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M&P In Brief

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M&P Files Amicus Brief For Kentucky Bankers Association In Creditor's Rights Case

On October 22, 2008, M&P filed an *amicus curiae* brief on behalf of the Kentucky Bankers Association in *MPM Financial Group, Inc. v. Morton*, a case pending before the Kentucky Supreme Court. The brief urges the Kentucky Supreme Court to stop efforts by debtors who have not filed bankruptcy to claim asset protections available under the federal Bankruptcy Code.

The case arises from a 2005 amendment of KRS 427.170 by the Kentucky General Assembly. That statute involves the interrelationship between state exemption laws and federal bankruptcy proceedings. It was first enacted in 1980 after a major rewrite of the federal bankruptcy laws. For more than 25 years, bankruptcy judges, attorneys, borrowers and lenders understood that KRS 427.170 was enacted to exercise a right under bankruptcy law giving states the option to "opt-in" or "opt-out" of the list of federal bankruptcy exemptions. Those exemptions specify what property a debtor may "exempt" from his bankruptcy estate.

When KRS 427.170 was enacted in 1980, Kentucky became an "opt-out" state. It created its own list of exemptions to be applied in a bankruptcy proceeding in lieu of the federal exemption list. This was the statute's sole purpose. In the 25 years since its enactment, the statute was never applied except in a federal bankruptcy proceeding.

KRS 427.170 was next amended in 2005, again in connection with a major rewrite of the bankruptcy laws, which included revisions to the federal exemptions. During the discussion of the bill, the state legislators explained that its sole purpose was to change Kentucky from an "opt-out" state to an "opt-in" state. The House Judiciary Committee debated whether Kentucky should remain an "opt-out" state but change its list of bankruptcy exemptions or amend KRS 427.170 to become an "opt-in" state and use the new federal bankruptcy exemptions. The statements made by all the legislators and witnesses unanimously agreed that the amendments applied only in a federal bankruptcy proceeding filed by a debtor.

However, an embezzler who wishes to avoid repaying his defrauded employer without filing bankruptcy is now arguing that the 2005 amendment to KRS 427.170 allows him to claim the federal bankruptcy exemptions to defend against an ordinary state non-wage garnishment. He was successful in the Kentucky Court of Appeals, which issued the 2-1 decision that the Supreme Court is reviewing. In their majority opinion, two judges of the Court of Appeals turned the longstanding view of bankruptcy asset exemption law in Kentucky on its head. Special Judge Paisley wrote in the majority opinion that KRS 427.170 "applies to all debtors in the Commonwealth, the statute's legislative history notwithstanding." Judge Wine dissented, stating that there can be "no other conclusion" but that the Kentucky legislature "intended for KRS 427.170 to be limited to bankruptcy proceedings."

Since that decision, debtors in at least 2 other cases have attempted to use federal bankruptcy exemptions in state judgment enforcement proceedings, though they had not filed bankruptcy.

Now, the Kentucky Supreme Court has decided to settle the issue. The Kentucky Bankers Association asked for M&P's help. It asked M&P to explain that the KBA's members have made and continue to make decisions about whether to extend credit based upon a

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Equine Law v. Thoroughbred Industry Practice

The Thoroughbred industry, like many others, has been affected by the current economic conditions. While the industry remained optimistic at the close of the Keeneland 2008 September Yearling Sale, though the total gross dropped 14.8%, the anticipated market recovery failed to materialize at the Keeneland 2008 November Breeding Stock Sale. At the November sale, the total gross dropped 45.6% from 1 year ago. As the 15-day November sale came to a close, the consensus among breeders and consignors was that value of bloodstock was down, while cost of production was on the rise. A decrease in the amount of credit available to buyers was also noted, and is widely believed to be a contributor to the staggering drop in gross auction proceeds at the November sale.

Due to the lower market value of horses, owners have greater amounts of debt that they are unable to satisfy with the November sale proceeds. Secured lenders, owners of breeding rights in stallions, board farm owners, veterinarians, farriers, judgment lien holders, consignors and agents, and auction companies are all coming head-to-head in the race to collect these debts, as it becomes increasingly clear that owners cannot pay them all. This article presents a brief overview of where the law on lien priority and industry custom collide.

For the most part, Kentucky law favors the secured lender that holds a perfected security interest and first priority lien on all of the owner's horses and other equine interests. However, the practice and custom in the industry routinely overrides the secured lender's position once the horses are entered into an auction. For example, the following scenario has become all too familiar to equine lenders and other affected parties:

A Mare in-foal is entered in the Keeneland 2008 November Breeding Stock Sale. The following parties are creditors of the Owner at the time of the Sale and expect payment from the sale proceeds: (1) KY Bank, who loaned Owner money to purchase the Mare and is still owed $350,000 and who has a prior, perfected security interest in the Mare; (2) Boarding Farm, who boarded the Mare for 11 months and is owed $10,000; (3) Stud Farm, who is owed a $25,000 stud fee; (4) Vet, who is owed $1,500 for services performed upon the Mare within the last 12 months; (5) Consignor, who boarded and prepared the Mare for sale for 30 days prior to the Sale, and will claim a 5% commission; and (6) Keeneland, who will be owed its customary entry fees and sales commissions.

A month before the Sale, KY Bank conducts a lien search with the Kentucky Secretary of State's Office and finds no liens of record. KY Bank feels confident going into the Sale that it will recover all of the proceeds, less commissions and sale costs. Three days before the Sale, however, KY Bank discovers that the stud fee hasn't been paid and that there is an outstanding board and vet bill. Couple this with a downturn in the market and KY Bank no longer feels secure.

Case law dealing with the sale of horses and priority of interests in the proceeds is scarce and outdated; however, the statutory law is quite clear. Effective July 1, 2001, Kentucky adopted Revised Article 9 of the Uniform Commercial Code and, unlike other states, specifically added "equine interests" to its definition of "farm products." "Farm Products" are statutorily defined as "goods . . . with respect to which the debtor is engaged in a farming operation and which are . . . Equine interests, including, but not limited to, interests in horses, mares, yearlings, foals, weanlings, stallions, syndicated stallions, and stallion shares (including seasons and other rights in connection therewith), *whether or not the debtor is engaged in farming operations and without regard to the use thereof.*" (Emphasis added) The effect of including equine interests in the definition of "farm products" is to make liens on horses and interests in horses subject to the rules of priority and perfection of Revised Article 9. Similarly, the definition of "secured party" was broadened to include the holder of an agricultural lien and "collateral" to include property subject to an agricultural lien.

Kentucky law also provides for a variety of lien rights that protect "equine interests." Most people in the industry are familiar with an "agister's lien" and many have used it to recover the cost of boarding services rendered to the horse owner. Additionally, Kentucky law allows for a lien for stud fees and costs against the offspring of a stallion. It also provides veterinarians a lien right "against the animal" for professional services rendered. The statutory liens provided to the agister, the stallion owner and the veterinarian are "agricultural liens", as that term is defined in Revised Article 9.

In the scenario above, as a matter of law KY Bank would recover first from the sale proceeds because none of the other parties filed liens or perfected their security interests/agricultural liens. KY Bank was the only party to perfect its security interest by filing a financing statement with the Kentucky Secretary of State. KY Bank's description of collateral included all of the value of the Owner's horses and equine interests available to satisfy the security interest, and specifically includes additional collateral such as all the interest in and to the offspring, born and unborn, of any thoroughbred horses owned by the Owner and the proceeds and contract rights therefrom.

On the other hand, if we assume that all the parties have properly filed and perfected liens, KY Bank's interest in the mare (and in the *in-utero* foal) still takes priority over the other *later created security interests*, like Stud Farm's lien and/or security interest, and agricultural liens, agister's liens and vet liens. As a matter of law, the first security interest or agricultural lien to be perfected has priority over conflicting perfected security interests and agricultural liens, and over unperfected conflicting interests.

However, industry practice and custom is often in direct conflict with the law. It tends to favor an unperfected or inferior lienholder rather than a prior, perfected secured lender like KY Bank. For example, as a matter of law, Boarding

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Indiana Collection Tools

A major part of our work at Morgan & Pottinger, P.S.C. is the filing of lawsuits for bank and other creditor clients in order to collect on promissory notes or other debt instruments that are in default for non-payment. In many cases, the entry of a judgment is only the starting point for getting paid, and various collection tools can be used to recover the amount due on the judgment.

In Indiana, judgments are rarely collected through the issuance of a writ of execution. A writ of execution requires the sheriff to seize everything the judgment-debtor owns, to appraise the property seized, and to deliver an inventory and appraisal list of the items seized to the court. A hearing is then held so that the judgment-debtor can claim property exempt from execution. The final step is the sale of the non-exempt property by the sheriff so that proceeds can be applied to the judgment debt. This approach is not favored because (i) the judgment-debtor does not have any significant property which is non-exempt, (ii) the cost of the process does not justify the typical low-dollar recovery, and (iii) the judgment-debtor could and typically will file a bankruptcy petition in order to either stop the sale, or to prompt the trustee to recover the sale proceeds as a preference if the bankruptcy is filed within 90 days after the sale.

The more effective method for collecting judgments in Indiana is to have the court convene proceedings supplemental to execution. This is done by the judgment-plaintiff filing a motion stating that proceedings on a writ of execution will not yield payment of the judgment. Some courts require that the judgment-debtor be ordered into court for a hearing as a first step. The benefit of ordering the judgment-debtor into court for a hearing is that the order can also require the judgment-debtor to bring copies of tax returns, lists of property owned, and statements from any bank accounts held. Typically, if the judgment-debtor has a job and/or a bank account, proceedings supplemental is the starting point for having the court order the employer to garnish the judgment-debtor's wages, or to have the bank garnish the account. However, there are a number of additional collection remedies available.

I.C. 34-55-8-7 tells us that the judge presiding over proceedings supplemental has authority to order "any property, income, or profits of the judgment debtor . . . or any debt due to the judgment debtor . . . to be applied to the satisfaction of the judgment and forbid transfers of property or choses in action." The lawyers at Morgan & Pottinger make the most out of the remedies permitted in these proceedings. For example, the court can order the judgment-debtor to garnish his or her own wages, which is quite helpful if the judgment-debtor is self-employed, has more than one job, or if there are non-employment related sources of income (like tax refunds, mineral royalties, tort claim recoveries, or rental income).

The judge can also order a lien on all of the judgment-debtor's personal property as a compliment to the real estate judgment lien automatically created upon entry and docketing of the judgment. The personal property lien can be perfected by filing a financing statement. Once the lien on personal property has been perfected, a 90 day wait prior to exercising lien rights will preclude any bankruptcy trustee's action to void the lien as a preference; and, during that 90 day period, the court may also order the judgment-debtor not to sell, dispose of, or otherwise convey any personal property having significant value without court approval. Should the judgment-debtor fail to abide by the court's orders, then it is possible to have the court find the judgment-debtor in contempt.

These proceedings also allow the court to convene additional hearings in the future in order to insure that the judgment-debtor is complying with all orders entered, and to follow up on potential assets or collection opportunities should the need exist. In particular, the court can order assets to be sold by private auction rather than having the sheriff conduct an execution sale, which will typically yield more in proceeds because of better marketing and advertising.

In Kentucky, Civil Rule 69.03 says that judgments are to be collected through the writ of execution process, unless the Court "directs otherwise." We think "directs otherwise" unambiguously means the court has the power to conduct collection proceedings independent of the writ of execution process. Although not yet widely used in Kentucky, we believe the concept of proceedings supplemental will become a valuable tool for creditors' counsel in the Commonwealth to enhance the process of collecting judgments.

Garret B. Hannegan

Amicus Brief

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25+ year understanding that the federal exemptions available under the Bankruptcy Code only apply in an "opt-in" state, when an individual debtor files bankruptcy, and when the Bankruptcy Court is determining what is the property of the bankruptcy estate. The KBA's *amicus curiae* brief points out that the KBA's view is based upon express statutory language, well-established principles of statutory construction, and unambiguous legislative history.

M&P does not expect a decision from the Kentucky Supreme Court for several months, and we will continue to keep you advised. If your business is involved in or aware of litigation raising issues of industry-wide significance, particularly in disputes involving creditor's rights, please contact us. M&P has a long history of filing *amicus curiae* briefs with courts at all levels, and we welcome the opportunity to help prevent (or remedy) erroneous judicial decisions.

M. Thurman Senn

Equine Law

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Farm cannot claim a perfected lien by possession since it released the Mare to Consignor 30 days before the Sale. Legally, it must file a financing statement to remain perfected once the Mare is removed. Nevertheless, the industry custom provides Boarding Farm with leverage—a board farm typically will not agree to release the horse until it is guaranteed payment for delinquent board.

Similarly, industry custom also favors Stud Farm. Stud Farm holds the stallion service certificate, which it can use as "collateral" for payment of the stud fee. Customarily, a stud farm will not release the certificate to the horse owner unless it is guaranteed an amount from the sale proceeds to cover the stud fee. A stallion service certificate is evidence of the breeding of a thoroughbred stallion to a mare. In the example above, the certificate is attached to the mare's Jockey Club registration papers so that the Mare can be sold in-foal at auction. The effect being that the buyer of the Mare at auction can register the now *in-utero* foal with the Jockey Club after the foal is born.

Until the foal is born, however, Stud Farm only has a contractual security interest pursuant to a stallion service agreement. This agreement typically provides the stud farm with a security interest in the stallion service certificate and in any foal or *in-utero* foal, but not in the mare itself. However, despite the fact that Stud Farm may have failed to perfect its security interest by filing a financing statement, or filed it after KY Bank's, it will likely have its debt paid prior to KY Bank's. This is because a stud farm can refuse to turn over the stallion service certificate until its fee is paid or until the parties reach a separate agreement *prior* to the sale regarding the division of proceeds.

Without interference from the court, which is often impractical because of time and the cost of litigation, the secured lender is routinely forced to settle with the stud farm and the board farm, and ultimately accept a lesser amount of the sale proceeds than it is entitled to under Revised Article 9. By forcing the secured lender to settle for less of the sale proceeds in the end, this industry practice is also causing the lender to lend less, or even none at all, to the owners and buyers in the beginning.

Given that the gross dipped in the Keeneland September yearling sale, and arguably plummeted in the Keeneland November sale, it is clear the market value of horses is governed not only by quality and demand but also by current economic conditions, including the availability of credit. Credit is a necessary part of the Thoroughbred industry. The present decrease in the amount of credit available is being felt not just by buyers and owners but by board farms, stud farms, veterinarians, consignors, and auction companies alike.

Emily H. Cowles

Firm News

M&P would like to wish everyone a happy and safe holiday season.

M&P is pleased to announce . . .

Margaret Kramer Seiffert, formerly of the National City Bank Law Department, has joined M&P as of counsel. Margaret practices in the areas of commercial lending, equine lending, business transactions, and fiduciary law. Margaret is located in M&P's Louisville office and can be reached at 502-572-7031 or *mks@morganandpottinger.com*.

Taylor M. Hamilton has joined the firm as an associate attorney. Taylor is a 2008 graduate of the University of Kentucky, College of Law where he was a member of the *Kentucky Law Journal* and graduated Order of the Coif. He obtained his bachelor's degree from the University of Kentucky in business administration. Taylor intends to focus his practice on commercial litigation. Taylor is located in M&P's Louisville office and can be reached at 502-572-7058 or *tmh@morganandpottinger.com*.

In other news . . .

John McGarvey has been named one of the best lawyers in America in the area of banking law by the 2009 *The Best Lawyer's of America*.

Thurman Senn and John McGarvey were presenters at the 28th Annual Conference on Legal Issues for Financial Institutions sponsored by the University of Kentucky, College of Law.

On August 14, 2008, John McGarvey gave an online presentation entitled "Default, Remedies and Enforcement under Revised Article 9", which was sponsored by the Texas Bankers Association.

On September 18, 2008, John McGarvey gave an online presentation entitled "The Name is the Game", which was sponsored by the Texas Bankers Association.

Mindy Sunderland gave a video presentation for the University of Kentucky, College of Law, Office of Continuing Legal Education, on "Extraordinary Remedies", which includes writs of possession, executions and injunctions.

Emily Cowles has been chosen to present at the 2009 National Conference on Equine Law sponsored by the University of Kentucky, College of Law.

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