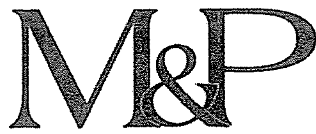

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Spring 2006

Legislative Summary

The 2006 Regular Session of the Kentucky General Assembly opened on January 2, 2006, and adjourned on April 12, 2006. During that time, the Senate introduced 258 bills and the House introduced 754 bills. Several of the bills passed will have a direct impact on the business of many M&P clients. The effective date for legislation passed in the 2006 Regular Session is July 12, 2006.

Senate Bill 154 amended various articles of the Kentucky Uniform Commercial Code. It adopted Revised Article 1, which, among other things, adopts an overall standard of good faith. The most significant amendments, however, were to Articles 3 and 4. These amendments are important to Kentucky's banking institutions because of their treatment of remotely created checks. A remotely created check is defined by SB 154 as "an item drawn on an account, which is not created by the payor bank and does not bear a handwritten signature purporting to be the signature of the drawer."

These amendments, and recent changes to Regulation CC by the Federal Reserve Board (effective July 1, 2006), shift the risk of loss on a remotely created check from the drawee bank to the depository bank. While the Kentucky amendments apply only to consumer transactions, Reg. CC applies to all remotely created checks. It is likely that Reg. CC will preempt state law in this area. Both Reg. CC and the Kentucky amendments provide for a new warranty on remotely created items: any person who presents a draft to the drawee bank for payment, or who transfers an item and receives a settlement or other consideration, warrants that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.

Senate Bill 154 also includes a few "clean up" amendments for Revised Article 9. It makes clear that a Kentucky Repossession Affidavit is a transfer statement. It also brings the "minor errors" rule of KRS 355.9-506 into the transition section to apply to in-lieu of initial financing statements. This means that the information required about previous filings at the county level is subject to the same minor errors standard as the other information on the financing statement. This rule is important to secured parties because more in-lieu filings were done in Kentucky than in any other state.

Another amendment deals with installment sales contracts under KRS 190.090 *et seq.* The statute has been the subject of much controversy and now provides that the holder of a retail installment contract must begin an action for breach against the retail buyer within four years of the earlier of: 1) the maturity date of the contract; 2) if the motor vehicle has been repossessed, the date the motor vehicle was sold or otherwise disposed of; or 3) the date the balance due on the contract is accelerated if there has not been a repossession.

This amendment is a result of the ruling in *Barnes v. Community Trust Bank*. In *Barnes*, the Court of Appeals applied the 4-year statute of limitations of KRS 355.2-725 to an action for a deficiency due under a motor vehicle installment sale contract. From at least 1948 until the *Barnes* decision, purchasers/assignees of retail motor vehicle paper in Kentucky had operated under the 15-year contract statute of limitation. The lingering issue from the *Barnes* decision was when the cause of action began to accrue. This matter should be resolved by the enactment of SB 154.

Section 63 of Senate Bill 154 amends KRS 186A.190 to include KRS 355.9-311(4) as an exception to the requirement that a lien be noted on the title for property for which the state issues a

Continued on page three.

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Statute of Frauds and the Loan Commitment Letter

In August of 2005, the Supreme Court of Kentucky rendered a decision which strengthens the application of the statute of frauds in the context of a loan commitment letter. In *Farmers Bank & Trust Company of Georgetown v. Willmott Hardwoods, Inc.*, the Court dealt with an alleged oral extension to a written commitment letter.

In July 1996, Farmers gave a commitment letter to Willmott which stated that the loan was to close by August 10, 1996, "unless extended in writing by the bank. If the loan is not closed by the specified closing date, this letter and the bank's obligation to make the loan shall terminate without any further liability or obligation to the bank." After Willmott paid a loan fee, Farmers sent him a draft loan agreement stating that the closing of the loan "shall occur . . . on August 10, 1996 at 9:00 am local time or at such other time and such other date as the parties shall mutually agree upon."

Willmott informed Farmers that he would not be able to close on August 10, 1996 and Farmers orally agreed upon an August 23rd closing date. Willmott met with a bank officer who provided him with a hand-written note that stated "closing on the 23rd." Before August 23rd, Farmers contacted Willmott to inform him that the loan would not close and needed to be resubmitted to the bank's board. By September 1, Willmott closed the business and liquidated his assets to satisfy a prior note.

Willmott filed a complaint asserting various claims for: failure to make a loan, fraud, equitable estoppel and breach of the duty of good faith in fair dealing. The circuit court granted summary judgment, holding in part that equitable estoppel did not create an exception to the application of the statute of frauds. The Court of Appeals reversed, finding that the draft loan agreement was an offer in writing to set an alternate date. Further, the Court of Appeals held the detrimental reliance by Willmott upon the representation of the bank precluded application of the statute of frauds.

The Kentucky Statue of Frauds, KRS 371.010(9) provides that "no action shall be brought to charge any person . . . upon any promise, contract, agreement, undertaking or commitment to loan money . . . unless the promise . . . be in writing and signed by the party to be charged therewith or by his authorized agent." Kentucky case law holds that if the contract is required to be in writing, evidence is not allowed to prove an oral agreement which materially modifies the writing. The Kentucky Supreme Court then looked at whether the time of closing was material or "of the essence" to the contract.

The Court believed that the language contained in the commitment letter was sufficient to imply that the time for closing was material. The Court also found that detrimental reliance by Willmott would not prevent the application of the statue of frauds because (1) equitable relief should only be granted under limited circumstances and (2) it was Will-

Continued on page four.

Firm News

We are pleased to announce the opening of a new office in Cincinnati, Ohio, and the addition of W. Douglas Haman as an associate attorney. Doug is a 1998 graduate of the University of Cincinnati College of Law. He will focus his practice on consumer and commercial collections. Doug is licensed to practice in Ohio, Kentucky and Indiana, and also holds an Ohio Title Agent license. Prior to joining M&P, Doug maintained a solo practice in Cincinnati, Ohio, and is a former judicial extern to the Hon. J. Vincent Aug, Jr. of the United States Bankruptcy Court. Doug can be reached at *wdh@morganandpottinger.com* The contact information for the Cincinnati office is as follows:

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In other firm news, M&P is pleased to announce that it has completed renovations of its primary office, located at 601 W. Main Street, Louisville, Kentucky. We invite you to visit our new offices.

Our collections practice has moved to 204 E. Market Street, Louisville, Kentucky. Over the years, our collections practice has grown rapidly and recently occupied space at three addresses on West Main Street. In order to better accommodate that growth and the differences between that practice and our more traditional practice, we have organized the non-legal part of that practice as M&P Collections, LLC. The Louisville collections operations are now in one location. We believe that these changes will enhance our ability to better serve our clients.

M&P is proud to announce that John McGarvey has been appointed by the Legislative Research Commission of Kentucky to a four-year term as a Commissioner to the National Conference of Commissioners on Uniform State Laws.

John McGarvey and Mindy Sunderland were selected to revise and edit Unit 6 on Remedies/Execution/Collection of Judgment and Unit 8 on Commercial Law for the 5th Edition of the Caldwell's Kentucky Form Book published by Lexis/Nexis.

John McGarvey presented the Uniform Commercial Code Update at the 26th Annual Conference on Legal Issues for Financial Institutions on April 14, 2006.

On February 24, 2006, Camille Rorer was a panel speaker on issues of diversity at the UofL College of Business and Public Administration Faculty Meeting.

Margie Loeser has been appointed to the American Arbitration Association's Large Complex Construction Dispute panel. This panel consists of arbitrators specially qualified to handle cases in excess of $500,000.

Legislative Update

Continued from page one.

certificate of title. By inserting the reference to KRS 355.9-311(4), the legislature has cleared up any ambiguity as to the means of perfection on any titled vehicle while in the inventory of a dealer of that type of property. This issue had arisen with respect to used motor vehicles while the vehicles were in the inventory of a dealer. The proper way to perfect such a security interest is by filing a financing statement. However, it is important to note that this exception only applies if the collateral is being sold or leased by a person who is in the business of selling or leasing goods of that kind.

House Bill 234 adopts with changes the Uniform Partnership Act and the Uniform Limited Partnership Act. This adoption is significant because it brings Kentucky in line with other states who have adopted these uniform laws. HB 234 also creates a new section of KRS Chapter 275 to permit the conversion of a limited liability company to a limited partnership.

House Bill 472 is an act clarifying that state lottery prizes paid in installments over time may be assigned under certain circumstances. The bill sets out certain disclosures that are required by the assignor, such as the existence of a spouse. The bill also states that the assignment must be pursuant to order of the Circuit Court.

House Bill 508 creates a new section of KRS Chapter 416 to set forth the allowable uses for eminent domain. The new statute bars the condemnation of private property for transfer to a private owner for the purpose of economic development that will benefit the general public only indirectly. An example of an indirect public benefit is increasing the tax base. It also amends KRS 416.540 to replace the phrase "public purpose" with the phrase "public use" and provides a definition for "public use."

Senate Bill 45 amends KRS 382.270 to provide that a deed, deed of trust or mortgage that is not acknowledged or proved according to law, but which was recorded prior to the effective date of the amendment, is deemed recorded and is constructive notice to all interested parties.

Senate Bill 45 amends KRS 382.360 to require an assignee to record an assignment of a mortgage within 30 days of an assignment. It amends KRS 382.365 to provide for damages to a property owner for an assignee's failure to record an assignment. Though the damages are not as great as those assessed against a lienholder who fails to release its lien upon receipt of written notice, it does provide that a property owner can recover three times his actual damages plus his attorney's fees and costs.

SB 45 also states that the statutorily required written notice must be sent by certified mail and sets out where the notice should be sent if the lienholder or assignee is a corporation, individual, etc. Another amendment to KRS 382.365 is that an assignee or lienholder can now be found liable to not only the property owner but to any party who has an interest in the real property.

For further information on the 2006 Regular Session of the Kentucky General Assembly, please visit the Kentucky Legislature Home Page at *www.lrc.ky.gov*.

Melinda T. Sunderland

M&P Helps Protect Creditor's First-Priority Rights

In a published decision of the Kentucky Court of Appeals, Morgan & Pottinger was successful in overturning an order of the Clark Circuit Court that directed M&P's client, UPS Capital Business Credit ("UPS"), to seek satisfaction of a debt from alternative sources before exercising its first-priority lien against garnished cash accounts held by the circuit court. *See UPS Capital Business Credit v. C.R. Cable Construction, Inc.*, Ky.App., 181 S.W.3d 44 (2005).

Based upon an equitable doctrine known as "marshaling assets," the Clark Circuit Court ruled that UPS needed to first pursue its collection efforts against the debtors' guarantors before seeking access to court-held funds, the only funds to which creditor C.R. Cable had any right. Generally, the doctrine of "marshaling assets" requires that, when two creditors seek satisfaction out of assets of their common debtor, and when one creditor can resort to two or more funds while the other has recourse to only one, the former can be required to seek satisfaction out of funds the latter cannot reach before it is allowed to resort to funds over which both have access.

The Clark Circuit Court ruling put UPS at a decided disadvantage by cutting off first-priority rights to hundreds of thousands of dollars that had already been collected and were being held by the court. M&P shareholders John McGarvey and Tom Fenton were requested by UPS, at the last minute, to prepare the case for presentation to the Court of Appeals, and John delivered UPS's oral arguments at the scheduled hearing.

Relying on old (but still very good) Kentucky law, M&P persuaded the Court of Appeals that the principle of marshaling assets does not apply to a guaranty because a guaranty is not a fund in the hands of the common debtor. Since the funds or assets of a guarantor are not assets of the debtor, such assets are not subject to marshaling, and the creditor holding a guaranty cannot be compelled to satisfy its debt from a guarantor before resorting to the funds or assets of the debtor.

In the UPS case, to the extent the Clark Circuit Court found that four of the common debtors' guarantors were subject to the doctrine of marshaling assets, its order was reversed by the Court of Appeals, with directions that additional proceedings be held by the trial court to determine the parties' respective priority rights.

This was a big victory for UPS and for all creditors holding guaranties. The decision of the Court of Appeals clearly re-affirmed the established rule that guaranties and surety contracts are not considered when a junior creditor invokes the doctrine of marshaling assets.

Eric M. Jensen

Letters of Credit—The Basics

A letter of credit is a unique financial device used to facilitate the sale of goods or to back up guarantees of future performance. It is designed to create certainty in commercial transactions by the substitution of the issuer's financial strength for that of its applicant for the benefit of the beneficiary. In a sale of goods transaction, the letter of credit is referred to as a commercial letter of credit. In a future performance situation, the letter of credit is referred to as a standby letter of credit. The fundamentals of the structure and operation of each type are basically similar but there are substantial differences.

In a letter of credit transaction there are three parties: the issuer, the beneficiary, and the applicant. The issuer is the bank or financial institution which issues the letter of credit. The applicant is the customer of the issuer who requests the letter of credit be issued. The beneficiary is the party for whose benefit the letter of credit is issued. Letters of credit are not the same as surety agreements, loan commitments, lines of credit agreements or other kinds of financial arrangements.

Just as there are three separate parties in any letter of credit relationship, there are also three independent contracts: 1) the contract between the beneficiary and the applicant; 2) the contract formed by the letter between the issuer and the beneficiary; and 3) the reimbursement agreement between the issuer and the applicant.

The law in Kentucky regarding letters of credit is codified at KRS 355.5-101, *et seq.* However, many letters of credit opt out of using state law. Commercial letters of credit generally adopt the rules of International Chamber of Commerce Publication No. 500, Uniform Customs and Practices for Documentary Credits ("UCP 500"). International Standby Practices 98 ("ISP 98") provides rules more reflective of custom and usage for standby letters of credit.

A commercial letter of credit will be used where Company A, which is located in Kentucky, wants to sell goods to Company B, which is located in another country. Company A wants to make sure that it will be paid for the goods and Company B wants to make sure that it will receive the goods it has paid for. A letter of credit is designed to facilitate this transaction. Company B will ask that its bank issue a letter of credit for the benefit of Company A. The terms of the letter of credit will provide that when Company A presents to the bank certain documents, commonly a bill of lading for the goods and a demand for payment or sight draft for the amount due, the bank will honor the letter of credit by paying Company A. The parties anticipate that a commercial letter of credit will be drawn upon.

A standby letter of credit is used to support the performance of a party to do something in the future. Because it is a "standby letter," none of the parties anticipates it will be drawn against. For example, to induce a seller to provide financing, a buyer may request that its bank issue a letter of credit in favor of the seller. If the seller/beneficiary presents documents under the letter of credit to the issuer, typically a statement that a default has occurred and a demand for payment or a sight draft, the issuer will pay the amount due under the letter of credit to the seller/beneficiary.

Payment to the beneficiary under a letter of credit is generally unaffected by, and independent of, the relationship between the beneficiary and the applicant. If the beneficiary presents the items required under the terms of the letter of credit, the issuer must honor it. The beneficiary must strictly comply with the terms of the letter of credit. Substantial compliance is not sufficient when making a presentment.

Courts are very reluctant to allow disputes between the beneficiary and the applicant to affect the operation of the letter of credit. One narrow exception is where the beneficiary of the credit defrauds the applicant or issuer.

Typically, the issuer will charge a fee for the issuance of the letter of credit and will underwrite the transaction to make sure that if the issuer pays the letter of credit it will recover payment from the applicant. Issuers will frequently have cash collateral for commercial letters they know will be drawn upon. The obligation of the applicant on a standby letter is more often collateralized in the same fashion as a loan of equal amount. When a draw is made under a standby letter, what had been a standby obligation of the bank to the beneficiary becomes a primary obligation of the customer applicant to the bank.

Morgan & Pottinger, P.S.C.

Statute of Frauds

Continued from page two.

mott who was not ready to close the loan on the original date.

As a practical matter, this case helps to diffuse many claims raised by borrowers alleging oral modifications to loan agreements. Of even greater significance for those involved in litigation, is the Court's willingness to look beyond an "issues of fact" claim to support summary judgment as a matter of law based on the statute of frauds.

Margie L. Loeser

Actual resolution of legal issues depends upon 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 Melinda T. Sunderland, Editor, at the firm.

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