InBrief

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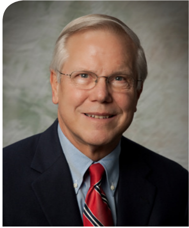
Collecting Post Charge-off Interest After *Unifund v. Harrell*


John T. McGarvey

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In *Unifund CCR Partners v. Harrell*, a recent case involving collection of an open-end consumer credit card account, the Kentucky Supreme Court held that by entering a written contract specifying interest at a contract rate in excess of 8%, the lender extinguished its right to later claim interest under KRS 360.010(1), Kentucky's general usury statute. The Court also held that by Unifund's decision to stop adding interest to the Account following charge-off, the lender waived its right to collect *contractual* interest from that point.

Although some of its language is broad in scope, the *Unifund* decision appears to be limited to cases involving open-end consumer credit card accounts and other consumer revolving credit accounts such as home equity lines of credit where, following a charge-off, the lender *also* decides not to add fees and interest to the account. However, the way in which the Court addressed "charge-offs" relating to a waiver of the right to charge interest could also affect commercial loans.

Unlike commercial loans, consumer accounts are subject to the Fair Debt Collection Practices Act and the Truth in Lending Act which were cited in the decision. For business reasons, including saving costs associated with providing periodic account statements to customers, and in accord with TILA, consumer lenders sometimes decide to stop adding fees and interest to accounts following charge-off. Pursuant to Regulation Z (12 C.F.R.226.5(b)(2)(i)), consumer creditors who have charged-off an account, *and will no longer charge fees and interest thereto*, may stop sending periodic statements to the customer.

Unifund is a case in which Citibank entered into an open-end consumer credit card agreement with its customer, which included interest at the contract rate of 27.24%. After default, Citibank charged-off the account, decided to stop charging interest, and stopped sending periodic statements in accord with Regulation Z.

Following charge-off, Citibank sold the account to a debt buyer which assigned it to Unifund. Unifund filed a collection action demanding prejudgment interest from the date of charge-off at 8%. The debtor answered and counterclaimed that Unifund's demand for prejudgment interest violated the FDCPA. After losing in the circuit court, the debtor prevailed in both the Kentucky Court of Appeals and the Kentucky Supreme Court.

The *Unifund* decision references provisions in TILA, the FDCPA, related regulations, and the Kentucky usury statute, in holding that Citibank's actions waived its right to charge interest at the contract rate and extinguished its right to post charge-off interest at the statutory rate. The decision cites the 6th Circuit's opinion in *Stratton v. Portfolio Recovery Associates, LLC,* in holding that "KRS 360.010(1) does not create an entitlement to statutory interest, rather it sets a default rate in the absence of a contractually agreed upon interest rate."

The Kentucky Supreme Court found that when Citibank entered the written account agreement for interest at a contract rate higher than the statutory rate, it was bound by that decision and its right to seek interest at the statutory rate was extinguished. The Court held that the general usury statute "… specifically states that the parties to a contract – and their assignees – '*shall be bound* for such rate of interest as is expressed in any such contract… and no law of this state prescribing or limiting interest rates shall apply to any such agreement ….'"

The Court also held that, *after* the charge-off occurred, "[b]y then forgoing its right to collect contractual interest during the ten months following the charge-off of Harrell's account, Citibank waived its right to collect that [contractual] interest." Because an assignee acquires no greater rights than those possessed by its assignor, the Court found Unifund was bound by Citibank's extinguishment and waiver of its rights.

In today's low interest rate environment, it should be noted that the usury statute's use of the words "any such contract" refers only to contracts or obligations in writing that provide for interest "in excess of" the statutory rate. Thus, *Unifund* does not apply to written agreements with a contract interest rate less than the 8% statutory rate, and the election of a contract rate should not be deemed as an extinguishment of the ability to agree to, or, in a later collection action, demand an interest rate under KRS 360.010(1).

Neither *Unifund* nor *Stratton* directly addresses KRS 360.040, the judgment rate statute, which provides that "a *judgment shall bear* … interest compounded annually from its date." [emphasis added]. While prejudgment interest may not be available in the factual settings of

(Continued on next page)

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Collecting Post Charge-off Interest After *Unifund v. Harrell* *continued*

Unifund and *Stratton*, interest on a judgment should still be available under KRS 360.040.

It is possible that *Unifund* could also apply to commercial accounts in that the decision is not entirely clear as to whether the act of charge-off alone (without regard to TILA or FDCPA) constitutes a waiver of the right to continue to add interest. However, other courts have held that creditors are entitled to charge post charge-off interest. *Peters v. Financial Recovery Services, Inc.*, 46 F. Supp. 3d 915 (WD Mo. 2014) indicates that the act of charge-off itself does NOT constitute a waiver of a right to charge interest; and *McDonald v. Asset Acceptance LLC*, 296 F.R.D. 513 (ED MI 2013), held that after charge-offs had been taken, creditors "had the absolute right to continue to impose interest." The act of charge-off alone should not be held as a waiver of the right to add and collect interest thereafter.

The ultimate resolution of the issues presented by *Unifund* may require a legislative revision of KRS 360.010 to clearly show a lender is always entitled to collect post charge-off interest even if at a rate less than the contract rate.

Lessons from *Unifund*

1. Entering a written agreement providing interest *at a rate higher* than the usury rate extinguishes the right to subsequently collect a statutory rate under KRS 360.010(1);
2. A charge-off itself may, and a decision not to add fees and interest thereafter on a consumer account will, waive the right to the contract rate going forward;
3. Claiming prejudgment interest on an open-end consumer credit card or HELOC subject to TILA and FDCPA following extinguishment of contractual right to claim interest could result in an FDCPA violation.

In a decision on June 12, 2017, *Henson v. Santander*, the U.S. Supreme Court found that debt buyers, when collecting debts they own, are outside the scope of the FDCPA. The U.S. Supreme Court's decision may be a defense for Unifund to the FDCPA violation, however, it does not change the result of the reasoning of the Kentucky Supreme Court on post charge-off waiver of interest by the original lender. If lenders encounter arguments based on *Unifund* or *Stratton* on *commercial* lending facilities, they should contact counsel for advice as to if and how those cases may apply and how to address any issues.

John T. McGarvey and Thomas W. Volk

2017 Kentucky Legislative Update

J. Morgan McGarvey

A record 193 bills were passed into law during the 2017 session of the Kentucky General Assembly. This summary is by no means exhaustive, but covers some of the major legislation that was passed, as well as laws that might impact your profession. Please feel free to contact one of the attorneys at Morgan & Pottinger if you have additional questions. Unless a bill was declared an emergency or contained a special effective date, all enacted legislation will take effect on June 29, 2017.

2017 Kentucky Legislative Update *continued*

Child protective services. House Bill 253 requires unannounced welfare checks on children who have been the subject of reported child abuse or neglect in the home. Unannounced visits would continue intermittently until the child's safety has been safeguarded. In addition, schools and child care providers are required to provide a social worker access to a child who is the subject of an investigation without parental consent.

Civics education. Senate Bill 159 requires all public high school students to pass a locally approved civics test, based on the U.S. citizenship test, in order to receive a regular diploma. A score of 60% correct answers out of 100 questions is required to pass, and students can retake the test as often as needed.

Criminal Justice Reform. Senate Bill 120 is designed to help people leaving prison to rejoin society more successfully. The bill expands the opportunities for work during incarceration, removes certain obstacles to obtaining professional licensure, and creates pilot projects for alternative substance abuse supervision during reentry into the community. The bill also creates an "Angel Initiative," which allows law enforcement to refer persons voluntarily seeking help to drug treatment without requiring arrest.

Driver's licenses. House Bill 410, known as the REAL ID Bill, creates an enhanced Kentucky driver's license that meets federal anti-terrorism standards. By federal law, Kentuckians will be required to have the enhanced ID to board domestic airplanes and enter federal facilities, including military facilities and the federal courthouse, beginning January 1, 2019. It also continues the old type of "standard" driver's license, permit or state personal ID card for individuals who do not want the enhanced license.

Education Reform. Senate Bill 1 creates a less burdensome, time-consuming process for testing elementary and secondary students. It also allows local schools to establish the process for evaluating their teachers. The legislation requires a review of academic standards for schools at the Ky. Department of Education, and updates benchmarks for measuring college and career readiness. The intent of the bill is to reduce the paperwork burden on teachers.

Garnishment. Senate Bill 62 prohibits creditors from being able to garnish the funds in a health savings account.

Hemp. Senate Bill 218 updates the pilot project within the Department of Agriculture for the licensure of industrial hemp to align with federal laws. The purpose of the pilot project is to enable the Department, licensees and affiliated universities to study the methods of cultivating, processing and marketing industrial hemp.

Human trafficking. House Bill 524 is designed to enhance public awareness of human trafficking, including sexual and labor exploitation, by requiring the National Human Trafficking Reporting hotline phone number to be posted at public schools and highway rest areas. The bill also expands the definition of "serious physical injury" as it relates to children under the age of 12.

Juvenile offenders. Senate Bill 195 allows juvenile convictions to be expunged after two years if the conviction was not a sex crime and would not classify the juvenile as a violent offender. The bill also requires dismissed juvenile cases to automatically be expunged.

Legal Interest Rate. The legal interest rate on judgments in state court has been lowered from 12.0% per annum to 6.0% per annum. It is important to note that this does not lower the interest rate established in a contract, promissory note, or other written obligation. The new interest rate will apply judgments and orders entered after the effective date of this Act (June 29, 2017).

2017 Kentucky Legislative Update *continued*

Playground safety. House Bill 38 bans registered sex offenders from public playgrounds unless they have advanced written permission from the local government body.

Postsecondary education. Senate Bill 153 phases in performance-based funding for state colleges and universities determined by their student success rate, course completion, and operational needs.

Protecting children. Senate Bill 236 permits a parent or guardian to require a background check when employing a childcare provider.

School calendars. Senate Bill 50 allows school districts whose first day of instruction is on or after the Monday closest to August 26 to use a "variable student instructional year." A variable student instructional year is one that requires the same annual hours of instruction that is currently required by law, but allows for fewer student attendance days than the current minimum of 170. Districts can use the variable schedule beginning with the 2018-19 school year.

Tobacco treatment. Senate Bill 89 mandates private insurance and Medicaid coverage of all FDA-approved tobacco cessation medications and all tobacco cessation programs approved by the U.S. Preventive Services Task Force. The bill prohibits copayments, deductibles and utilization restrictions for services associated with the first two attempts to quit in any 12-month period.

J. Morgan McGarvey

How to Respond to an Order of Garnishment When the Only Funds in the Account Are Exempt from Garnishment

Molly E. Rose

A recent Kentucky Court of Appeals decision in *Deal v. First and Farmers National Bank, Inc.*, 2017 WL 1193175 (Ky. App. 2017), details how banks must handle garnishment orders when there are conflicting federal and state laws.

Cindy Deal ("Ms. Deal") obtained a money judgment for $64,000.00 against her ex-husband, James Deal ("Mr. Deal"). As part of her collection efforts, Ms. Deal's attorney took a post-judgment deposition of Mr. Deal, who testified that he maintained a deposit account at First and Farmers National Bank (the "Bank").

As a result of Mr. Deal's testimony, Ms. Deal's attorney sent a garnishment order, along with an AOC-150.1 form, to the Bank. The Bank responded that it did not have any of Mr. Deal's money or property.

Puzzled by the inconsistencies between Mr. Deal's testimony and the Bank's response, Ms. Deal's attorney personally pushed for answers from senior management at the Bank. The Bank's Vice President emailed Ms. Deal's attorney that the Bank had no "garnishable funds".

The seeming lack of funds prompted Ms. Deal to file a contempt motion against Mr. Deal in circuit court. Mr. Deal testified he had an account with the Bank but there was nothing there. The contempt hearing resulted in Mr. Deal's attorney providing statements proving Mr. Deal maintained an account with a positive balance at the Bank, but that the money in the account was federally protected from garnishment because it was from either veteran's or social security benefits.

Order of Garnishment *continued*

Ms. Deal then filed a separate action against the Bank for returning a garnishment order with false and misleading statements. This lawsuit was based on Kentucky's garnishment statutes. The Bank responded by claiming the federal statutes preempted Kentucky's laws, and that no disclosure was required.

No one disputes that Mr. Deal maintained an account at the Bank, that the funds in the account were exempt from garnishment under federal law, or that the Bank failed to disclose that Mr. Deal maintained an account at the Bank. The legal issues addressed by the Court were: (1) whether federal law preempted a state law requiring any funds to be turned over to the proper authority, and (2) whether the Bank was required to identify that Mr. Deal maintained an account.

The first issue results from conflicting requirements between state and federal laws. Kentucky's garnishment statutes require banks to identify *any* money belonging to the judgment debtor and turn it over to the clerk of the court, the sheriff, or the attorney for the judgment creditor. That money must be held for at least 15 days to allow the judgment debtor time to object to the release of the funds. If the judgment debtor objects, the court determines whether the objection is valid.

Federal law, on the other hand, prohibits financial institutions from releasing federally protected funds. This puts the onus on the financial institution to determine whether there are garnishable funds in an account.

The Deal decision makes clear that the federal law expressly preempts Kentucky's statutes when handling accounts with federally protected funds. The Court held that financial institutions must decide whether the funds in an account are garnishable, and "that the Bank's review is to be performed without judicial oversight." Perhaps more importantly, the Court stated, "the Bank's review is deemed to be conclusive." In this instance, the Bank properly concluded the funds were protected from garnishment and correctly refused to release them to the proper authorities.

The second issue, whether the Bank had to disclose that Mr. Deal maintained an account, did not raise a direct conflict between the state and federal statutes. Kentucky law requires financial institutions to identify whether they are in possession or control of property belonging to the judgment debtor. See KRS 425.511. Federal law does not require that financial institutions notify the judgment creditor of the presence of money or an account, however, as the Court noted, "[n]ot requiring notice to be provided is a far different matter than prohibiting it. The federal regulations neither explicitly nor implicitly suggest that it is a violation of federal law for the financial institution to respond to a garnishment order with information as to the amount of funds it holds, even if the funds are exempt, so long as the financial institution does not impair the account holder's access to the funds."

Recognizing that Kentucky's statutory requirement of disclosure does not conflict with the corresponding federal laws, the Court ruled that the Bank should have disclosed Mr. Deal's account to the judgment creditor. The Bank argued it could not comply with the Kentucky and federal statutes because the AOC-150.1 form did not have an appropriate space for notice of disclosure only.

The Court agreed with the Bank that the AOC form was deficient, but held "the form is provided for the convenience of garnishees . . . it should go without saying that a financial institution should not use the AOC's form if doing so would cause it to submit incorrect or incomplete information in violation of Kentucky's garnishment statutes." The Bank's failure to provide correct information *(Continued on back page)*

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Order of Garnishment *continued*

"created confusion and resulted in a technical violation of KRS 425.511."

Ms. Deal, therefore, could bring a separate action against the Bank for failing to disclose Mr. Deal's account. The final question for the Court was to determine her damages.

Ms. Deal argued the Bank was strictly liable to her for the entire amount of the judgment, plus costs and attorney fees. The Court disagreed and held "[t]he statute cannot be used to punish a garnishee for a mere technical violation that did not result in actual money or other property being wrongfully withheld from the judgment creditor."

The main takeaways for your institution are: (1) financial institutions must unilaterally determine if funds are exempt from garnishment, and (2) financial institutions must alert judgment creditors to the presence of an account, regardless of whether the AOC provides the proper form or there are garnishable funds in the account.

Please feel free to contact one of our attorneys if you have any questions about these developments with garnishments.

Molly E. Rose

Actual resolution of legal issues depends on many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this newsletter. If you have any questions about this newsletter, or suggestions for future articles, contact Morgan McGarvey, Editor.

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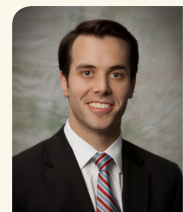

Morgan McGarvey

Charlie Otten is now admitted to practice law in both Kentucky and Indiana.

Mindy Sunderland was named a "Top Woman In Business" by the Lane Report. Mindy also chaired the University of Kentucky College of Law's 4th Biennial Collection Law Conference and presented on Collection matters at a Kentucky Bankers Association seminar in the Spring of 2017.

Morgan McGarvey was inducted into the duPont Manual High School Hall of Fame for his accomplishments as an attorney and Kentucky State Senator.

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