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M&P In Brief

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Drop-Dead Date

On July 1, 2006, Revised Article 9 of the Uniform Commercial Code, dealing with secured transactions, will have been in effect in Kentucky, Indiana and Tennessee (and nearly all other states) for five years. But we cannot forget about filings made under former Article 9 during this last year of the five year transition period.

Under the transition rules of Revised Article 9, at the end of the day on June 30, 2006, all financing statements filed with a Kentucky county clerk, which do not cover collateral related to real estate, and which have not been moved to the new central filing office at the Secretary of State, will cease to be effective. The same statute and result applies to certain centrally filed financing statements in other states.

Part 7 of Revised Article 9 deals with the transition from former Article 9 to Revised Article 9. The transition period ends on June 30, 2006, also known as the "Drop-Dead Date". During the transition period, secured parties must move their local filings to the central filing office by filing an In-Lieu Of Initial Financing Statement (the "ILO"). This is often done at the same time a secured party continues or amends its financing statement. The initial financing statement is filed "in-lieu" of a continuation or amendment in the former filing office.

All financing statements, other than those covering fixtures, timber to be cut, or as extracted collateral, originally filed in a Kentucky county clerk's office must have been moved to the Secretary of State through an ILO.[1] Although most in-lieu filings will be made in Kentucky as Kentucky is the only state transitioning from a completely local filing system, this issue will come up in other states when the proper place of filing changes.

Under Revised Article 9, financing statements are filed in the residence of the debtor rather than the location of the collateral under former Article 9. For an organized entity, the place to file is the state in which the organization was originally created. For instance, an Indiana business with only one place of business in Marion County that is a Delaware corporation is deemed, as a matter of law, to reside in Delaware. Thus, a secured party that is perfected by filing with the Indiana Secretary of State must have filed an ILO with the Secretary of State of Delaware before the existing filing in Indiana expires, or June 30, 2006, whichever is earlier.

The ILO must meet all of the requirements of an ordinary financing statement and must additionally: identify the original financing statement by listing the office in which it was filed; provide the dates and file numbers, if any, of the financing statement and the most recent continuation statement; and contain a statement that the original financing statement remains effective.

The drafters of Revised Article 9 set the transition period for five years, the effective period of a financing statement. This was done because the drafters believed that at the end of the transition period, all of the local filings would have either lapsed of their own accord or would have been continued to the central filing office. This is not quite true.

There is a very specific group of filings for which the Drop-Dead Date will be significant. They are those that were originally filed between July 1, 1996, and December 31, 1996.[2] Under former Article 9, these filings would have lapsed on their normal lapse date during the second half of 2001, which is subsequent to the effective date of Revised Article 9. However, if any of these filings were properly continued prior to the effective date of Revised Article 9[3], they would have continued the effectiveness of the financing statement for another five year period, beginning on the lapse date in the last six months of 2001.[4]

Thus, under former Article 9, the financing statement would be effective until its lapse date in the second half of 2006. However, UCC §9-705(c)(2) states that all filings which must be filed in a new

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Equitable Mortgages in Kentucky

An equitable mortgage is an interest in real property that has the intent but not the form of a mortgage. It attaches when money is advanced and continues for the life of the debt. It can result from either the improper execution or the improper recording of a mortgage.

The doctrine of equitable mortgages is founded upon the principles of equity. It applies when one party loans money to another in exchange for a promise to execute a mortgage on real property as security for payment of the debt. However, the mortgage is not executed or, if executed, is so defective or informal as to fall short of the statutory requirements of a properly executed and recorded mortgage. In such a situation, equity will impose a lien on the real property in favor of the creditor who made the loan. When circumstances warrant finding an equitable mortgage, the courts are to treat it the same as they would a properly executed and recorded mortgage.

Given the doctrine of equitable mortgages, a creditor might question why it should go to the effort of converting an equitable mortgage into a properly executed and recorded mortgage. The answer is priority.

Kentucky is a "Race-Notice" state, meaning that the party who records first, without notice of prior unrecorded claims, has priority. To the extent that a creditor has actual knowledge of prior liens, those liens will take priority even if they are not properly executed or recorded. By properly executing and recording its mortgage, a creditor can ensure proper notice of its interest to other potential lienholders and also the priority of its mortgage.

Where the holder of an equitable mortgage fails to take corrective action before a junior lien attaches, the question can arise of whether the junior lienholder had knowledge of the senior equitable lien. In order to win the priority battle, the junior lienholder must establish that it properly executed and recorded its interest in the real property without actual notice of the senior equitable mortgage.

K.R.S. §382.270 is the controlling statute. It states in pertinent part that "no deed or deed of trust or mortgage conveying a legal or equitable title to real property shall be valid against a purchaser for a valuable consideration, without notice thereof, or against creditors, until such deed or mortgage is acknowledged or proved according to law and lodged for record." This means that no instrument not properly executed and recorded is valid against a subsequent purchaser for value who had no notice of the prior interest. The term "creditors" is defined as all creditors, including those who acquired a lien by equitable means.

The Supreme Court of Kentucky has long held that the "without notice" requirement in the above statute applies equally to creditors as to purchasers. Further, it has construed that clause to mean without actual knowledge of the existence of a mortgage, either unrecorded or improperly recorded, or knowledge of such facts as would lead a reasonably prudent person under like circumstances to inquire into the matter. It is immaterial how the party charged with notice acquired its knowledge. Proof of notice can be established by circumstantial evidence.

Once a senior lienholder establishes sufficient proof that a junior lienholder had actual notice of its interest, it is entitled to prevail on that issue unless the other party is able to produce evidence to the contrary. It is wrong for a court to rule in favor of the junior mortgage in the absence of any countervailing evidence to prove that the junior mortgagee did not have notice.

Nevertheless, there is one situation in which having an equitable mortgage is virtually fatal. When the debtor files bankruptcy, 11 U.S.C. §547 applies and stops the holder of an equitable mortgage from taking any corrective action on its interest in the subject matter real estate. The Sixth Circuit Court of Appeals recently ruled in the case of *In Re Vance*, 99 Fed.Appx.25 (6th Cir. 2004), that under Kentucky law, a defectively acknowledged but recorded mortgage can be avoided by a bankruptcy trustee. As a matter of law, the trustee is considered a hypothetical bona fide purchaser for value. In *In Re Vance*, the Sixth Circuit held that the express language contained in 11 U.S.C. §544 precluded the trustee from having actual notice.

In further support, the Sixth Circuit cited to the holding in *State Street Bank and Trust Co. v. Heck's, Inc.*, 963 S.W.2d 626 (Ky. 1998), that a defectively acknowledged mortgage was not sufficient to put the trustee on constructive or inquiry notice. In effect, as to the trustee, the equitable mortgage creditor is unsecured and if the mortgage is challenged through an adversary proceeding, the trustee will avoid it. If the mortgage is avoided, the trustee can sell the property free and clear of the mortgagee's interest and can distribute the proceeds in accordance with the law, inevitably resulting in pennies on the dollar, if any, for the now unsecured creditor.

Though an equitable mortgage may suffice in some instances, there is no doubt that a party with a properly executed and recorded mortgage is in a much stronger position. Accordingly, it is important to know how an equitable mortgage can be remedied once the execution or recording error is made known. This is usually accomplished by correcting the error and properly re-recording the mortgage contemporaneously with a *Scrivener's Affidavit*. Where the error is recording in the wrong county, the error can be fixed by recording the mortgage in the correct county. If the corrections are accomplished before additional liens are placed on the real property, or if more than ninety days before the debtor files bankruptcy, a creditor can successfully amend its equitable mortgage and maintain its priority interest in the real property.

Larry T. Powell

Judgment Liens in Indiana

Most of the time, winning the Judgment is the hurdle, while consideration of how to collect will take a back seat to the effort made to prevail on the claim. There does come a time, however, when winning a claim becomes a Pyrrhic victory unless the award can be turned into cash. There are more than a few situations where collection becomes the hurdle, and knowledge of the *ins* and *outs* of Judgment law is critical to success.

One of the best collection tools in an attorney's repertoire is a Judgment lien attaching to the Debtor's real property. Once the lien attaches, the Creditor need only wait for the Debtor to sell the property or to refinance an existing mortgage. Inevitably, there is a call from the Debtor to see how much money it will take to obtain a release of the lien. There are several statutes governing Judgments in Indiana which affect this process. Indiana Code 34-55-9-2 states, "All final judgments for the recovery of money or costs in the circuit court and other courts of record . . . in Indiana, whether state or federal, constitute a lien upon real estate and chattels real liable to execution in the county where the judgment has been duly entered and indexed in the judgment docket as provided by law." While other states like Kentucky require a separate filing and fee to be paid in order to create the lien, Indiana's procedure is that the lien is created *automatically* on property in that county when the Clerk, as a matter of routine, enters the Judgment in the Clerk's Judgment Docket Book. Judgments from any Indiana federal court or from another Indiana county can also be filed for a nominal fee in *any* county where the Debtor may own real estate.

One drawback to the Judgment lien is that it is valid under the statute "until the expiration of ten (10) years after the rendition of the judgment." This is in contrast to the general "life" of the Judgment, which is determined by I.C. 34-11-2-12. That statute says, "Every judgment and decree of any court of record of the United States, of Indiana, or of any other state shall be considered satisfied after the expiration of twenty (20) years." However, Indiana courts have construed this statute to create only a presumption of payment in full, which is rebutted by a showing that a balance is still due; in other words, the Judgment is collectible forever. {See: *Odell v. Green*, 122 N.E. 791 (Ind.App. 1919)}. So, it would appear that in the long run of collecting, the Judgment lien runs out of gas early in the game and a Debtor might wait out the remainder of the lien's life before cashing in on equity in real estate. Or, is there a way to extend or renew that ten year lien life? Many who practice collection law believe there is a way.

The decision of our Appellate Court in the case of *Bostic v. House of James, Inc.*, 784 N.E. 2d 509 (Ind.App. 2003), stands for the proposition that the Judgment, and, by extension, the Judgment lien, can be "renewed" by suing on the existing Judgment in a new action to create a new lien. The issue before that court was where the suit to "renew" the Judgment could be brought. The answer is in the county where the original Judgment was entered. In its discussion of the issues, the *Bostic* court looked at the history of such actions and cited to an 1887 Indiana case for the premise that a Plaintiff Creditor can "use his judgment as a cause of action, and bring suit thereon in the same court, or any court of competent jurisdiction, and prosecute such suit to final judgment." {See: *Becknell v. Becknell*, 10 N.E. 414 (Ind. 1887)}. That "new" Judgment, just as the old one, then becomes a lien when it is entered in the Clerk's Judgment Docket Book. Or does it?

The answer comes from another case, *Needham v. Suess*, 577 N.E.2d 965 (Ind.App. 1991), where the court took on the issue of a "renewed" Judgment and whether the renewal created a new ten year lien. The court recited the holding of *Petrovich v. Witholm*, 152 N.E. 849 (Ind.App. 1926) that, "As no court is above the law, and as all courts must enforce the law as it is written, it necessarily results that a lien created and limited by statute, can not be extended beyond the period fixed by the lawmakers." In short, the *Petrovich* court held that the lien provided for by the legislature will expire after ten years, and no court has the authority to extend that period even where the underlying Judgment itself is renewed.

Garret B. Hannegan

Firm News

We are pleased to announce the opening of a new office in Indianapolis, Indiana, and the addition of Edward A. B. Castaldo as an associate attorney. Ed is a 1998 graduate of the University of Arkansas School of Law. He will focus his practice on consumer and commercial collections. Ed is licensed in Indiana and will soon be obtaining his Kentucky license. Prior to joining M&P, Ed was an associate with Bleeker, Brodey & Andrews in Indianapolis and also served as Deputy Attorney General for the state of Indiana. Ed can be reached at *eac@morganandpottinger.com*. The contact information for the Indianapolis office is as follows:

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Camille Rorer has joined the firm as an associate attorney. Camille is a 2005 graduate of the University of Kentucky, College of Law, where she participated in the JD/MBA program. Camille obtained her undergraduate degree from the University of Louisville. Camille is licensed in Kentucky and will focus her practice on commercial litigation and bankruptcy.

In other firm news, M&P is pleased to announce that it has renewed its commitment to the West Main Street Historic District and entered into a 10-year lease to retain its primary office. When M&P occupied this building in 1980 it was one of the first two renovated structures on the block. M&P is excited to remain a part of Louisville's most dynamic area.

M&P is proud to announce that it

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Drop-Dead Date

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office under Revised Article 9, even though they may still be active under the rules of former Article 9, cease to be effective on June 30, 2006. The financing statements caught in this trap should be few in number. It only applies to financing statements that would have expired during the last six months of 2001, were properly continued prior to July 1, 2001, that the secured party desires to be effective after June 30, 2006, and that must be filed in a new filing office.

For example, Secured Party properly files a financing statement covering all of the assets of Debtor with a Kentucky county clerk, or a secretary of state other than the state in which the registered organization was organized, on October 31, 1996. To continue its financing statement, Secured Party must file a continuation statement sometime between April 30, 2001 and October 30, 2001. Secured Party files its continuation statement with the local filing office on May 30, 2001, which is prior to the effective date of Revised Article 9. Under former Article 9, Secured Party's financing statement is now good through October 31, 2006. Nevertheless, Revised Article 9 says that Secured Party's financing statement lapses on June 30, 2006.

Under the old law, the continuation statement could be filed only during the last six months of the effective period of the financing statement. Using the above example, whether that period is measured from the October 31 lapse date or the June 30 Drop-Dead Date makes no difference under the transition rules. When the continuation of a financing statement is accomplished through filing an ILO, it can be filed in the new filing office at any time the original filing remains effective, not just during the last six months of the effective period.

An issue that is sure to arise concerning ILOs is mistakes made in the additional information required to make an ordinary financing statement an ILO. UCC §9-506 is the section that excuses minor errors in the information included on a financing statement; however, it refers only to financing statements filed under Part 5 and not to in-lieu filings under Part 7. Due to the sheer number of in-lieu filings being filed with the Kentucky Secretary of State, this issue will probably be resolved by the Kentucky courts.

Is a mistake in the additional information required by Part 7 covered by the minor errors rule? Two of the drafters of Revised Article 9 have told this writer that was the drafters' intent; however, that intent is not spelled out in Revised Article 9 or its Official Comments. Professor Richard Nowka has written an excellent article making the argument that the minor errors rule should apply to the additional information required to make an ordinary financing statement an ILO in the Summer 2004 issue of the University of Louisville's Brandeis Law Journal.

The good news for secured parties is that at the end of the transition period they can search one filing office and be confident that they are aware of all financing statements filed on a particular debtor. The only thing to remember is to follow the rules of the new law on where to file and to search.

John T. McGarvey
Melinda T. Sunderland

End Notes

[1] Kentucky's county clerks retain the authority to accept termination statements for financing statements on file in their offices.

[2] The affected filings could also include financing statements filed between July 1, 1991, and December 31, 1991, and then continued, going back each successive five year period.

[3] Under former Article 9, to be effective, continuation statements could only be filed during the six month window prior to the financing statement's lapse date. The same rule applies under Revised Article 9. However, ILOs can be filed at any time.

[4] If Revised Article 9 required filing in a different office, continuation statements properly filed after the effective date could only be filed through an ILO and will not be impacted by the Drop-Dead Date.

Firm News

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achieved 100% participation from its associates in the Louisville Legal Aid Society's Associates Campaign for Justice Fundraiser.

On June 28, 2005, John McGarvey and Mindy Sunderland conducted a telephonic seminar entitled "Common Mistakes in UCC Filings". The seminar was sponsored by the Texas Bankers Association.

On August 30, 2005, John McGarvey and Mindy Sunderland conducted an online seminar entitled "Default, Remedies and Enforcement Under Revised Article 9". The seminar was sponsored by BankersOnline Learning Connect and was webcast to over 90 locations across the nation.

On October 20, 2005, Margie Loeser conducted a seminar on Kentucky Mechanics' Liens for the Construction Specifications Institute, Lexington, Kentucky Chapter. On October 21, 2005, Margie conducted a seminar entitled Legal Issues for Kentucky Professional Engineers sponsored by Half Moon, LLC. On December 1, 2005, Margie will present a seminar on Ethics in ADR, which is sponsored by the American Arbitration Association.

On November 11, 2005, Ed Castaldo will conduct a seminar on Collection Techniques and the Law for Lorman Education Services in Indianapolis, Indiana.