



MORGAN &  
POTTINGER  
ATTORNEYS P.S.C.

Patrick E. Morgan  
John T. McGarvey  
C. Edward Hastie  
M. Deane Stewart  
James I. Murray  
Douglas Gene Sharp<sup>o</sup>  
John A. Majors  
Mark J. Sandlin<sup>o</sup>  
Scott T. Rickman  
M. Thurman Senn<sup>^</sup>  
Hal D. Friedman

<sup>o</sup> Admitted KY & IN  
<sup>+</sup> Admitted IN Only  
<sup>\*</sup> Admitted KY & GA  
<sup>^</sup> Admitted KY, VA &  
District of Columbia

Thomas C. Fenton  
T. Lawson McSwain, II  
Ruthanne Whitt Goodman<sup>\*</sup>  
Garret B. Hannegan+  
Margie L. Loesser  
Andrea L. Wasson<sup>o</sup>  
Daniel T. Albers, Jr.  
Larry T. Powell  
Carolyn M. Bauer  
Molly E. Rose  
Of Counsel:  
Elmer E. Morgan  
J. Jeffrey Cooke  
David C. Pottinger  
(1934-1999)

## Quarterly Newsletter

[www.morganandpottinger.com](http://www.morganandpottinger.com)

Summer 2002

### 11<sup>th</sup> Circuit Finds Uncertificated CD Is a Deposit Account, M&P Client Recovers \$1,000,000

Adopting an argument advanced by M&P's John T. McGarvey, the 11<sup>th</sup> Circuit United States Court of Appeals recently reversed the decisions of two lower courts and held that an uncertificated certificate of deposit is a deposit account under Article 9. The result of the decision is that National City Bank of Kentucky, the firm's client, will retain the principal and interest of a \$1,000,000 CD that the two previous courts had ruled was property of a bankruptcy estate and had to be surrendered by the Bank.

The case, *In re Alabama Land and Mineral Corp.*, was decided in a unanimous opinion issued by the Court on June 5, 2002. The Court ruled in favor of National City primarily based on a clarification of the law under revised Article 9 of the Uniform Commercial Code, about which we have reported numerous times in this newsletter.

National City issued a \$1,000,000 letter of credit in favor of a bonding company for a customer that later filed Chapter 7 bankruptcy. As collateral, National City entered into a Reimbursement and Security Agreement creating an escrow account for \$1,000,000 that the debtor and its parent company could request be invested in a CD. At the time of the bankruptcy the funds were invested in a National City CD for which no physical certificate was ever issued.

After the bankruptcy, National City sought relief from the automatic stay to realize on its CD and apply the proceeds to the pre-petition debt. The trustee argued

that the bank had not properly perfected its security interest and the proceeds of the CD belonged to the bankruptcy estate.

The Alabama Bankruptcy Court and the U.S. District Court both sided with the Trustee, ruling that National City's collateral should be classified as a negotiable instrument and that its security interest could be perfected only by possession of

the instrument. The courts reasoned that because National City did not issue a negotiable instrument, it did not hold possession of its collateral and its security interest was not perfected.

On appeal to the 11<sup>th</sup> Circuit, M&P was asked by National City to join as co-counsel to respond to the Court's request for  
*Continued on page four.*

### Guarantors Cannot Use Oral Side Deals To Avoid Written Guaranty Agreements

In a case arising out of the collapse of the Kentucky Central Life Insurance Co., the Kentucky Court of Appeals on July 12, 2002, rejected efforts by loan guarantors to avoid their written guaranty agreements based upon alleged oral side agreements. *Janie A. Miller, As Liquidator Of Kentucky Central Life Insurance Co. v. R. Dudley Webb, et al.*, No. 1998-CA-002487-MR.

In deciding to uphold the written agreements, the Court of Appeals' decision specifically mentions the public policy arguments made in the "friend of the court" briefs filed by Morgan & Pottinger, P.S.C. on behalf of the Kentucky Bankers Association. However, the Court of Appeals refused to enforce one of the guaranty agreements on the ground that it was signed after the fact and without the lender providing any benefit to the guarantors for the agreement. As such, the Webb decision highlights certain pitfalls in obtaining

guaranty agreements after a loan is made that, while avoidable, can cause problems for the lender.

The guarantors in the case are Donald, Julie and Dudley Webb. Kentucky Central made a number of real estate loans to businesses controlled by the Webbs, and the Webbs signed written guaranty agreements which provided that the Webbs personally guaranteed repayment of the loans. When Kentucky Central went out of business, its state-appointed liquidator brought suit against the Webbs to enforce the guaranties. However, the Webbs generally defended on the ground that they had oral agreements with the prior head of Kentucky Central, Bud Burnett, that the guaranties would not be enforced except if the Webbs diverted money from the real estate projects or if the Webbs prevented the property from being deeded to Kentucky  
*Continued on page three.*

601 West Main Street • Louisville, KY 40202 • Telephone (502) 589-2780 • Fax (502) 585-3498  
133 West Short Street • Lexington, KY 40507 • Telephone (606) 253-1900 • Fax (606) 255-2038  
120 Market Street • P.O. Box 77 • New Albany, IN 47150 • Telephone (812) 948-0008 • Fax (812) 944-6215  
Affiliate Collection Office: 4329-C Memorial Drive • Decatur, GA 30032

## Attorneys and Creditors Hit with Sanctions Over Undisclosed Attorney Fees in Proofs of Claim

Three new cases out of the United States Bankruptcy Court for the Southern District of Alabama, all of which were certified as class actions and involved several thousand loans, merit the attention of all creditors and attorneys who file proofs of claim. In two of these Chapter 13 cases, *Slick v. Norwest Mortgage, Inc.*, No. 98-14378-MAM, Adv. No. 99-1136 (Bankr. S.D. Ala. 5/10/02) and *Dean v. First Union Mortgage*, No. 00-11321-MAM-12, Adv. No. 99-1144 (Bankr. S.D. Ala. 5/10/02), the bankruptcy court awarded substantial damages (a combined \$4 million) against both mortgage companies and their counsel for failing to disclose the inclusion of attorney fees in several thousand proofs of claim filed by these creditors in Chapter 13 cases over a 6-7 year period.

Why? The court reasoned that the United States Supreme Court had already decided that Chapter 13 debtors may pay post-petition (but pre-confirmation) attorney fees through their Chapter 13 plans. Therefore, the conduct of the creditors and their counsel, in not clearly disclosing post-petition fees in their proofs of claim but instead "tacking" these fees on the loans to be paid at a later date, deprived the debtors in each case of this option.

In both cases, the mortgage companies hired outside counsel or bankruptcy service vendors to prepare proofs of claim for them. These fees were not disclosed on the proofs of claim, but the mortgage companies later assessed the fees they paid to their counsel and vendors on these accounts for each debtor and added them to the balance due on the accounts. Post-confirmation fees are not part of a creditor's secured claim, but pre-confirmation fees are, according to the court. The essence of the Court's ruling was that "a creditor should not be able to dictate to a debtor what option he/she selects [regarding payment of fees] by its non-disclosure". Damages were awarded at such a high level given the vast number of cases the court found this practice was utilized in.

In the third case, *Powe v. Chrysler Financial Corp.*, 98-10935-MAM-13, Adv. N. 99-1121, decided by the same court on the same day, the judge held that Chrysler did not run afoul of this rule, because its proofs of claim disclosed the fees in "various [if not necessarily uniform] ways." Finally, it is important to note that even if the attorney fee is properly disclosed, it still

needs to be "reasonable" to pass muster before the Court. A "reasonable" fee is one that is generally in line with the prevailing local rates for other attorneys who handle similar work, and may also be dictated in part by the experience of the counsel handling the work for the client.

These appear to be the first such rulings on the issues presented by a bankruptcy court. As the rulings make clear, the act of filing a proof of claim is fraught with pitfalls and is not as simple a task as many might believe.

Our firm recommends that creditors adopt procedures designed to address these rulings. Disclosure of the actual attorney fee charged by the attorney or service handling post-petition but pre-confirmation matters for the creditor on the proof of claim should suffice. Of course, this may

or may not be possible in all circumstances. For example, fees charged by some counsel may not be set at a flat fee or predictable hourly rate; various counsel charge different rates; and, in many cases additional fees may need to be charged for handling other non-routine matters post-petition but pre-confirmation (such as an objection to confirmation). In such cases, the total fees charged may not be able to be established with exactitude at the time the proof of claim is filed by the creditor or the attorney representing the creditor. An alternative might be to note on the proof of claim that an attorney fee is being charged for "post-petition but pre-confirmation services", and then address the issue with the debtor and his/her counsel on the record at the meeting of creditors, advise of the general

*Continued on page three.*

## Kentucky Bankruptcy Courts to Move to Electronic Filing

All creditors and attorneys who are involved with bankruptcy matters need to be aware that effective August 15, 2002, both the Eastern District and Western Districts of Kentucky will switch to an electronic filing method for all proofs of claim, and many standard or routinely filed pleadings (bankruptcy petitions, motions for relief from stay, adversary proceeding complaints, to name just a few). The program, known as Electronic Case Filing or "ECF", will change the way debtors, creditors, and their counsel do business with the Bankruptcy Court's in Kentucky. As of August 15, 2002, the courts will "expect" regularly practicing trustees, attorneys, and creditors who file significant amounts of paper work (such as proofs of claim) "to file documents using the Internet or by submitting documents in PDF format on diskette." (letter from John Bruebaker, Chief Deputy Clerk for the United States Bankruptcy Court, Western District of Kentucky). In addition, the Court will no longer maintain paper files on cases filed on or after August 15, 2002.

To register for ECF, a participant must complete a training registration form and submit it to the Clerk's office; have access to the internet; maintain a PACER (the bankruptcy court's primary information

website) account; install a PDF writer, such as Adobe Acrobat 5.0; and, have a credit card authorization form on file with the Clerk's office (all filing fees will be paid using a credit card; and, checks will be prohibited or discouraged). You will also need a scanner that can convert text documents into PDF format for electronic transmittal to the Court.

Training on the use of the system will be provided by the Clerks office in the two districts at varying times throughout July and August, and will continue through September 2002. To obtain more information, you may wish to visit the Bankruptcy Courts' websites located at [www.kywd.uscourts.gov](http://www.kywd.uscourts.gov) (W.D. Kentucky) or [www.kyed.uscourts.gov](http://www.kyed.uscourts.gov) (E.D. Ky.).

Our firm has is preparing to go on line with both Districts. Hal D. Friedman of the firm was asked by the Court to serve on the advisory panel for the Western District of Kentucky in this regard and has been tracking the Court's progress as it moves towards ECF.

If you would like more information, please feel free to contact Hal D. Friedman or John A. Majors (Western District of Kentucky) or Scott T. Rickman (Eastern District of Kentucky) here at the firm.

## Guaranty Agreements

*Continued from page one.*

Central if any of the projects developed financial trouble. For one of the loans, the Webbs also argued that the transaction was not a loan but a joint venture and that Kentucky Central agreed to absorb its own losses notwithstanding the Webbs' personal guaranties. For another loan, known as the Woodlands loan, the Webbs also argued that they should not have to pay because they signed their personal guaranties months after the loan was made and without Kentucky Central giving them anything in return.

The trial court accepted the Webbs' arguments, causing great consternation in the lending community. Banks and other lenders feared that allowing the Webbs to prevail would effectively destroy the utility of written guaranty agreements since guarantors could always claim the existence of unwritten, oral promises that the guaranties would not be enforced. Thus, when the case was appealed, the Kentucky Bankers Association requested Thurman Senn at Morgan & Pottinger, P.S.C. to explain to the Court of Appeals the importance of enforcing loan documents as written.

To the relief of lenders, the Court of Appeals reversed the trial court and issued a decision that strongly supports the enforcement of written guaranty agreements as written. Deciding the case for a unanimous three-judge panel, Judge McNulty explained that "when parties put their agreements in writing, all prior negotiations and oral agreements are merged in the instrument, and a contract as written cannot be modified or changed by parol [oral] evidence in the absence of mistake or fraud in the preparation of the writing." This doctrine is commonly referred to as the "parol evidence rule."

The Court of Appeals found that no such mistake or fraud existed. There was no mistake because the Webbs knew that the written guarantees did not contain the side oral agreement. Nor did the Webbs argue that the written guarantees accidentally omitted the side oral agreement. More importantly, the Webbs could not allege fraud because the Webbs did not request that the written guarantees be changed to include the side agreement. Citing the 1964 decision in *Mario's Pizzeria, Inc. v. Federal Sign And Signal Corp.*, Ky., 379 S.W.2d 736, the Court of Appeals concluded that by going ahead and signing, the Webbs accepted the agreements as written and could not claim fraud. As for the al-

leged "joint venture," there was no mention of it in the written loan documents. Therefore, under the parol evidence rule, the Webbs could not claim it as a defense to the written guaranty.

In further support of its decision, the Court of Appeals relied upon arguments made by M&P on behalf of the lending community that it is sound public policy to prevent borrowers from using unwritten, oral agreements to avoid written loan documents in industries which are "affected with the public interest." The Court of Appeals agreed, noting that banks and insurance companies are both "businesses that are public concerns" and whose written loan documents are "affected with the public interest." Thus, the Court of Appeals found that "the Webbs should be estopped from claiming that their agreement was something other than that which was expressly stated in the agreements and the public records of [Kentucky Central]."

The Webbs, however, were successful with their defense to the Woodlands loan. In that loan, the Webbs were not asked to sign their guaranties until several months after the loan was made. The Court of Appeals held that "[f]or the promise of a surety subsequent to the advancement of money, there must be new consideration." The term "consideration" refers to the legal doctrine that a promise to do something must be given in "consideration" of a benefit given, or detriment incurred by, the recipient of the promise. In the case of the Woodlands loan, there was no evidence that the recipient of the promise, Kentucky Central, gave anything new "in consideration for" the Webbs' promise to repay the loan. Thus, Kentucky Central could not enforce the agreement.

The result in the Woodlands loan can be easily avoided since most lenders do give consideration in the form of additional time to repay the loan or an agreement to excuse loan defaults. The critical aspect is to make sure that the later executed guaranty agreement contains a provision reciting the consideration given by the lender in exchange for the guaranty.

Unfortunately, the Court of Appeals' decision in the Webb case is not to be published. Moreover, the decision is not yet final since there is still time for the parties to ask the Court of Appeals to reconsider its decision or to appeal the case to the Kentucky Supreme Court. Nevertheless, the decision is still good news for Kentucky lenders.

*M. Thurman Senn*

## Sanctions

*Continued from page two.*

range of the fee, tell the debtor that this fee will be added to the balance of the loan due the creditor and paid in the normal course of payment, and obtain the debtor and/or their counsel's approval to this. In our experience, few if any debtors attorneys will object to the treatment of fees in this manner, because they don't want to have to go back and amend their schedules and/or plans to include these small amounts as debts to be paid through the Trustee.

Another option might be to include a notice which would be mailed to the debtor's counsel along with the proof of claim (copies of the proof of claim must be mailed to debtor's counsel under the Bankruptcy Rules), or to put a notice directly on the mailing "certificate" portion of the claim, advising that an attorney's fee is being charged, that it will be within a certain range, and informing the debtor through his/her counsel of their rights to object to this or to pay it through the plan. Obviously, in pro-se cases this notice would be sent to the debtor directly. As creditors react to the new decisions, standard compliance procedures will likely emerge.

While none of these options create a "perfect" solution to the problem, the key here is disclosure, in some meaningful way, to the debtor regarding his/her rights with respect to such fees. Creditors and their attorney (and all non-attorney bankruptcy service vendors who assist creditors) should, following these rulings, examine their proofs of claim, the disclosures and information contained therein, and make changes and adjustments in their procedures to avoid such errors from coming back to hit them later on.

Our firm has discussed these potential resolutions with one of the prominent Chapter 13 Trustees in Kentucky (who also served as an expert witness in the *Powe* case, above) and, while we can make no guarantees, we feel that these strategies should help avoid potential exposure on the issues presented. It is important to note that these cases are not yet the law in Kentucky or Indiana, and the Alabama Court's decisions are not binding on Kentucky or Indiana courts. However, given the significance of the issues prudence dictates a measured response by creditors and their counsel outside of Alabama at this time.

*Hal D. Friedman*

## Firm News

- ◆ The firm is pleased to announce that it has hired **Larry T. Powell** as an associate attorney in its foreclosure department. Mr. Powell, who was formerly with the law firm of Weltman, Wienberg and Riez, will start with the firm on July 15, 2002.
- ◆ The firm is pleased to announce that it has hired **Mike Hamilton** as an associate attorney in its Lexington office. Mike was a former law clerk with the firm and will be taking the bar examination in August.
- ◆ The firm has hired **Loren Prizant** as a summer associate in its Louisville office. Loren is a student at the University of Louisville Brandeis School of Law.
- ◆ The firm has hired the following new staff employees: **Linda Greer** has joined new in Foreclosure department; and, **Deb Foster** (skiptracer) and **Geraldine Baxter** (collector) have joined the firm's Collection Department. The firm has also hired **Kevin Fisher**, formerly with the firm on a part time basis, as a full time to assist Brian Parrish in its Information Technology Department. Welcome to all.
- ◆ The firm is pleased to report that **Andrea Richardson**, Bankruptcy Paralegal, gave birth to a new daughter, Lindsey, on April 29th. Andrea should be returning to work from her leave in mid-August. Congratulations Andrea and Charlie.

### CD Is a Deposit Account

*Continued from page one.*

supplemental briefs on the effect on the case of Revised Article 9. We argued that Revised Article 9 was definitive and in favor of the Bank. Mr. McGarvey and David Anderson, a Birmingham, Alabama

## New Technology at M&P

Morgan & Pottinger's Collection Department is pleased to announce that we are installing a new computerized predictive dialer system. This system will vastly increase the amount of calls made to debtors in collection cases, and increase all important "contacts" with debtors. We are confident that it will further increase our recovery and liquidation rates for our clients on account placements. We believe that this technology is necessary to further the firm's decision to increase its pre-suit collections and to satisfy client demand for these services. The firm has also purchased hardware and software that will allow us to scan pleadings and other documents and to store this data in our systems without the need to maintain paper files. All of these new technology additions are to insure that our level of service keeps pace with the fast moving collection environment and the needs of our clients. If you would like more information about what these new technologies may mean to your organization as a client, contact Steve Douglas, Operations Manager, Becky Baumann, Collections Manager, Amy Hannegan, Client Services, or Hal Friedman here at the firm.

attorney, argued the case before the 11th Circuit in Atlanta, Georgia.

The 11th Circuit agreed with our argument and looked to Revised Article 9's new definition of deposit account, and the Official Comment to the definition that categorizes uncertificated CDs as deposit accounts. Using the new definition, and treating it as a clarification of the prior law, the Court found that National City's uncertificated CD was a deposit account. The Court reasoned that as a deposit account, which at the time of the transaction was not governed by former Article 9, the CD was subject to the common law pledge in favor of National City. The appeals court then went on to find that National City had properly taken a common law pledge, and reversed the lower courts.

In reaching its decision, the Court quoted from Official Comment 12 to Revised Article 9-102 (KRS 355.9-102). The Comment clarifies an area where the interaction of modern banking practices and the original version of Article 9 created confusion, and states:

"an uncertificated certificate of deposit would be a deposit account . . . whereas a nonnegotiable certificate of deposit would be a deposit account only if it is not an 'instrument' (a

question that turns on whether the nonnegotiable certificate of deposit is 'of a type that in the ordinary course of business is transferred by delivery with any necessary indorsement or assignment')."

Now that deposit accounts are within the scope of Revised Article 9, the lesson for banks is to have counsel examine how they issue and take security interests in CDs. Under Revised Article 9, an uncertificated CD is clearly a deposit account and the process in which to take and perfect a security interest is clear.

The nonnegotiable, paper form of CD creates uncertainty about how to perfect a security interest. If it is a deposit account, perfection is by control. However, if the nonnegotiable CD is customarily transferred by delivery, it is an instrument and perfection requires possession of the certificate, and if at a third party institution, a control agreement.

A security interest in a CD issued as a negotiable instrument must always be perfected by possession. However, as pointed out to the 11th Circuit at oral argument, the negotiable instrument form of CD is nearly extinct. If you would like more information on the case or its import, contact John T. McGarvey.

*Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this newsletter. If you have any questions about this newsletter, or suggestions for future articles, contact Hal D. Friedman, Editor, at the firm.*

THIS IS AN ADVERTISEMENT.