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M&P In Brief

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Improper Bank Name Use by Third Parties

If you are frustrated by third-party entities soliciting business by referencing your institution's name—giving borrowers the impression that you are either sending or endorsing these solicitations—take heart: A relatively new Kentucky statute gives you a way to strike back.

KRS 286.2-685 went into effect in July 2006 and prohibits use of "financial institution trademarks" by unauthorized entities or individuals. Subsection (1) of the statute defines a "financial institution" as "any person or entity operating in the Commonwealth . . . as a bank, bank holding company, credit union, savings and loan association, or any wholly owned subsidiary thereof."

As to what the statute prohibits, subsection (2) states that no person is permitted to use "the trade name, trademark, service mark, logo, or symbol, or any combination thereof" (or anything remotely similar to the name, mark, logo, or symbol) "in any marketing material, solicitation, or advertising provided or directed to another person in a manner such that *a reasonable person may be confused, mistaken, or deceived that the marketing material, solicitation, or advertising originated from, is endorsed by, or has been consented to by the financial institution.*"

The prohibition is directed mostly at entities that comb public records for mortgage information. They use this data in mass mailings, trying either to get borrowers to refinance or to purchase mortgage-related life and/or disability insurance. Because these mailers usually reference lenders by name (and often do not include conspicuous disclaimer language), some borrowers are confused when they receive them. Indeed, improper use of a trade name frequently comes to light when customers ask bank personnel why they have received a particular mailer.

If your institution experiences the improper use of its name, KRS 286.2-685 provides powerful remedies. Subsection (4) creates a distinct cause of action in state court for any wrongful use, permitting a financial institution to seek an injunction against future use, a monetary recovery in the sum of 3 times the amount of actual damages, and a civil penalty of $1,000. The civil-penalty language is broadly crafted. Thus, the argument can be made that a $1,000 fine attaches to each separate name use that a plaintiff financial institution is able to establish.

If matters get to the point that filing suit is deemed the best way to address improper name use, our experience has been that the mere act of filing can have the desired effect of prompting a defendant to cease and desist. Under those circumstances, the manner in which a resolution is fashioned is limited only by what a defendant will agree to in addition to halting name use.

In a lawsuit handled by M&P, a defendant mortgage broker agreed to pick up attorney's fees expended in pursuing the action, filed on behalf of two Louisville-based institutions, along with entering into an agreed judgment that permanently enjoins future use of the names of any and all Kentucky-based financial institutions (providing also for an instant fine in the event the permanent injunction is ever violated). To date, there has not been another problem with name use by this particular mortgage broker.

KRS 286.2-685 is an important weapon in a financial institution's arsenal when it comes to improper name use, and, given its broad language, the statute has a reach beyond the solicitation scenarios delineated above.

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Bankruptcy: The Pitfalls of Defective Mortgages and the Keys to Mortgage Defense in Bankruptcy

While the number of bankruptcies being filed throughout the country continues to increase, a primary issue facing banks is defending defective mortgages against the Trustee's avoidance powers. By statute, the Trustee has the power of a bona fide purchaser of real property. In short, this power allows the Trustee to avoid mortgages that do not effectively provide notice to a bona fide purchaser based on the public record.

Of particular concern to banks in Kentucky are mortgages with defective notaries and acknowledgements under KRS § 382.270 and KRS § 61.060. While such errors can have a significant impact in bankruptcy actions, it is important to determine whether an error is fatal or curable and, subsequently, whether to expend valuable resources in litigation costs or to negotiate a settlement with the Trustee.

KRS § 382.270 provides that no deed or deed of trust or mortgage conveying a legal or equitable title to real property shall be lodged of record, and, thus, 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. However, if a deed or deed of trust or mortgage conveying a legal or equitable title to real property is not so acknowledged according to law, but it has been, prior to July 12, 2006, otherwise lodged for record, such deed or deed of trust or mortgage conveying a legal or equitable title to real property or creating a mortgage lien on real property shall be deemed to be validly lodged for record for purposes of KRS 382, and all interested parties shall be on constructive notice of the contents thereof . . .

First, it is important to distinguish whether an error is a notary error or an error in acknowledgment. Errors in acknowledgements are generally indefensible; however, notary errors are subject to strong defenses under bankruptcy law.

The primary case involving the defense of a mortgage with a defective notary is *In Re: St. Clair*, 380 B.R. 478 (Bankr. E.D. Ky. 2006). In *In Re: St. Clair*, the debtors, Denny St. Clair and Nicole St. Clair, purchased real property located in Dayton, Kentucky and executed a mortgage thereon. However, the notary was not present when the debtors executed the mortgage. Nevertheless, the notary notarized the mortgage. Six months later, the debtors filed for Chapter 7 bankruptcy protection and the trustee sought to avoid the mortgage pursuant to KRS § 382.270.

The court refused to invalidate the mortgage pursuant to KRS § 382.270, holding that it was valid on its face. The court then looked to KRS § 61.060 to determine whether the mortgage should be avoided. KRS 61.060 generally states that a notary's acknowledgement may only be attacked by a direct action against the notary or pursuant to a claim of fraud by the benefited party or mistake on the part of the notary.

The court held that the Trustee did not seek actual recovery from the notary by reason of her dereliction, such as a suit on her bond, so there was no relief to be sought against the notary directly. The court also denied the claim of fraud because the trustee did not allege that the fraud was actually committed by the party benefited—the lender—and that the actions of the notary, who was an employee of the lender, could not be imputed to the lender.

The court also denied the claim of mistake because there was no allegation that the debtors were harmed by the notary and, in fact, the debtors benefited from the notary notarizing the mortgage. In denying the use of parol evidence to show "mistake", the court noted that KRS § 61.060 was enacted to "stabilize the public records and make title to real estate in Kentucky more secure" and that allowing the use of parol evidence would "invite unnecessary litigation regarding innumerable real estate documents."

Ultimately, *In Re: St. Clair* provides lenders security in defending notary errors in bankruptcy. Such mortgages are readily defensible and are worthy of expending litigation costs in bankruptcy. However, that is not the case regarding defective acknowledgements.

The leading case in the Sixth Circuit regarding defective acknowledgements is *In Re: Trujillo*, 378 B.R. 526 (Bankr. 6th Cir. 2007). In *In Re: Trujillo*, the debtor, Gary Victor Trujillo, executed a mortgage on real property located in Fayette County, Kentucky. The debtor signed the instrument, but, according to the trustee, the mortgage was defective because the debtor was not named or identified in the certificate of acknowledgment. The Mortgage specifically stated:

/s/ Gary Victor Trujillo (Seal)
GARY VICTOR TRUJILLO
(Seal)
STATE OF KENTUCKY
COUNTY OF /hw/ FAYETTE ss
(Seal)

The foregoing instrument was acknowledged before me this /hw/ 8th day of /hw/ August 2001.

My commission expires /hw/ 8-4-03
/s/ [illegible signature] (Notary Public)

Prepared by /s/ [illegible signature]
/hw/ Fayette County, Kentucky.
(signature)

The creditor argued that the mortgage was valid because the debtor was identified in the instrument and that the instrument had a proper acknowledgement because the mortgage stated "acknowledged before me." The creditor also claimed that there was no need for a notary to identify the person acknowledging if he is one and the same as the person executing the instrument.

Rejecting the creditor's arguments, the court looked to Kentucky statutes. KRS 382.270 provides that a bona fide purchaser of real property is put on constructive notice of a prior interest by the presence of a recorded deed or mortgage "acknowledged . . . according to law." KRS Chapter 423 sets out the elements of an adequate acknowledgement. The court accepted the creditor's invitation to revisit an unpublished Sixth Circuit case, *In re Vance*, 99 Fed. Appx. 25 (6th

Continued on page three.

Can a Bank Stop Payment on Its Cashier's Check?

The lessons from a new decision by the Indiana Court of Appeals are that the world of commerce treats cashier's checks as a near cash equivalent and that the law of UCC Article 3 reflects that view. A bank that stops payment may be liable for a sum much greater than the amount of the check.

M&P successfully represented South Central Bank of Daviess County, the depository bank, against the issuing bank, Lynnville National Bank, that stopped payment on its cashier's check. As is frequently the case, Lynnville's customer/remitter requested the stop payment alleging fraud by the payee of the check.

Lynnville's customers, the Fishers, ordered a Patriot manufactured home from Landmark, a dealer. They obtained a loan from Lynnville for the down payment of $31,917.55. Lynnville intended to take a lien on the home after the purchase. Lynnville issued its cashier's check payable to Landmark.

Landmark deposited Lynnville's cashier's check into its account at South Central. An employee of South Central called Lynnville and confirmed the check was genuine. South Central gave Landmark immediate access to the credit from the deposited check. Landmark purchased a $24,000 cashier's check from South Central, payable to a principal of Landmark. South Central paid checks drawn on the account for the remaining balance.

The Fishers determined that Landmark was no longer a dealer for Patriot and that it could not sell them the manufactured home. They requested that Lynnville stop payment on the cashier's check. A Lynnville employee called South Central to advise that Lynnville would not pay the cashier's check because of the suspected fraud of South Central's customer. However, South Central had already issued its cashier's check for $24,000 and had already paid the remaining funds from Landmark's deposit account. The next day, South Central paid its $24,000 cashier's check purchased with the immediate credit it gave on Lynnville's check.

South Central sued Lynnville for the face amount of the cashier's check, plus interest, costs, and expenses including attorney fees. Lynnville raised a number of defenses. The trial court found that Lynnville had properly refused to pay the cashier's check and entered summary judgment denying South Central's claims.

South Central appealed the trial court's decision. Following briefing by John McGarvey, Garret Hannegan and Thurman Senn, and oral argument by John McGarvey, the Indiana Court of Appeals rendered its decision in favor of South Central. It directed the trial court to enter judgment for South Central for the face amount of the check plus interest and to set a hearing on other damages such as attorneys' fees. The decision is precedent setting in Indiana and has already received positive comments in several national publications as a thorough and correct analysis of the law under Revised UCC Article 3.

The discussion on the topic starts with Indiana Code 26-1-3.1-412 (part of Indiana's enacted version of Revised UCC Article 3), which provides, "The issuer of a note or cashier's check or other draft drawn on the drawer is obliged to pay the instrument . . . according to its terms at the time it was issued." The Indiana Appellate Court surveyed the rulings of other state and federal courts and confirmed that a cashier's check is a " 'bill of exchange drawn by a bank upon itself and accepted in advance by the act of issuance,' " and that " '[i]n the business community, cashier's checks are treated as the next best thing to cash.' " The Court looked further at the Official Comments to this section of Article 3, which say that a bank can pay the holder of a cashier's check issued by another bank "despite notice that there may be an adverse claim to the check."

The Court then turned to Indiana Code 26-1-3.1-411 to examine damages awardable against a bank that refuses to pay its own cashier's check. That statute provides that a party entitled to enforce the check after the dishonor can also recover expenses, interest, and consequential damages from the issuer of the check.

The Indiana Court finished its review of the law applicable to the case, finding that South Central was a holder in due course of Lynnville's check, having given value (i.e., it issued its own cashier's check and paid checks issued on the deposit) in good faith and without notice of defenses at the time it gave value. In overturning the trial court's decision, the Court of Appeals cast aside a number of equitable defense raised, and held in particular that South Central had neither failed to mitigate its damages nor breached its duty to exercise ordinary care in its decision to give Landmark immediate access to the deposit credit. As to Lynnville's contention that South Central should have dishonored its own cashier's check after it received notice of Lynnville's dishonor,

Continued on page four.

Bankruptcy

Continued from page two.

Cir. 2004), which held that where an acknowledgement failed to comply with statutory requirements, the mortgage failed to provide constructive notice. Affirming the ruling of *Vance*, the court concluded that the creditor's mortgage was defective and failed to provide constructive notice, even though recorded, because the acknowledgement did not name the mortgagor, and the mortgage could be avoided by the trustee.

Creditors should take a hard look at their mortgages when a debtor enters bankruptcy to determine the proper strategy for defending them. Under Kentucky law, if the mortgage deficiency involves a notary error, it is likely the Court will uphold the mortgage absent a deliberate fraud by the creditor. Conversely, if the mortgage deficiency involves an acknowledgement error, it is likely the mortgage can be avoided by the Trustee. Nonetheless, properly analyzing errors in mortgages will ultimately lead to more cost effective litigation and the maximization of asset value in bankruptcy.

Timothy A. Schenk

Have You Saved Your Old Financing Statements?

It has been 8 years since the Kentucky Secretary of State became the central filing office for financing statements on non-real estate related collateral. Prior to July 1, 2001, nearly all financing statements were filed with Kentucky's county clerks.

So why the question about saving copies of old financing statements? It relates to the priority of security interests originally perfected by filing in a county clerk's office but that are now perfected through in lieu of initial financing statements filed with the Secretary of State. Secured parties used the "in lieu of" process to move their perfection from the local to the central filing office. This occurred during the 5 year transition period that ended July 1, 2006.

The in lieu of initial financing statement, in addition to all of the ordinary requirements for a financing statement, also required information about the prior filing in the county clerk's office. The additional information included the date of the original filing and that of the most recent continuation.

The information about the prior financing statement established the priority date of the new filing with the Secretary of State. The priority date, regardless of when the financing statement was filed with the Secretary of State, relates back to the original date of perfection in the office of the county clerk.

But how do you prove that the prior financing statement, and all of its amendments and continuations, satisfied the technical requirements of the former law of secured transactions? By having "file stamped" copies of all of the filed financing statements related to a transaction. Without that proof, the priority date established by the old filings can be questioned by competing secured parties.

Because there were more in lieu of financing statements filed in Kentucky than all of the other states combined, this is a significant issue for secured parties whose security interests are perfected in the Commonwealth. Kentucky adopted a non-uniform section of the transition rules for Revised Article 9 to insure the old records would be available. However, they won't be available forever.

By statute, Kentucky's county clerks are required to retain all of their old records of financing statements until July 1, 2008. For financing statements moved to the Office of the Secretary of State, county clerks are now free to destroy their old UCC records.

A secured party with a security interest in collateral that was originally perfected before July 1, 2001 should make sure it retains "file stamped" copies of its UCC records filed with a county clerk. If you do not have copies of the old filings, and are concerned they might be needed, you should quickly request copies from the clerk in whose office they were filed.

Each of Kentucky's 120 county clerks will act according to the storage and space needs of their office, but there is no longer a statutory requirement that they maintain records you may need to prove the priority date of your security interest originally perfected in the old system. The UCC perfection system was effective in Kentucky in 1960 and many secured parties have customers still in business for which a security interest was perfected at or near the beginning of the system.

John T. McGarvey
Melinda T. Sunderland

Stop Payment

Continued from page three.

the Court said, "South Central merely recognized that the law applies equally to South Central and Lynnville."

When a customer requests that an issuing bank stop payment on a cashier's check, the issuer is not obligated to agree to the request, and if the issuer agrees to stop payment it should have a strong indemnity agreement from an equally strong customer. The only sure way for the issuing bank to protect itself when the remitter wants to stop payment is to insist that the remitter obtain a court order directing the issuing bank to not pay the check.

The Indiana Court of Appeals decision is published as *South Central Bank of Daviess County v. Lynnville National Bank*, 901 N.E.2d 576 (Ind.App. 2009).

John T. McGarvey
Garret B. Hannegan

Firm News

M&P is pleased to announce . . .

Mindy Sunderland has been named to the Leadership Kentucky Class of 2009.

Camille Rorer and Tyler Powell were named Senior Associates.

Camille Rorer was elected Secretary of the Louisville Black Lawyers Association, Inc.

In other news . . .

Emily Cowles was a speaker at the 2009 National Equine Law Conference in Lexington, Ky. Her topic was "Documentation and Negotiation of Unique Breeding Practices."

Scott White received the KBA's KyLAP "Trusted Servant" Award.

Scott White was appointed by Governor Beshear to the Governor's Early Childhood Task Force.

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It is with deep regret that we inform you of the passing of Jim Scroghan on April 6, 2009. Jim was a beloved friend and colleague. He will be missed.

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