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Legislative Summary

The 2007 Regular Session of the Kentucky General Assembly was a short session, meaning that it lasted only thirty legislative days. The effective date for legislation passed in the 2007 Regular Session is June 26, 2007. Several of the bills passed will have a direct impact on the business of many M&P clients.

Perhaps the most important legislation for the banking industry is House Bill 443 concerning a data match system for identifying and seizing the financial assets of delinquent Kentucky taxpayers. A similar system exists for collecting unpaid child support which requires financial institutions to identify and hold accounts of a parent subject to a state child support lien. The Kentucky Revenue Cabinet attempted to expand the child support match concept to tax collection in 2006. The 2006 legislation was inserted as part of the budget bill, and it had been attacked on various legal and policy grounds by the banking industry.

The 2007 legislation reflected a compromise between the Revenue Cabinet and the banking industry. Unlike the 2006 bill, the 2007 legislation expressly requires that the tax match system use the existing child support data match system. Furthermore, while a financial institution may voluntarily participate in the system earlier, a financial institution cannot be required to participate until the system is prepared for implementation in 90% of all financial institutions within a period of not longer than 18 months from the June 26, 2007, effective date of the Act. A "financial institution" is not just a depository institution (a bank), but it includes credit unions, insurance companies, safe deposit companies, money market mutual funds, brokerage firms, and trust companies authorized to do business in Kentucky. Substantial penalties can be imposed on a financial institution that fails to comply. A financial institution that is requested to voluntarily participate prior to system reaching the 90% threshold should carefully examine whether it wishes to (or is required to) do so. Also, financial institutions operating in Indiana should be prepared for a similar tax collection data match system authorized in Indiana House Bill 1505, which was enacted during the 2007 Indiana legislative session.

Methamphetamine labs have become a significant issue for the mortgage industry in Kentucky given their disastrous affect on property value. House Bill 94, entitled "Clean Up of Methamphetamine Contaminated Property", is a step in the right direction. It establishes a decontamination standard of one microgram of methamphetamine per one hundred square centimeters. It also requires contractors to obtain certification from, and register with, the Environmental and Public Protection Cabinet before providing decontamination services. HB 94 requires law enforcement agencies, upon discovery of a meth lab, to report such information immediately to the local health department. The health department then has the obligation to post notices of methamphetamine contamination on the property. Finally, the bill requires state agencies to pursue federal funding to help defray the costs of assessment and decontamination for families of lower and moderate income. No person found to be responsible for the contamination may obtain funding.

House Bill 321 creates a new section of KRS Chapter 134 limiting the recovery of a private purchaser of a tax bill. A private purchase can recover only the amount actually paid to purchase the tax bill, the interest accrued from the date of purchase, and the purchaser's attorney fees. However, the amount of attorney fees that can be recovered are also limited, depending upon the purchase price of the certificate.

House Bill 334 amends KRS Chapters 271B, 273, 275 and 386 to be more consistent with the Model Business Corpora-

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Ky. Highlands Investment Corporation v. Bank of Corbin, Inc.

On September 15, 2006, the Kentucky Court of Appeals issued a decision in *Ky. Highlands Investment Corporation v. Bank of Corbin, Inc.*, affirming the grant of summary judgment in favor of the Bank of Corbin, Inc. The Kentucky Supreme Court has since denied the motion for discretionary review, making the decision final.

Kentucky Highlands Investment Corporation was involved in a lending relationship with Tri-County Manufacturing and Assembly Incorporated and its affiliates, including Tritech Electronics, LLC ("Tritech"). During the course of the relationship, KHIC extended more than five million dollars of credit to the Tritech. As collateral for the various loans, KHIC took a security interest in Tritech's personal property and an assignment of Tritech's accounts receivable. KHIC properly perfected its security interest in same. In addition, the agreement between KHIC and Tritech included a provision requiring the remittance of customer payments directly to KHIC.

At some point, Tritech opened a deposit account with the Bank of Corbin. The Bank held a security interest in the deposit account pursuant to a loan agreement. Though Tritech's accounts receivable were not generally deposited into this account, KHIC was aware of its existence. Further, KHIC took no steps to enter into a control agreement with the Bank pursuant to KRS 355.9-104(1).

In the spring of 2002, the relationship between KHIC and Tritech began to sour. An audit conducted by KHIC revealed that Debtors had vastly overstated their accounts receivable. In addition, KHIC began to suspect Tritech's president of illegal activity. As a result, KHIC instructed Tritech not to collect any accounts. As one might expect, Tritech did not follow KHIC's instructions.

Tritech proceeded to deposit customer payments totaling approximately $400,000 in Tritech's account with the Bank. The Bank immediately set-off these deposits towards overdrafts and other past due accounts. KHIC subsequently sued the Bank to recover the set-offs, alleging that it had a prior interest in the funds. It further alleged that the Bank had colluded with Tritech to convert KHIC's collateral.

The Court of Appeals looked first at KHIC's priority argument. KHIC argued that its position was supported by *General Motors Acceptance Corporation v. Lincoln National Bank*, 18 S.W.3d 337 (Ky. 2000), in which it was held that a secured creditor had priority over the interest of the deposit bank in the account by virtue of its security agreement with the depositor. KHIC argued that the Bank had knowledge of its properly perfected security interest in the accounts receivable. It also argued that the Bank had a duty to determine if the off-set funds were proceeds of KHIC's collateral.

In return, the Bank argued that *Lincoln National Bank* had been overruled by the enactment of Revised Article 9 of the Uniform Commercial Code in July 2001. It claimed that Revised Article 9 provided a mechanism to protect a creditor in KHIC's position, which was a control agreement with the depository bank. See KRS 355.9-104. Additionally, the Bank claimed to have a superior security interest pursuant to KRS 355.9-327, which states that a security interest held by the depository bank has priority over a conflicting security interest. The Bank claimed that its right of set-off was superior to KHIC's interest as well. KRS 355.9-340 provides that a depository bank may exercise any right of recoupment or set-off against a secured party that holds a security interest in the deposit account unless the secured party's interest is perfected by a control agreement.

In considering the issue, the Court of Appeals agreed with the Bank and overruled *Lincoln National Bank*. The Court stated that "[b]y enacting the revisions, the drafters of Revised Article 9 and the legislature of Kentucky have clearly and deliberately shielded depository banks from claims and priority disputes with secured creditors." 53 K.L.S. 9, p. 12. KHIC "was aware of its debtors' deposit account with the Bank of Corbin and yet acquiesced in its use without taking any action to assert priority as to proceeds to which it claimed entitlement". 53 K.L.S. 9, p. 13. The Court found that KHIC could have protected itself by obtaining a control agreement with the Bank. Further, the Court found that KHIC, as a secured creditor, had a duty "to monitor its debtor's business and police its own collateral". *Id.*

The Court also held that the Bank had no duty to ascertain the source of the deposited funds. "A depository bank no longer bears the burden to ascertain the source of funds deposited into its customers' accounts and to determine whether there is a creditor who may have a lien on those funds before a bank can assert its rights as a secured creditor — namely, its rights to set-off against the account". 53 K.L.S. 9, p. 13. Official Comment 4 to §9-327 states that such a public policy "enables banks to extend credit to their depositors without the need to examine either the public record or their own records to determine whether another party might have a security interest in the deposit account".

Moreover, the Court disagreed with KHIC's argument that KRS 355.9-340 could be distinguished because it had a security interest in cash proceeds in the account rather than a security interest in the deposit account itself. The Court found "[t]hat construction would fail to distinguish between a creditor who neglected to protect its interests and a conscientious secured party that took the necessary steps to establish its priority". 53 K.L.S. 9, p. 13. The Court concluded its holding by stating that the "Bank was statutorily authorized to ignore even direct 'instructions' from Kentucky Highlands with respect to its conduct toward the deposit account". *Id.*

Next, the Court considered KHIC's argument that the Bank colluded with the Tritech to convert its collateral. In support of its argument, KHIC cited to KRS 355.9-332 which provides that a transferee of funds from a deposit ac-

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The Good with the Bad: Kentucky's Claim for Negligent Misrepresentation

In *Presnell Construction Managers, Inc. v. E.H. Construction, LLC*, 134 S.W.3d 575 (Ky. 2004), the Supreme Court of Kentucky adopted Section 552 of the Restatement (Second) of Torts, which permits an injured party a recovery based on negligent misrepresentations. This decision expands the law and presents both opportunities and risks to banks.

Prior to the adoption of Section 552, Kentucky recognized intentional fraud (the making of an intentional misstatement) or deceit (the failure to disclose a known material fact) as the basis for a lawsuit. Much of the law of lender liability has been based upon actions for fraud or deceit. The adoption of Section 552 broadens the scope under which claims can be asserted. That Section states:

One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Several salient points need to be made with respect to this Section. The first is that to be liable the defendant must have a pecuniary interest in the transaction. Secondly, the liability is limited to pecuniary losses; damages are limited to economic business losses. Lastly, the claim is based upon negligence in either obtaining or communicating information.

The Good

This change offers banks the opportunity to recover against accountants for their negligence in auditing financial information on borrowers. In instances where the accountant knows that the audited financials are to be supplied to creditors, whether they be banks or trade creditors, they may be held liable for the negligent preparation of the financial statements. In *Bethlehem Steel Corporation v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991), the Supreme Court of Tennessee recognized that Section 552 of the Restatement (Second) of Torts was applicable to accountants. That court limited the liability, however, to "those persons or class of persons, as determined by current business practices in the particular factual situation, when the accountant at that time the report is published should reasonably expect to receive and rely upon the information." *Id*. at 596. *Bethlehem Steel* was cited by the Kentucky Court of Appeals in *E.H. Construction, LLC v. Delor Design Group, Inc.* (unpublished opinion). The Kentucky court recognized that *Bethlehem Steel* stood for the proposition that accountants could be liable under Section 552 of the Restatement. When an accountant knows or reasonably knows that a bank will rely upon its financial statement, the accountant can now be held liable for its negligence in auditing the statement.

The Bad

While Section 552 may be helpful to a bank in recovering losses from negligent accountants, it may open the door to increased lender liability claims. In *Morton v. Bank of the Bluegrass & Trust Co.*, 18 S.W.3d 353 (Ky.Ct.App. 1999), the court approved a summary judgment for the bank on a claim for negligent misrepresentation, but did so only because it permitted a claim for compensatory damages which were also covered by the insurance claim. Though this decision predated the adoption of Section 552 by the Supreme Court in *Presnell Construction*, it clearly indicated the willingness of the court to look at Section 552 within the context of lender liability. Two unpublished opinions of the Kentucky Court of Appeals also suggest that Section 552 may be applied against banks.

In June, 2006 the Kentucky Court of Appeals decided *Durbin v. Bank of the Bluegrass & Trust Co.* (unpublished opinion), in which the Durbins asserted a claim for negligent misrepresentation against the bank arising out of their co-signing a note for Edward Madden. The Durbins claimed that the bank represented that Madden "was financially sound and there would be little risk to them as co-signers." The Durbins, however, conceded their liability on the note. By doing so they eliminated their negligent misrepresentation claim: their measure of damages would be, as limited by the economic limitation, the amount of the note. The Court of Appeals did recognize, however, that they had presented "at least colorable claims" against the bank for negligent misrepresentation. Thus, the court has recognized that Section 552 may be the basis for a lender liability claim against banks.

In *Miller, et al. v. J.J.B. Hilliard, W.L. Lyons, Inc.*, another unpublished opinion of the Kentucky Court of Appeals, the court recognized that the heirs of Mrs. Barbara Thacker presented a colorable claim under Section 552 when she made a Mr. James Boyd her sole beneficiary based upon alleged representations of the broker. The court recognized: "Although the alleged intended beneficiaries did not rely on the false information themselves and did not even discover the existence of the annuities until after Mrs. Thacker's death, the alleged false information was supplied for their ultimate benefit. Therefore, Hilliard-Lyons could properly be found liable." As a result, the Court of Appeals reversed the trial court's dismissal of the heirs' claims.

Thus, to the extent that banks give customers guidance on the structure of accounts or the disposition of funds, if their advice is wrong or negligently given, there is an arguable claim they could be held liable. Whenever a bank discusses with borrowers its intentions, the business effects of a transaction, the financial consequences of borrowing,

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tion Act. The bill allows corporations to convert to limited liability companies and states what information must be contained in the plan of conversion. Section 18 of the bill provides for conversion of an LLC to a limited partnership. The new law will allow an LLC to enter into a share exchange with a corporation and sets forth various statutes governing the exchange. HB 334 provides new rules governing an LLC's status as a non-profit entity. It also sets forth the required information for notifying the Secretary of State of a change in the principal office address. Finally, it requires domestic and foreign business trusts authorized to transact business in Kentucky to continuously maintain a registered agent in Kentucky.

House Bill 490, entitled "Fairness in Construction Act", creates new sections in KRS Chapter 371. The Act applies to both public and private construction projects but exempts residential construction. It provides definitions for "contractor", "disputed amount", "construction" and "contracting entity". Section 2 of the Act sets forth contract provisions that are deemed to be against the public policy. It also sets forth required payment provisions. The Act only applies to construction contracts entered into after the effective date of the Act.

Senate Bill 82 is an act relating to brownfields redevelopment. It amends various sections of KRS Chapters 132 and 141 and allows nonrefundable tax credits to those who have made expenditures on qualifying voluntary environmental remediation property as long as, among others, the clean up was not financed through a public grant program or the Petroleum Storage Tank Environmental Assurance Fund.

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Ky. Highlands

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count takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party. The Court dismissed this argument out of hand, finding that a depository bank does not qualify as a "transferee" under the statute.

This is a good decision for the banking industry. The opinion recognizes the change in Kentucky law made by the adoption of Revised Article 9 and it correctly applies the new law.

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the financial condition of a co-borrower, the value of collateral, even if the bank officer discussing these matters believes that the information is accurate, if he is negligent in that belief or in his statement, the bank may be held liable under Section 552 of the Restatement.

Section 552 of the Restatement offers to Kentucky banks both the good and the bad.

Douglas G. Sharp

Firm News

- M&P is pleased to announce that Scott White, who has been of counsel to the firm since 2005, has become a shareholder. Scott is located in M&P's Lexington office and can be reached at (859) 253-1900 or *tsw@morganandpottinger.com*.
- M&P is proud to announce the launch of its new website. Please visit us at *www.morganandpottinger.com*. Previous editions of M&P In Brief are located on our website.
- We are pleased to announce that Tyler Powell has joined the firm as an associate attorney. Tyler received his bachelor's degree from the University of Kentucky. He obtained his law degree from Washington University in 2003. Upon graduating from law school, Tyler clerked for Judge James Massey, United States Bankruptcy Court, Northern District of Georgia. Tyler's practice with M&P will focus primarily on bankruptcy law. Tyler is located in our Lexington office. Tyler can be reached at (859) 253-1900 or *mtp@morganandpottinger.com*.
- M&P is pleased to announce that Mindy Sunderland has been named a senior associate.
- M&P is pleased to welcome Taylor Hamilton, a third year law student at the University of Kentucky College of Law, as its summer law clerk.
- On April 20, 2007, at the University of Kentucky's 27th Annual Conference on Legal Issues for Financial Institutions, John McGarvey presented on recent developments under the Uniform Commercial Code. Thurman Senn gave the annual case law update for bank counsel.
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