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2008 General Assembly Passes House Bill 552 To Address "Housing Crisis"

On April 24, 2008, Governor Beshear signed into law House Bill 552 in response to the housing market difficulties and the "subprime" mortgage mess. This 68-page bill consists of 35 sections, and it has an "emergency" effective date of April 24, 2008 (with some exceptions). The following is an overview of the bill. Persons directly affected by the bill should carefully review the many changes its creates.

High-Cost Home Loans

KRS 360.100 regulates certain "high-cost" consumer home mortgage loans between $15,000 and $200,000 that are secured by the borrower's residence. Among other things, a loan covered by the statute cannot have a prepayment penalty greater than exceed 3% for the first year, 2% for the second year, and 1% for the third year of the loan, and no prepayment penalty may be assessed against a borrower refinancing with the same mortgage loan company that funded the original mortgage. No high-cost home loan can be made with a prepayment penalty unless the lender offers the borrower in writing a loan without a prepayment penalty and the borrower declines it in writing. A lender cannot make a high-cost home loan unless the lender reasonably believes the borrower can repay it.

HB 552 expands the coverage of the statute and broadens the definition of a "high-cost home loan" by lowering the threshold on the "points-and-fees" test. Previously, the definition was tied solely to the interest rate and points-and-fees tests under the federal Home Ownership and Equity Protection Act of 1994 (15 U.S.C. § 1602(aa)). The federal test used an interest rate test of greater than Treasury securities rate plus 8%, or fees and points more than the greater of 8% of the loan amount or $400. Now, under Kentucky law, a home loan will be considered "high-cost" if it meets either the HOEPA test *or* if the total points and fees payable by the borrower at or before the loan closing exceed the greater of $3,000 or 6 percent of the total loan amount.

HB 552 provides a safe harbor to lenders on question of reasonable belief of the borrower's ability to repay. If the loan was approved by an automated underwriting service offered by FNMA or Freddie MAC, or the lender verified and documented that the borrower has liquid assets equal to fifty percent (50%) of the principal loan amount, or the borrower has sufficient "residual income" as defined in guidelines established by the VA, then the borrower is presumed able to repay the loan.

The bill also sets new affordability requirements for high-cost home loans including verification of the borrower's income, assessment of ability to pay based upon maximum interest rates for ARM's, requirements to escrow taxes and insurance, and HUD-approved counseling before refinancing into a high-cost home loan. Several restrictions are placed on servicers of high-cost loans as well.

New Mortgage Counseling Service

HB 552 creates within the Kentucky Housing Corporation a new consumer information and mortgage counseling service—the Kentucky Homeownership Protection Center. Once the Center is operational, a mortgagee will be required at closing to provide the bor-

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Tired of Paying Check-Fraud Claims? Help Is Available!

The Uniform Commercial Code ("UCC"), which has been adopted in substantially similar form in all 50 states, provides numerous defenses to a wide variety of check-fraud claims. Two of the most important of those defenses are contained in UCC §4-406.

As a general proposition, a bank that pays a check bearing a forged or otherwise unauthorized drawer's signature must repay its customer for the amount of the check. However, there are limits to a bank's liability for paying such checks. Some of those limits take effect shortly after a bank sends, or otherwise makes available to the customer, an account statement reflecting payment of checks against the account. The bank must also provide either originals or copies of the paid checks or information sufficient to allow the customer to identify the paid checks. For a typical checking account, that is the monthly bank statement.

UCC §4-406 requires that a customer "exercise reasonable promptness in examining the statement or the items [i.e., checks] to determine whether any payment was not authorized because ... a purported signature by or on behalf of the customer was not authorized." It goes on to state, "If . . . the customer should reasonably have discovered the unauthorized payment, the customer must promptly notify the bank of the relevant facts." If a bank's customer fails to meet these requirements, by *promptly examining* its bank statement and checks and *promptly notifying the bank* of any checks that were paid with unauthorized signatures, the risk of loss for those checks and, especially, for future unauthorized checks can shift from the bank to the customer.

If a bank can show that its customer's failure to "promptly examine and notify" caused the bank to suffer a loss, then the customer may be precluded from asserting an unauthorized signature against the bank. Furthermore, if the customer fails to notify the bank of an unauthorized signature on a check within a "reasonable period of time, not exceeding 30 days," it may be precluded from asserting against the bank *future unauthorized signatures made by the same wrongdoer*. However, neither of these preclusions applies if the customer can prove that the bank failed to exercise reasonable care in paying the items and that the bank's failure substantially contributed to the loss resulting from those payments. Yet in today's world of automated check processing, a bank's failure to compare the signature on a check it pays to the signature card for the account does *not* necessarily mean the bank failed to exercise ordinary care. To the contrary, courts have upheld the practice of banks processing and paying checks without examining them at all.

Another provision of UCC §4-406 precludes a customer from asserting an unauthorized signature against its bank unless it notifies the bank of the unauthorized signature within one year after the relevant account statement or check is made available to the customer. This one-year preclusion is *absolute*. It applies even if the bank failed to exercise ordinary care in paying the check.

The one-year absolute preclusion and the 30-day "same wrongdoer" preclusion often work in tandem to insulate banks from all liability for long-term embezzlement schemes perpetrated against their customers. Consider this example: A bookkeeper for a company embezzles from his employer by preparing checks to himself and forging the signature of the company's owner, who is the only authorized signer. The bookkeeper then deposits the forged checks in his personal account at another bank and uses all the funds to feed his gambling habit. Because the owner allows the bookkeeper to reconcile the monthly bank statements as

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The Defense of Breach of Fiduciary Duty

Borrowers in default often use breach of fiduciary duty as a defense, increasing banks' litigation costs and delaying collection efforts. However, Kentucky Courts have strongly upheld the principle that the relationship between the bank and its borrower is one of debtor-creditor. Under ordinary circumstances, a bank does not owe a fiduciary duty to its borrower.

The Kentucky Court of Appeals recently examined this issue in Arie De Jong v. Leitchfield Deposit Bank, No. 2006-CA-000744-MR and 2006-CA-000746-MR, November 21, 2007. In *De Jong*, a group of investors, including De Jong, invested in shares of Lakeview Golf Club, Inc. Lakeview borrowed $1.1 million from the bank and provided as security a mortgage on the real property and a security interest in its personal property. The investors also executed personal guaranties. Before closing the loan, De Jong met several times with a bank officer and inquired about the prospects of the golf course being successful and the various safeguards that may be necessary to increase the likelihood of that success. The bank officer told De Jong that the bank would "scrutinize" any expense exceeding $20,000.

Lakeview defaulted on its loan and Leitchfield Deposit Bank filed a foreclosure against Lakeview and the guarantors. De Jong filed a counterclaim against the bank for breach of fiduciary duty, contending that he had more than the typical debtor-creditor relationship with the bank. De Jong argued the bank owed him a fiduciary duty of disclosure

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Legislative Update

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rower literature prepared by the Center describing its services.

Rights of Rescission for Loans Solicited at a Home

KRS 367.420 is amended to give consumers 10 days (instead of the current 3 days) to rescind a loan secured by a mortgage on the borrower's principal dwelling that was made as a result of a home solicitation.

Appraisal Fraud

HB 552 makes it "unlawful for any person in the course of a mortgage transaction to improperly influence the development, report, result, or review of a real estate appraisal sought in connection with a mortgage loan." The section expressly allows asking an appraiser to consider additional appropriate property information, to provide further detail, substantiation, or explanation for the appraiser's conclusion of value, or to correct errors in the appraisal report.

More Regulation of Mortgage Lenders and Brokers

In numerous respects, the bill regulates more strictly and in greater detail the licensing, training, continuing education, and operations of mortgage loan companies, brokers, originators, and processors. Many financial institutions remain exempt from the provisions of the mortgage loan company subtitle (KRS Chapter 286.8) (bank, bank holding company, trust company, credit union, savings and loan association, service corporation subsidiary of a savings and loan association, insurance company, real estate investment trust, an institution of the farm credit system, and any wholly-owned subsidiary). However, the bill eliminated the exemptions for "affiliates" of such entities, for any person doing business relating to any broker-dealer, agent, or investment adviser, and for any person making less than five loans per year.

Natural Persons Making Mortgage Loans

In light of the change in exemptions, a private individual making a mortgage loan on residential real property is subject to full regulation and licensing if that person "holds himself out as being able to make" such loans. Also, any natural person making mortgage loans with his or her own funds for his or her own investment without the intent to resell is now subject to the examination provisions of KRS 286.8-170 and 286.8-180 when it appears on grounds satisfactory to the executive director that it is necessary; disclosure requirements; investigation and enforcement provisions; and the prohibited acts limitations under KRS 286.8-220 and KRS 286.8-990. Also, any mortgage loan originator or processor who is an employee of such an individual is subject to registration and continuing education requirements.

Duties to the Customer

KRS 286.8-270 is amended to expressly provide that non-exempt mortgage loan brokers have the duty to "exercise good faith and fair dealing," "act in the best interest of the borrower," and "not compromise a borrower's right or interest in favor of another's right or interest."

Limits on Prepayment Penalties

In addition to the limits on prepayment penalties in high-cost home loans, prepayment penalties on any loan made or brokered by non-exempt mortgage loan companies or brokers are subject to the same restrictions. Under prior law, prepayment penalties up to 5% during the first 5 years of the loan were permissible. Now, under HB 552, prepayment penalties are limited to 3% for the first year, 2% for the second year, and 1% for the third year. In addition, no prepayment penalty may be assessed following the third anniversary date of the mortgage or *60 days prior to the date of the first interest rate reset,* whichever is less.

Limits on Origination and Broker Fees

The net income that a non-exempt originating lender or broker can receive is capped at the greater of $2,000 or 4 percent of the total loan amount, including all origination fees, broker fees, lender fees, discount points if retained by the originating person as income, processing fees, administrative fees, document preparation fees, yield spread premiums, servicing release premiums, and financial counseling fees. Not included are interest on the mortgage loan itself and fees paid to compensate unaffiliated third parties.

Solicitations and Consumer Reports

For non-exempt mortgage loan companies or brokers, new provisions are added restricting when it is permissible to use prescreened trigger lead information derived from a consumer report to solicit a consumer.

Enhanced Penalties for Mortgage Fraud

The penalties for engaging in mortgage fraud under KRS 286.3 are substantially enhanced and now include forfeiture to the Commonwealth of "all real and personal property of every kind used or intended for use in the course of, derived from, or realized through a violation . . ." Mortgage fraud is a Class D felony, and if repeated can be a Class C felony.

M. Thurman Senn

Fiduciary Duty

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that was violated by not revealing to him that Lakeview was a "disaster waiting to happen."

The Circuit Court granted summary judgment for the bank and De Jong appealed. The Court of Appeals affirmed the decision, stating De Jong failed to present evidence that a confidential relationship existed between him and the bank. The Court of Appeals supported its decision by quoting *Sallee v. Fort Knox Nat'l Bank, N.A.* 286 F.3d 878, 893 (6th Cir. 2002):

> Banks do not generally have fiduciary relationships with their debtors. This flows from the nature of the creditor-debtor relationship. As a matter of business, banks seek to maximize their earnings by charging interest rates or fees as high as the market will allow. Banks seek as much security for their loans as they can obtain. In contrast, debtors hope to pay the lowest possible interest rate and fee charges and give as little security as possible. Without a great deal more, a mere confidence that a bank will act fairly does not create a fiduciary relationship obligating the bank to act in the borrower's interest ahead of its own interest...

In fact, Kentucky courts have imposed a fiduciary duty on a bank on only two occasions. In both cases, the bank profited, at the borrower's expense, from confidential information it received from the borrower. In *Steelvest, Inc. v. Scansteel Serv. Ctr.*, Inc. 807 S.W.2d 476 (Ky. 1991), the bank used the confidential business plans of one borrower to help one of the borrower's competitors generate new business for the bank. *See Id.* at 485-486. Similarly, in *Henkin, Inc. v. Berea Bank & Trust Co.*, 566 S.W.2d 420 (Ky. App. 1978), the bank usurped a corporate opportunity of one of its borrowers for its own profit. Absent such a situation, where the bank profits from confidential information provided by the borrower, no fiduciary duty exists.

While debtors in default may continue to utilize breach of fiduciary duty as a defense, it is one that should be readily terminated in a summary judgment proceeding. Absent the bank profiting from confidential information provided by the borrower to the bank, no fiduciary duty exists. It is not the duty of the banks to scrutinize business opportunities for their borrowers and ensure that all ventures are going to succeed. Banks are not fiduciaries of their borrowers, and borrowers must make their own judgments as to what ventures to pursue.

Timothy A. Schenk

Check Fraud

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well as prepare checks, the scheme continues for two years before being discovered. The owner of the company then demands that the bank repay all the embezzled funds, on the basis that his signature was forged on every check. In response, the bank is able to assert the one-year absolute preclusion against claims on checks more than one year old, as well as the 30-day "same wrongdoer" preclusion against claims on more recent checks. By utilizing both defenses, the bank may be able to avoid all liability to the customer.

These legal defenses are only two of many included in the UCC. Armed with the right defenses to fit each situation, banks can significantly reduce the number and amount of check-fraud claims that they end up paying.

Clyde H. Foshee, Jr.

Firm News

M&P Is Pleased to Announce . . .

- John T. McGarvey, a State Commissioner of the National Conference of Commissioners on Uniform State Laws, has been appointed to the Joint Review Committee for Uniform Commercial Code Article 9.
- Scott White has been named to the Class of 2008 by Leadership Kentucky.
- Brad Salyer, a third year law student at the University of Kentucky, College of Law, has accepted a summer clerkship position with M&P.

In Other News . . .

- Clyde Foshee was a speaker at the annual meeting of the Kentuckiana Chapter of the International Association of Financial Crimes Investigators held on May 15, 2008.
- On April 13, at the Kentucky Bankers Association's Spring Forum in Lexington, John McGarvey presented a program entitled "Politics on the Horizon".
- On April 9, 2008, John McGarvey gave a presentation for BankersOnline Learning Connect entitled "The Name is the Game" on UCC filings.
- If you would like to receive future editions of M&P In Brief electronically, please e-mail us at newsletter@morganandpottinger.com.