ship bonus or introductory material in a timely manner,[261] failure to terminate promptly the membership of a "contract-complete subscriber"[262] upon his written request,[263] and shipment of substituted merchandise for that ordered by a subscriber without the subscriber's express consent[264] are all prohibited by the Act.

The use of negative option plans has become increasingly widespread, and has been a source of numerous problems for consumers. Even when the rights provided by the new Act are represented as incorporated in a plan's promotional materials, consumer demands in exercise of those rights may fall, consistently and over extended periods of time, on the plan's unresponsive computer. The above-described legislation, broadening as it does the definition of an "unfair, false, misleading and deceptive practice," establishes minimum standards of fairness to consumers in connection with the use of such plans, and provides a mechanism by which such standards may be practicably enforced.

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[259] A right to return a particular selection exists when:

(a) The selection is sent to a subscriber whose form indicating that he does not want to receive the selection was received by the seller by the return date or was mailed by the subscriber by the mailing date;

(b) Such form is received by the seller after the return date, but has been mailed by the subscriber and postmarked at least three (3) days prior to the return date;

(c) Prior to the date of shipment of such selection, the seller has received from a contract-complete subscriber, a written notice of cancellation of membership . . .;

(d) The announcement and form are not received by the subscriber in time to afford him at least ten (10) days in which to mail his form.

KRS § 367.585(1) (Supp. 1978).

[260] KRS § 367.585(2)(a) (Supp. 1978).

[261] KRS § 367.585(2)(b) (Supp. 1978).

[262] A "contract-complete subscriber" is defined as a subscriber "who has purchased the minimum quantity of merchandise required by the terms of membership in a negative option plan." KRS § 367.570(3) (Supp. 1978).

[263] KRS § 367.585(2)(c) (Supp. 1978).

[264] KRS § 367.585(2)(d) (Supp. 1978).

EPILOGUE

Most of the Kentucky decisions discussed in this survey article were rendered by the court of appeals. It should be noted, however, that the Kentucky Supreme Court has granted discretionary review in several of these cases. Practitioners should, therefore, continue to supervise the status of the cases discussed in this survey, to determine whether the Supreme Court approves or discards the reasoning of the courts of appeals.