In Brief

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2012 Kentucky Legislative Update

The 2012 legislative session saw several bills passed that will have an impact on M&P's financial institution and lender clients. The new legislation will become effective on July 12, 2012, though certain bills may have provisions accelerating or delaying this effective date.

Senate Bill 97, concerning the Uniform Commercial Code, will likely have the most significant impact of the bills passed. It addresses various articles of the Uniform Commercial Code, including modernizing Article 7 by allowing electronic warehouse receipts. It also amended the definition section of Article 1, including revising the definition of "authenticate" to include electronic documents and by adding a new term, "public organic record", which facilitates a new name standard for registered organizations.

Significantly, it also adopted the 2010 Amendments to Article 9, which addressed the uncertainty that had developed regarding the form of the debtor's name for financing statements to perfect against an individual. Kentucky enacted Alternative A, also known as the "only if" test. It provides that "if the debtor is an individual to whom this State has issued a [driver's license] that has not expired," the name of the individual debtor is stated correctly "only if" it provides the name from the license. If the individual does not hold an unexpired driver's license, the fall back is to perfect under the individual's surname and first personal name. Many financial institutions preferred this alternative as it gives guidance on the search side of the secured transaction as well as the filing side. The driver's license test was selected in both alternatives because identification of customer rules ordinarily result in a copy of the driver's license being obtained by the secured party.

Senate Bill 97 also adopted amended forms for financing statements and amendments, reflecting changes in the debtor name standards, the change in required information for registered organizations, and in other ways to make them both more useful and user friendly.

The 2010 Amendments also amended the Official Comments to 9-610 and 9-613 to specifically indicate that dispositions of collateral may be conducted over the internet and to instruct secured parties on how to use the safe harbor form notices of disposition when the disposition will be by electronic auction. The changes to the Official Comments are already effective in Kentucky as KRS 355.1-103(3) provides that the Official Comments represent express legislative intent.

A few bills relate to foreclosure of real property. House Bill 23 requires court ordered appraisals be made available prior to the foreclosure sale and be included in the court files. House Bill 62 requires deeds in lieu of foreclosure to be recorded within 45 days of execution. A penalty will be assessed against any mortgage holder who fails to comply with this law. House Bill 396 creates an expedited sale process for foreclosures involving vacant or abandoned property. In order to reach a determination of vacancy or abandonment, the mortgage holder must file an affidavit stating that no legal resident has occupied the property for 45 days or more and that 2 or more requirements, as set forth in the statute, exist to indicate the property is abandoned or vacant. If the property is found abandoned or vacant, the master commissioner is required to sell the property within 70 days of the order of sale. Importantly, this bill also amends KRS 517.060 to provide that it is a crime to intentionally damage a secured creditor's collateral with the intent to lower the value of the collateral and increases the penalty for any person found guilty of such a crime.

House Bill 417 relates to motor vehicles and retail installment contracts. Kentucky's law on motor vehicle installment sales contracts has not been substantially revised since enacted in 1956. It did not take into account the computerization of interest calculations and the many products now offered for sale by motor vehicle dealers that did not exist in 1956. House Bill 417 brings the statute up-to-date and clarifies certain

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matters that have confused the courts over the years. The two most important clarifications relate to imposition of finance charges. There have been at least two court challenges to the calculation of permitted finance charges on an annual basis. The statute was silent as to whether the permitted finance charge is calculated over the life of the contract, which would be nonsensical, or whether the maximum permitted finance charge applies on an annual basis. The legislation specifies it is an annual finance charge.

The other change relates to the availability of simple interest calculations. The add-on interest charges were the only way interest charges could be calculated by hand in a dealer showroom and were appropriate for the 1950's. In the digital era, computers calculate finance charges and simple interest predominates. The amendments to the statute refine a very short amendment, enacted in the 1980's, to permit simple interest on motor vehicle installment sale contracts.

Melinda T.Sunderland
Shareholder

The Consumer Financial Protection Bureau What is it and what can it do?

The Consumer Financial Protection Bureau (CFPB), as enacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), has rulemaking, supervisory and enforcement authority over traditionally regulated financial institutions and, for the first time, over certain non-bank entities. It was created to regulate the offering and provision of consumer financial products or services under federal consumer financial laws. The CFPB is presently working to define the outer limits of its authority. Entities falling under the watchful eye of the CFPB will find themselves subject to the authority of a self-proclaimed aggressive bureau, with an agenda geared at protecting consumers against unfair, deceptive, or abusive acts or practices.

What is known about the authority of the CFPB so far? The CFPB has authority over companies of all sizes in the mortgage, payday lending, and private student loan markets; over "larger participants" of a market for other consumer financial products or services; and insured depository institutions and credit unions with total assets of more than $10,000,000,000, and their affiliates and service providers. Additionally, it can promulgate regulations, require reports and include examiners on a sampling basis of the examination of insured depository institutions and credit unions with total assets of $10,000,000,000 or less. Thus, all insured depository institutions will be subject to the CFPB's authority in some form or fashion. Further, non-bank entities that have typically been exempt from federal regulatory authority are now subject to oversight by the CFPB.

The true breadth of the CFPB's authority is established by its defining of "larger participant", which it has done through a series of rules tailored to address specific markets. This approach also enables it to expand into additional markets in the future. Presently, the CFPB has defined "larger participant" for two markets: consumer debt collection and consumer reporting. The CFPB is expected to issue its final rule in July 2012.

The consumer debt collection market encompasses collection activities, including those undertaken by third-party collectors, attorneys, and debt buyers, to collect a debt owed or asserted to be owed to another and related to any consumer financial product or service. In this market, a non-bank covered entity that offers consumer debt collection is a "larger participant" if annual receipts resulting from consumer debt collection are more than $10 million. The CFPB estimates the proposed rule will cover approximately 175 debt collection firms—or 4% of debt collection firms—accounting for 63% of annual receipts from the debt collection market.

Consumer reporting means collecting, analyzing, maintaining, or providing consumer report or other account information that is expected to be used in connection with any decision regarding the offering or provision of a consumer financial product or service. This definition is meant to include consumer reporting agencies such as credit bureaus, consumer report resellers, and specialty consumer reporting agencies such as those specializing in payday lending transactions. In this market, a non-bank covered entity that offers or provides consumer reporting is a "larger participant" if annual receipts resulting from consumer reporting are more than $7 million. The CFPB believes this will cover fewer than 30 agencies.

It is important to note that under both definitions, annual receipts include gross receipts of affiliated companies resulting from activities related to the market in question, thus broadening the reach of the CFPB. A company that does not individually meet the "larger participant" threshold may well do so when its annual receipts are combined with those of its affiliates.

Sarah Mattingly
Associate

Spoliation of Evidence

One of the most anxious aspects of litigation is not knowing what documents need to be preserved, what materials can be discarded or destroyed, and when to take action with regard to the preservation of evidence. "Spoliation", as it is called, is the destruction or material alteration of evidence, or the failure to preserve property for another's use as evidence, in pending or reasonably foreseeable litigation.

The answer to these questions is unfortunately not always clear. Certainly, the essential purpose of litigation is to get to the truth of matters. When evidence is destroyed or lost, the chances of discovering the truth become difficult. The proliferation of electronic documentation makes answering these questions even more complex and expensive.

In *Zubulake v. UBS Warburg* and *Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, LLC*, United States Southern District of New York Judge Shira A. Scheindlin has written what are considered to be the seminal federal cases on the preservation of evidence. These cases can be used as a guide for businesses faced with litigation.

The general rule is that evidence must be preserved when a party reasonably anticipates litigation. As soon as a business understands, or ought to understand, that litigation is imminent or even likely, it should begin preserving information. Judge Scheindlin laid out the steps a party should take to preserve evidence when on notice of such pending litigation.

First, the party should issue a *written* litigation hold – a formal directive regarding the preservation of relevant data and the method of monitoring its collection – to anyone who may be in possession of relevant documents to the litigation and suspend any routine document destruction policy. Second, identify all the key players, that is, the people most likely to be called as witnesses to any lawsuit, and ensure the preservation of electronic and paper records in their possession. Third, preserve and discontinue the deletion of records of former employees that are in a party's possession, custody, or control. And finally, preserve back-up tapes that are the sole source of relevant information or relate to key players, if not otherwise obtainable from readily accessible sources.

Obviously, when spoliation has occurred, the party left wanting lost information will likely seek a remedy from the court. As Judge Scheindlin writes, what a court should do to remedy spoliation is a difficult judgment call because it is often impossible to know what lost documents would have contained.

Nevertheless, according to Judge Scheindlin, courts should always impose the least harsh sanction that can provide an adequate remedy. These include further discovery, court costs and legal fees, fines, jury instructions with an adverse inference instruction, precluding evidence from use by the spoliating party, and worst of all, dismissal of a case or default judgment. According to Judge Scheindlin, it is the spoliating party's actions that determine the appropriate remedy.

Judge Scheindlin contemplates three degrees of conduct by the spoliating party, namely, negligence, gross negligence and willfulness. Negligence is a failure to conform to the standard of meaningful and fair participation in the discovery process. Gross negligence is "something more than negligence" and "differs from ordinary negligence only in degree, not in kind." Finally, willful misconduct occurs when "the actor has intentionally done an act of unreasonable character in disregard of a known or obvious risk that was so great as to make it highly probable that harm would follow, and which thus is usually accompanied by a conscious indifference to the consequences." The failure to issue a written litigation hold, identify key players, preserve documents and back-up tapes likely falls under the ambit of gross negligence.

Kentucky law differs somewhat from federal law. There is no tort of spoliation in Kentucky. In Kentucky, missing evidence instructions are only proper when it is shown that a party or business has intentionally failed to preserve or collect missing evidence. Although this is an area ripe for constant interpretation and litigation, it is important to note that the standard is at least different between the state and federal courts.

Clearly, *Zubulake* serves as notice to businesses that procedures must be in place to both recognize matters that are likely to be litigated and to preserve relevant documentation and evidence when the responsibility to do so arises. Having a formal plan in place will not only help avoid possible sanctions for misconduct, but will also assist in controlling the costs of preserving and producing relevant information – which can be hefty in the modern age of electronic discovery.

Thomas R. Coffey
Senior Associate

Taylor Hamilton
Associate

Thomas R. Coffey and **Taylor Hamilton** are both members of Morgan & Pottinger's Litigation Practice Group.

Did you know?

M&P is pleased to offer our clients a variety of seminars on topics ranging from Article 9 to bankruptcy to foreclosure. Seminars are held in M&P's meeting room at its Louisville office. Alternatively, M&P's attorneys are available to come to your office as well.

For more information, please contact Eric Jensen.

Firm News

M&P is pleased to announce:

Morgan McGarvey, an associate attorney with M&P, has won his primary election and, with no opponent in the general election, will be the next Kentucky State Senator for District 19.

Tim Schenk was named to the 2012 class of Leadership Kentucky.

Taylor Hamilton has been admitted to practice in the state of Indiana.

John McGarvey and **Clyde Foshee** were named as Top Lawyers in the area of Banking Law in Louisville Magazine.

In other news:

Mindy Sunderland was named by the Kentucky Bar Foundation to the IOLTA Board of Trustees.

Scott White has been reappointed to the Fayette County Board of Health.

John McGarvey presented on the 2010 Amendments to Article 9 at the Commercial Law League of America's annual meeting.

Mindy Sunderland, in conjunction with the Kentucky Bankers Association, presented a seminar on foreclosure, bankruptcy and workouts in February 2012.

John McGarvey, in conjunction with the Kentucky Bankers Association, presented "Default, Remedies and Enforcement Under Article 9" in February 2012.

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