Rosenberg College of Law
Continuing Legal Education

41st Annual Conference on

Legal Issues for Financial Institutions

October 2021

Presented by
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OFFICE OF CONTINUING LEGAL EDUCATION

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660 South Limestone Street
Lexington, Kentucky 40506-0417

Phone
(859) 257-2921

Facsimile
(859) 323-9790

Website
law.uky.edu/CLE

41st Annual Conference on

Legal Issues for Financial Institutions

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Conference Chair
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Stock Yards Bank

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Limestone Bank

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Stites & Harbison PLLC

WILLIAM T. REPASKY
Frost Brown Todd LLC

MARTHA A. ZISKIND
Wyatt Tarrant & Combs LLP

ABOUT THE 2021 CONFERENCE SPEAKERS

ELLEN MCCOY SHARP (Conference Chair) is Vice President and Assistant General Counsel with Fifth Third Bank. Prior to joining Fifth Third, Ms. Sharp served as Senior Vice President with Central Bank & Trust Company. Ellen is a graduate of Rollins College, and earned both her M.A. and J.D. degrees from the University of Kentucky. She graduated with Honors from the Graduate School of Banking at Colorado in 2018. Prior to moving in-house, Ellen practiced law with Frost Brown Todd LLC, where she practiced in the area of creditors' rights, commercial and consumer foreclosure, bankruptcy law, real estate law, and general creditor/debtor issues. She has served on the planning committee for UK CLE's annual conference on Legal Issues for Financial Institutions for a number of years and began her tenure as Conference Chair of this conference in 2020.

ADAM M. BACK is a member of Stoll Keenon Ogden's Lexington, Kentucky office where he works with the firm's Bankruptcy & Financial Restructuring, Business Litigation, and Appellate practice groups. Mr. Back is a cum laude graduate of Eastern Kentucky University and earned his J.D. degree from the University of Kentucky College of Law. Adam is listed in Best Lawyers in America, Kentucky Super Lawyers, is rated AV Preeminent, and is a member of the 2014 class of Leadership Lexington.

EMILY H. COWLES is a Partner of Wyatt, Tarrant & Combs, LLP, where she concentrates her practice in the areas of banking and finance law, commercial real estate, business and corporate law, litigation, foreclosures, and equine law. With two decades of legal experience, Emily routinely speaks on banking and real estate issues, and most notably has been recognized as a leader in her field numerous times, such as the Kentucky Super Lawyers' lists "Top 50 Attorneys in Kentucky" (2018-2020) and "Top 25 Women Attorneys in Kentucky" (2018-2021), the Best Lawyers in America (2017-2021), and recognized as a "Top Women in Business" in the Lane Report's 2014 edition. Emily served as an Attorney Member (2017-2020) and Chairman (2020-2021) on the Inquiry Commission of the Kentucky Bar Association, which receives allegations of professional misconduct by attorneys. Emily is heavily involved in various civic organizations such as Court Appointed Special Advocates (CASA), Kentucky Horse Council, Commerce Lexington, the Kentucky Chamber and the Kentucky Banker's Association. Emily's civic work further extends into the boardrooms of Women Leading Kentucky, as Vice-Chairman, and Sayre School where Emily is the current Chair of the school's Board of Trustees. Emily also serves as a Director of Peoples Exchange Bank and on the bank's Audit Committee.

LEA PAULEY GOFF is a Member in the law firm of Stoll Keenon Ogden, PLLC, where she serves as Chair of the firm's Bankruptcy & Financial Restructuring practice. She also serves as Co-Chair of the firm's Banking Litigation practice. A law graduate of Vanderbilt University, Lea is an active member of the Bankruptcy Sections of both the Kentucky and the Louisville Bar Associations, as well as the Kentucky Bankers Association, and American Bankruptcy Institute. Lea serves on the planning committee for this annual program and has provided the annual bankruptcy law update for several years. She is rated AV Preeminent by Martindale-Hubbell and is listed in The Best Lawyers in America.

JOSEPH MCBRIDE, CFA, Head of CRE Finance at Trepp, is a key leader of the firm's product development and market research initiatives. He leads Trepp's Commercial Real Estate and Banking businesses that support clients that invest, lend, broker, value, and risk manage commercial real estate (CRE) assets. Mr. McBride works closely with clients and industry groups to build and enhance data, models, and analytics that drive client investment decisions and streamline their work. His market analysis is frequently cited in publications such as Crain's, Wall Street Journal, various regional business journals and other media that monitor the CRE market. As a liaison to banks and other financial institutions, Mr. McBride has helped data teams in integrating Trepp loan data into bank proprietary

systems. His responsibilities include helping clients incorporate the data, develop applicable modeling data sets, and determine an approach for the process of building a "bottom-up" CRE stress testing model. Mr. McBride also helped to develop Trepp's proprietary CRE Default Model for use in risk scoring processes and CECL reserving. Prior to his research and bank support, Mr. McBride led Trepp's internal public relations team. He is one of Trepp's trusted press contacts providing data, commentary, and analysis about the US CMBS and CRE markets to financial publications. Mr. McBride is a regular contributor to TreppWire™, Trepp's own widely read daily market commentary newsletter distributed to clients and industry leaders; TreppTalk™, the firm's blog; and Commercial Real Estate Direct Mid-Year and Year-End, biannual magazines and with in-depth market analysis. Mr. McBride is also co-host of the TreppWire Podcast, a show listened to and followed by many in the CRE and CMBS industry. Mr. McBride began his career as an intern with Trepp's Bond Finance team while he studied Finance at Fordham University. Upon graduating, he returned to Trepp fulltime in 2012 as a Research Analyst. Mr. McBride holds a BS and MBA in Finance and is an Adjunct Professor of Finance at Fordham University.

JOHN T. MCGARVEY is a shareholder and Chair of the Executive Committee at the law firm of Morgan Pottinger McGarvey. He has been a frequent speaker at UK/CLE's annual conference on Legal Issues for Financial Institutions and has served on the Planning Committee for the annual event since 1987. John is received his B.A. from the University of Kentucky and was awarded his J.D. degree from the University of Kentucky College of Law where he was a member of the Moot Court Board. He currently serves on the faculty here at the UK College of Law and was also recently inducted into the UK College of Law Hall of Fame. He is listed in Best Lawyers in America; is a Kentucky Super Lawyer; is an active member of the Uniform Law Commission; and is a member of the American Law Institute.

NANCY EFF PRESNELL is a Member of Frost Brown Todd LLC, in Louisville, Kentucky, where she has over 22 years of experience working in-house with a number of financial institutions. Her practice is focused on regulatory compliance matters in the financial services industry and she often works with financial service providers with consumer compliance mattes, Bank Secrecy Act compliance and Community Reinvestment Act programs. Ms. Presnell is a graduate of the Louis D. Brandeis School of Law at the University of Louisville. She is also a Certified Regulatory Compliance Manager (CRCM), and a Six Sigma Green Belt. She is widely published and a frequent lecturer on financial institution legal matters.

WILLIAM T. REPASKY is a Member of Frost Brown Todd LLC, one of our region's largest law firms. While his practice is principally devoted to banking litigation and regulation, he is one of the original partner members of Frost brown Todd's "Blockchain Practice Group." This group now has many clients across the nation. Bill's focus in the new Blockchain Practice Group is federal laws and regulations, like the Bank Secrecy Act and FinCEN's regulations affecting money services businesses; and state laws and licensing regulations, such as those that impact money transmitter businesses. Bill is a graduate of the University of Michigan and Vanderbilt University Law School. Prior to joining Frost Brown Todd, he was in-house counsel for National City Bank for approximately 16 years, handling the Bank's commercial, retail and operational litigation. Bill served as Chair of this Conference for 10 years.

MATTHEW J. REGAN has served as an IT Examination Specialist with the FDIC out of the Chicago Regional Office since 2008. Mr. Regan began his career with the FDIC in 2000 as a Safety and Soundness examiner out of the Detroit Field Office and served as the field office's IT Subject Matter Expert beginning in 2007, and has conducted financial institution Safety and Soundness and IT exams as a member of the field office. He received his MBA from Eastern Illinois University in 2000.

JOHN RYAN is currently Senior Vice President and Deputy Counsel for Stock Yards Bank & Trust, a position he assumed in June 2018. Previously, John was the Bank's Credit Manager and managed commercial and real estate credit analysis, real estate appraisals, construction monitoring, asset based lending administration and third party collateral tracking. John also serves as a voting member of the Bank's Executive Loan Committee, Criticized Assets Committee and Credit Policy Committee and chairs the Asset Quality Committee. He is Secretary of the Louisville chapter of the University of Kentucky Alumni Board and a member of the UK Alumni National Board of Directors where he serves on the Corporate Governance Committee. In 2016, John was awarded the UK Alumni Distinguished Service Award. John previously practiced law in the Capital Markets group at Stites & Harbison, PLLC, and is the immediate past-chair of this annual conference.

M. THURMAN SENN is Of Counsel with the law firm of Morgan Pottinger McGarvey, where his practice concentrates on banking and finance law, bankruptcy, foreclosure, commercial litigation and arbitration. He is a summa cum laude graduate of Vanderbilt University and earned his J.D. from Harvard University Law School. Thurman has served on the Planning Committee of this conference since 1994. He has spoken at each of the Annual Conferences since 1992 and served as the Conference's Program Planning Chair from 1997-2004. Mr. Senn is rated AV Preeminent by Martindale-Hubbell and has been named a Kentucky Super Lawyer for 2010-2019. He has also been listed in Best Lawyers in America for Banking & Finance Law from 2013-present. Thurman is widely published and a frequent lecturer in the area of financial institutions law.

MARTIN B. TUCKER is a partner with Dinsmore & Shohl LLP in Lexington, Kentucky and Vice Chair of the firm's Business Restructuring Practice Group where he focuses his practice on banking law, creditor's rights law, complex bankruptcies, and real estate law. Mr. Tucker is a graduate of Northern Kentucky University and was awarded his J.D. from DePaul University College of Law, where he served on the DePaul Law Review. He is Peer Review Rated AV by Martindale-Hubbell, is a Kentucky Super Lawyer, and is listed in Best Lawyers for Bankruptcy and Creditor Debtor Rights / Insolvency and Reorganization Law and Bankruptcy Litigation. Mr. Tucker is a member of the Fayette County and Kentucky Bar Associations; the American Bankruptcy Institute; Kentucky Banker's Association, Leadership Kentucky (Class of 2013), and Leadership Lexington (Class of 2009). He is a frequent speaker at professional and legal education programs including many of the programs hosted by the University of Kentucky and the Kentucky Banker's Association.

CHARLES A. VICE was appointed Commissioner of the Kentucky Department of Financial Institutions effective August 16, 2008. As the Commissioner of the DFI, he has responsibility for the regulatory oversight of all state-chartered financial institutions, which includes examinations, licensing of financial professionals, registration of securities and enforcement. In addition, Commissioner Vice serves as Chairman of the Conference of State Bank Supervisor's (CSBS) Education Foundation and a Board member of the National Association of State Credit Union Supervisors (NASCUS). Mr. Vice has been a bank examiner for the FDIC for 18 years, serving the Lexington field office. His awards have included the 2007 FDIC Chicago Region employee of the year.

TIMOTHY R. WISEMAN is a member of Stoll Keenon Ogden and practices with the firm's Business Litigation, Business Torts, Bankruptcy & Financial Restructuring, and Tort Trial & Insurance service groups. Mr Wiseman is a summa cum laude graduate of the University of Kentucky, where he also earned an M.A. degree. Timothy graduated magna cum laude from the University of Richmond School of Law in 2012, where he served as the Annual Survey Editor for the Richmond Journal of Global Law and Business. Mr. Wiseman is listed in Best Lawyers in America, Kentucky Super Lawyers, and is listed as a Rising Start by Kentucky Super Lawyers.

41st Annual Conference on

Legal Issues for Financial Institutions

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zoom

Please keep these Quick Start instructions handy until you are familiar with the app.

1. **Click one of the links provided via email to open the Zoom stream.**

   Plan to do this about 10 minutes before the scheduled start time so that you can allow for software downloads/updates and setting adjustments.

   - If it's your first time using Zoom, you'll be prompted to install the Zoom app. Just follow the directions on the screen.
   - If it's your first time using Zoom, you'll be asked to enter your name. Please use the same name that you'd want on your conference badge. You can also change this later.

2. **A preview window will open, showing what you will be broadcasting to the world.**

   Please note this is still a private area that only you can see.

3. **There are audio and video icons in the lower left hand corner.**

   Test your audio or video and switch microphones or speakers here. ***MOST IMPORTANTLY, turn OFF the video of yourself and MUTE your microphone.*** You will still be able to see the video that plays in the Zoom meeting.

4. **Join the meeting.**

   Did you remember to mute yourself and stop sharing your video? You can do this at any time, but it's best if you do it before joining.

5. **Update your name and make use of the other icons in the "meeting room" window:**

   - **Participants** – The number shows you how many people are participating. Click on the icon to open a side bar that will allow you to give feedback to the presenter. If you hover your mouse over your own name and then click the "More >" pop up button, you can change the name everyone sees for you – i.e., if "Jane" last used Zoom with her family, she can now change it to "Dr. Jane Smith, Ph.D." for a work meeting. ***Please update your name as you are listed with the Bar for attendance tracking purposes.***
   - **Chat** – Click on it to open a side bar for text chatting with the group. Keep in mind, this is rather like passing notes in class and can be distracting depending on the situation. If you want to interact with the presenter (ask a question, etc.), use the Participants sidebar to raise your virtual hand.
   - **Reactions** – Click this icon to have quick access to "applause" and "thumbs up" reactions. These reactions are also available in the Participants sidebar under "more".

   Note that some or all of these options may not be available depending on if you are accessing Zoom from a desktop, laptop, tablet, or other mobile device.

6. **When you are ready to leave, look in the lower right hand corner for the "leave meeting" button.**

   If you click it, you will be asked to confirm that you want to leave, so be aware that it is not instantaneous.

Zoom Tips

- Muting yourself not only it improves the audio quality for everyone attending, but keeps little surprises like a ringing phone or a barking dog from being disruptive.
- With so many participants, it's important to join as audio-only (i.e., watching the presenter's video but not broadcasting any video). The less video your computer needs to process, the smoother everything else in Zoom will run. Remember you can still participate and ask questions in the Participants side bar!

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Please keep these Troubleshooting Tips handy until you are familiar with the app.

1. **You must have a stable, high-speed internet connection.**

   This can be wired or wireless, but be aware that standard data rates may apply if you're using a mobile device.

2. **Zoom gives different levels of complexity to different platforms.**

   A phone will have the fewest options available to you, whereas the desktop version will have the most. Sometimes simpler might be better, depending on your needs.

3. **Zoom has a section of help pages are geared towards those participating in a Zoom meeting.**

   Zoom Help Pages for Users and Participants:

   https://support.zoom.us/hc/en-us/articles/206175806

4. **But don't panic! Zoom really does try to keep it simple.**

   If it's your first time, Zoom should walk you through everything you need to know after you click on the link we sent you via email.

5. **The most common problem is frozen or choppy video.**

   There are many factors involved with this problem, including several beyond our control, such as: strength of your wifi or data connection; any bandwidth throttling your ISP might be doing; your computer/mobile device's processing power; etc. However, other than being able to see the speaker, everything you need (such as PowerPoint slides) will be included in your PDF packet. If the video is not displaying correctly, you can safely switch to audio-only settings without worrying about missing anything.

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Schedule for **Friday, October 15**

7:50 a.m.	**Registration and Continental Breakfast for in-person attendees.** Remote attendees join Zoom meeting: Click the link sent via email, follow the on-screen instructions from Zoom, and adjust your audio/video settings.
8:25 a.m.	**Welcome and Announcements**
8:35 a.m.	**Annual Legislative and UCC Update for Bank Lawyers** (60 min.) John T. McGarvey, Morgan Pottinger McGarvey
9:35 a.m.	**Key Case Law Update for Bank Counsel** (45 min.) M. Thurman Senn, Morgan Pottinger McGarvey
10:20 a.m.	**Morning Break** (15 min.)
10:35 a.m.	**Legal Issues in Bank Technology** (50 min.) William T. Repasky, Frost Brown Todd LLC
11:25 a.m.	**If You're Not at the Table, You're on the Table: Insolvency and Workout Update for Bank Counsel** (50 min.) Adam M. Back and Timothy R. Wiseman, Stoll Keenon Ogden PLLC
12:15 p.m.	**Lunch Break – Box Lunch provided for in-person attendees.**
12:25 p.m.	**Lunch Presentation: Update from the Dept. of Financial Institutions** Charles A. Vice, Kentucky Department of Financial Institutions
1:15 a.m.	**Legal Ethics Considerations During an Economic Downturn** (60 min.) **[Ethics]** Martin B. Tucker, Dinsmore & Shohl LLP
2:15 p.m.	**Afternoon Break** (15 min.)
2:30 p.m.	**PPP and SBA Issues for Banks** (45 min.) Ellen M. Sharp, Fifth Third Bank John Ryan, Stock Yards Bank
3:15 p.m.	**The NDAA and the Bank Secrecy Act** (30 min.) Nancy Presnell, Frost Brown Todd LLC
3:45 p.m.	**Commercial Real Estate Issues for Bank Counsel** (50 min.) Emily H. Cowles, Wyatt Tarrant & Combs LLP Joseph McBride, CFA, Trepp LLC
4:35 p.m.	**Adjourn Conference**

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Here's how to do it online!

1. Go to <**www.kybar.org**>.

2. Click on the **CLE** button.

3. Sign-in at the **Member Portal**.

4. Select **Submit New Credits**.

5. Select the **Educational Year** your program was completed. The form defaults to the current year.

6. Enter the **Program Number** and select the **Program Name** which you attended. *Be patient – it will take a moment for the program names to load.*

   This Program's Number: 234420

   This Program's Name: 41st Annual Conference on Legal Issues for Financial Institutions

7. Click Next and enter the **Total CLE Credits** you have earned of the Program's accredited CLE hours. (Click on the slider bar – slider may also be controlled using your arrow keys.)

   This Program's Accredited CLE Hours: 6.5 (includes **1.0** Ethics)

8. Add **your name** and **today's date**, then click **Next**.

That's all!

No need to send paperwork to the KBA!
Your credits will appear on your transcript.

SECTION A

ANNUAL UCC UPDATE FOR BANK LAWYERS

JOHN T. MCGARVEY
Morgan Pottinger McGarvey
Louisville, Kentucky

UNIFORM COMMERCIAL CODE UDPATE

John T. McGarvey

WHAT WILL HAPPEN, WHAT IS HAPPENING, AND WHAT HAS HAPPENED WITH THE UNIFORM COMMERCIAL CODE.

Amending the Uniform Commercial Code to Accommodate Emerging Technologies

The Uniform Law Commission ("ULC") and the American Law Institute ("ALI"), joint sponsors of the Uniform Commercial Code ("UCC"), begin to draft amendments to the UCC in 2015 to accommodate electronic notes. After much debate, the project was limited to electronic notes secured by first mortgage residential transactions. Those amendments to UCC Articles 1, 3, and 9 were completed, however, they were never offered to the states because a required corresponding Federal act, creating an electric note depository at the Federal Reserve Bank of New York, never reached the United States Congress. That failure was fortuitous.

The sponsors of the UCC quickly realized that technology, as it frequently does, was quickly getting ahead of the law and more extensive amendments were required to facilitate electronic commerce. In 2019 the ULC and the ALI appointed a joint study committee to determine whether amendments to the UCC were required to accommodate emerging technologies including artificial intelligence, distributed ledger technology, and virtual currencies. Typically, a study committee works for a year, issues a report, and a decision is then made by the sponsoring bodies on whether to appoint a drafting committee. In this instance, the study committee was quickly converted by its sponsors to a drafting committee for amendments to the Uniform Commercial Code to deal with digital assets, transactions in which the sale or lease of goods are bundled with the provision of services and/or the licensing of information, and certain discreet amendments required outside the field of emerging technologies.

The pages following this summary are the initial work product of the drafting committee presented to the ULC at its annual meeting in July. It is a work in progress. There is a several-page list of issues to address when the drafting committee is scheduled to meet again in November. The desired result of that meeting is to produce a final draft to be presented to the ALI Council in January 2022, the ALI annual meeting in May 2022, and the ULC's annual meeting in July 2022. Assuming approval of the sponsoring bodies, the amendments will be presented for consideration and enactment by the states in the Fall of 2022.

The draft amendments are divided into five parts: Controllable Electronic Records (new Article 12 on the transfer of property rights in intangible assets); Money (to accommodate intangible money as payments or security); Chattel Paper (updating existing Article 9 with a new definition that resolves uncertainty when goods are leased as part of a bundled transaction); Payments (by check or wire transfer); and Miscellaneous amendments (*e.g.*, a definition of "electronic" added to Article 1).

Most significant among the amendments is the creation of new Article 12. Initially, the drafting committee examined amending the existing Articles to accomplish its goals, but determined that the creation of a new Article, as an overlay, much like Article 1, was preferable. Hence, Article 12 (Articles 10 and 11 related to transition rules for prior amendments) appears in the first pages of the ***draft*** amendments included in these materials.

The draft amendments of Article 12 create a new definition of "controllable electronic records" ("CER"). Included within the definition of a CER are virtual currencies, non-fungible tokens, and digital assets with payment rights imbedded. A digital asset, as part of a controllable electronic record, would be negotiable, and transferable in a manner free of competing claims. Additionally, CERs can serve as collateral under Article 9 through perfection by control. Perfection by control, much like perfection on securities accounts and deposit accounts, would have priority over a security interest in a CER perfected only by the filing of a financing statement.

Article 12 defines a controllable electronic record as "an electronic record that can be subjected to control…" Under Section 12-105, a person has control of a CER if the CER, a record attached to or logically associated with the CER, or the system in which the CER is recorded, if any, gives the person the power to avail itself of substantially all of the benefit of the CER, the exclusive power to prevent others from availing themselves of substantially all of the benefit of the CER, and the ability to transfer control of the CER to another person. Further, the system in which the CER is recorded must enable the person to readily identify itself as having those powers and that person may be identified in any way, including by name, identifying number, cryptographic key, office, or account number.

A CER is a new form of digital/intangible property. The definition of a CER specifically does not include electronic chattel paper, electronic documents (warehouse receipts), investment property, each a category of property subject to the existing provisions of the UCC, or transferable records under E-Sign or the UETA, deposit accounts, or intangible money.

Guiding principles for drafting any amendments to the Uniform Commercial Code are to draft with durability, or to work with existing technology and with technologies not yet contemplated, and to do no damage to existing law. Hence, the proposed amendments do not require a change in how collateral is described in the security agreements through which a security interest attaches, or financing statements, through which a security interest is perfected. CERs will fall under the definition of general intangibles. If the CER represents a controllable account, or a controllable payment intangible, it is a payment intangible, and it falls within the definitions of "account" or "payment intangible," as those terms are currently defined in Article 9. The basic rules of existing Article 9 on attachment and perfection remain unamended and will cover digital assets such a CERs.

An example relates to accounts as collateral. If an account that 50 years ago would have been represented by a ledger card, is now a CER, the account debtor will be discharged from the debt if it pays the person known to be in control of the account, until such times as it receives a notification authenticated by the debtor, or by the debtor's secured party, that the account debtor should pay the secured party in control of the account.

Article 12's section on definitions adopts Article 9's definitions for account debtor, authenticate, controllable account, controllable payment intangible, deposit account, electronic chattel paper, intangible money, investment property, and proceeds.

To accommodate the Amendments, 9-102 adds definitions of "controllable account" and "controllable payment intangible" in proposed new subsections (27A) and (27B).

A CER, to fall within the scope of Article 12, must be susceptible to control as provided in 12-105. The distinction between a "transferrable record" under E-Sign or UETA, is that a record can become a CER in the absence of an agreement that it is transferrable, a requirement of UETA. A new section 9-107A on control of CERs defers to new 12-105 on what constitutes control.

One of the primary drivers for the Amendments to Accommodate Emerging Technologies is the advent of intangible money including virtual currencies. Unfortunately, the cryptocurrency industry has offered standalone statutes in a number of states to facilitate their industry without regard to the damage some of that legislation does to existing provisions of the UCC. That legislation was offered in the 2021 session of the Kentucky Legislature. Our legislative leaders wisely chose to wait for the UCC Amendments that will facilitate digital commerce generally, instead a limited focus on facilitating only the use of cryptocurrency.

(One of the reasons for this presentation and furnishing you with a copy of the draft Amendments is to let you know the ULC and ALI are on the way with a legislative framework for digital commerce. There is no need for one-off narrow solutions that do not smoothly meld into existing commercial law. If you become aware of efforts to offer non-uniform digital commerce legislation, please let me know and let the Kentucky Bankers Association know.)

The definition of "money" in the existing UCC would include virtual currency if the virtual currency is authorized or adopted by a government as legal tender (El Salvador has done that with Bitcoin, and the Federal Reserve Board seems to be looking that direction with a digital dollar), whether token based, or in a deposit account. The problem that creates is that existing Article 9 allows a perfection of a security interest in money only by possession of the money. The obvious problem is that intangible money by its very definition excludes physical possession. Control, as provided in the Amendments, will allow perfection of a security interest in virtual currency.

The draft amendments allow the normal perfection rules to apply if the intangible money is located in a deposit account. However, if the intangible money is not in a deposit account, control must be established through a means similar to a CER in order to perfect a security interest.

The essential purpose of the UCC is to facilitate commerce. As commerce has increasingly become electronic, and distributed ledger technology has been added to the business lexicon, the law must quickly follow. Currently, with no law to provide the certainty essential to business and commerce, people are agreeing to use Bitcoin, and other forms of virtual currency, as both a medium exchange and a store of value. Yet, there is no law to govern disputed claims to electronic records and the rights and benefits attached thereto.

Providing legal rules for transfer of CERs, either outright or for the purpose of security, is the essential purpose of Article 12, it governs the rights of parties to these transactions. The scope of Article 12 is limited to CERs but does not necessarily govern the property rights evidenced by CERs. The amendments to the existing Articles of the UCC, and the existing provisions of other Articles, particularly Article 9 on secured transaction, work hand-in-hand with the new Article 12 to facilitate digital commerce.

The following DRAFT of the proposed amendments to the UCC to accommodate emerging technologies is just that, the draft presented to the Uniform Law Commission in July 2021. This draft will be revised at the drafting committee's meeting in November, and possibly again when presented to the UCC's sponsoring organizations in 2022. The draft is provided to you in order that you can have an idea of where the most substantial drafting project since the inception of the UCC is going and can consider how it will affect your business practices, your forms, and how you conduct your business. It is also presented to you for your comments, questions, and suggestions that I will gladly present to the drafting committee.

When reading the draft, Article 12 is all new material. The amendments to the existing UCC Articles are presented in legislative format to show changes to the existing Code provisions.

Uniform Commercial Code and Emerging Technologies

ARTICLE 1

GENERAL PROVISIONS

Section 1-204. Value. Except as otherwise provided in Articles 3, 4, ~~[and]~~ 5, ~~[and 6],~~ [6,] and 12, a person gives value for rights if the person acquires them:

(1) in return for a binding commitment to extend credit or for the extension of immediately available credit, whether or not drawn upon and whether or not a charge-back is provided for in the event of difficulties in collection;

(2) as security for, or in total or partial satisfaction of, a preexisting claim;

(3) by accepting delivery under a preexisting contract for purchase; or

(4) in return for any consideration sufficient to support a simple contract.

Reporter's Note

1. *"Value."* The amendment to this section implements the policy choice described in Reporter's Note 8 to draft § 12-104.

ARTICLE 12

CONTROLLABLE ELECTRONIC RECORDS

Section 12-101. Short Title. This article may be cited as Uniform Commercial Code—Controllable Electronic Records.

Section 12-102. Definitions.

(a) In this article, "controllable electronic record" means an electronic record that can be subjected to control under Section 12-105. The term does not include deposit accounts, electronic chattel paper, electronic documents of title, intangible money, investment property, or "transferable records", as defined in the Electronic Signatures in Global and National Commerce

Act, 15 U.S.C. Section 7021(a)(1) or as defined in [cite to Uniform Electronic Transaction Act Section 16(a)].

(b) The definitions of "account debtor," "authenticate," "controllable account," "controllable payment intangible," "deposit account," "electronic chattel paper," "intangible money," "investment property," and "proceeds" in Article 9 apply to this article.

(c) "Value" has the meaning provided in Section 3-303(a).

Legislative Note: *In subsection (a), the state should cite to the state's version of the Uniform Electronic Transactions Act Section 16(a) or comparable state law.*

Reporter's Note

1. *"Controllable electronic record."* A "controllable electronic record" is an "electronic record," *i.e.*, information that is stored in an electronic or other intangible medium and is retrievable in perceivable form. To be within the scope of Article 12, the record must be susceptible of control under Section 12-105. Unlike a "transferable record" under E-SIGN or UETA, a record can be a controllable electronic record under Article 12 in the absence of an agreement to that effect.

The provisions of Article 12 are unsuitable for certain types of electronic records, and the definition has been limited accordingly.

2. *"Value."* The concept of value in Section 3-303 is narrower than the generally applicable concept in Section 1-201. Reporter's Note 8 to draft § 12-104 explains the difference between the two concepts and why the draft adopts the Article 3 approach.

Section 12-103. Scope.

(a) This article applies to controllable electronic records, controllable accounts, and controllable payment intangibles.

(b) If there is conflict between this article and Article 9, Article 9 governs.

(c) A transaction subject to this article is subject to any applicable rule of law which establishes a different rule for consumers and [insert reference to (i) any other statute or regulation that regulates the rates, charges, agreements, and practices for loans, credit sales, or other extensions of credit and (ii) any consumer-protection statute or regulation].

Reporter's Note

1. *Source of these provisions*. Subsection (b) follows Section 3-102(b). As is the case with respect to Article 3, Article 9 would defer to Article 12 in some instances. See draft § 9-331.

Subsection (c) is copied from Section 9-102.

2. *Controllable accounts and controllable payment intangibles*. As to controllable accounts and controllable payment intangibles, see Reporter's Note 1 to draft § 9-102.

Section 12-104. Rights in Controllable Electronic Records, Controllable Accounts, and Controllable Payment Intangibles.

(a) In this section, "qualifying purchaser" means a purchaser of a controllable electronic record or an interest in the controllable electronic record that obtains control of the controllable electronic record for value, in good faith, and without notice of a claim of a property right in the controllable electronic record or a controllable account or controllable payment intangible evidenced by the controllable electronic record.

(b) Except as provided in this section, law other than this article determines whether a person acquires a right in a controllable electronic record and the right, if any, the person acquires.

(c) A purchaser of a controllable electronic record acquires all rights in the controllable electronic record that the transferor had or had power to transfer.

(d) A purchaser of a limited interest in a controllable electronic record acquires rights only to the extent of the interest purchased.

(e) In addition to acquiring the rights of a purchaser, a qualifying purchaser acquires its rights in the controllable electronic record and a controllable account or controllable payment intangible evidenced by the controllable electronic record free of a claim of a property right in the controllable electronic record, controllable account, or controllable payment intangible.

(f) Except as provided in subsection (e) or law other than [the Uniform Commercial Code], a qualifying purchaser takes a right to payment, right to performance, or interest in property evidenced by the controllable electronic record subject to a claim of a property right in the right to payment, right to performance, or interest in property.

(g) The following rules apply to a purchaser of a controllable electronic record traceable to another controllable electronic record:

(1) An action based on a claim of a property right in the other controllable electronic record or a controllable account or controllable payment intangible evidenced by the other controllable record, whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against the purchaser if the purchaser acquires its interest in and obtains control of the traceable controllable electronic record for value, in good faith, and without notice of a claim of a property right in the traceable controllable electronic record or a controllable account or controllable payment intangible evidenced by the traceable controllable electronic record.

(2) The purchaser takes free of a security interest in the traceable controllable electronic record and a controllable account or controllable payment intangible evidenced by the traceable controllable electronic record if:

(A) the purchaser acquires its interest in and obtains control of the traceable controllable electronic record for value, in good faith, and without notice of a claim of a property right in the traceable controllable electronic record or a controllable account or controllable payment intangible evidenced by the traceable controllable electronic record; and

(B) the traceable controllable electronic record constitutes proceeds of the other controllable electronic record.

(h) Filing of a financing statement under Article 9 is not notice of a claim of a property right in a controllable electronic record.

Legislative Note: *In subsection (f), the state should insert the appropriate reference to the Uniform Commercial Code.*

Reporter's Note

1. *Source of these provisions.* Subsection (a) derives from Section 3-302(a)(2) (defining "holder in due course").

Subsections (c) and (d) derive from Section 2-403(1) (concerning the rights of a purchaser).

Subsection (e) derives from Section 3-306 (concerning the rights of a holder in due course).

Subsection (g) derives from Section 8-502 (protecting entitlement holders).

Subsection (h) derives from Section 3-302(b) (concerning notice of a claim).

2. *Applicability of other law.* As a general matter, this section leaves to other law the resolution of questions concerning the transfer of rights in a controllable electronic record, such as the acts that must be taken to effectuate a transfer of rights and the scope of the rights that a transferee acquires. *See* subsection (b). Subsections (c) through (h) contain important exceptions to this subsection.

> **Example:** *A* creates a controllable electronic record. Other law would determine what rights *A* has in the controllable electronic record. *A* and *B* agree to the sale of the controllable electronic record to *B*. Other law would determine what steps need to be taken for *B* to acquire rights in the controllable electronic record. Once *B* acquires those rights, *B* would be a purchaser (as defined in Section 1-201), whose rights would be determined by either subsection (c) or (e), depending on whether *B* was a qualifying purchaser.

The "law other than this article" that may apply to the transfer of rights in a controllable electronic record includes UCC Article 9. Section 9-203 would apply, for example, to determine whether a purported secured party acquired an enforceable security interest in a controllable electronic record.

3. *Nonpurchaser having control.* Under draft § 12-105, a person may have control of a controllable electronic record even if the person has no property interest in the controllable electronic record. A person that has control of, but no interest in, a controllable electronic record would not be a purchaser of the controllable electronic record and so would not be eligible to be a qualifying purchaser under this section.

Example: Debtor granted to Secured Party a security interest in all Debtor's existing and after-acquired accounts, chattel paper, and payment intangibles. Secured Party perfected its security interest in a specific controllable account by obtaining control of the controllable electronic record that evidences the controllable account. See draft § 9-107A.

Because Debtor's security agreement does not cover controllable electronic records, Secured Party would have no interest in the controllable electronic record. Accordingly, Secured Party would not be a purchaser of the controllable electronic record and would not benefit from the take-free rule in subsection (e) (discussed in Note 5). Secured Party's security interest in Debtor's controllable accounts and controllable payment intangibles would, however, have priority over a conflicting security interest that was perfected by a method other than control. *See* draft § 9-326A.

4. *Conditions for, and consequences of, becoming a qualifying purchaser.* The conditions for, and consequences of, becoming a qualifying purchaser were drawn from Article 3. More specifically, the conditions for becoming a qualifying purchaser were drawn from Section 3-302(a)(2), which defines "holder in due course" of a negotiable instrument. Among these conditions is that a person take the instrument "for value." As Note 8 explains, the concept of value in Article 3 differs from the concept of value that is generally applicable in the UCC. Article 12 adopts the Article 3 concept.

The definition of "qualifying purchaser" omits some of the conditions for becoming a holder in due course. For example, to qualify as a holder in due course, a holder must take "without notice that any party has a defense or claim in recoupment . . . ." Section 3-302(a)(2)(vi). A controllable electronic record is information; there are no parties to a controllable electronic record. (There are parties to a controllable account or controllable payment intangible. Sections 9-404 and 9-403 would determine whether a purchaser of the controllable account or controllable payment intangible takes free of a defense.)

Subsection (e) derives from Section 3-306, under which a holder in due course takes a negotiable instrument free of a claim of a property right in the instrument. A qualifying purchaser of a controllable electronic record takes free of all claims of a property right in the controllable electronic record and any related controllable account or controllable payment intangible.

5. *The take-free rule.* Subsection (e) makes controllable electronic records highly negotiable. It protects a qualified purchaser of a controllable electronic record against claims of a property interest in the controllable electronic record as well as in any related controllable account or controllable payment intangible.

As a general matter, law other than Article 12 would determine whether any particular transaction creates a property interest in a controllable electronic record. See subsection (b). The applicable law may provide that a hacker, who is essentially a thief, acquires no rights in a

"stolen" controllable electronic record. Even if this is the case, subsections (c) and (e) would enable a purchaser that obtains control from a hacker and that otherwise meets the definition of "qualified purchaser" (for value, in good faith, and without notice of property claims) to take the controllable electronic record and any related controllable account or controllable payment intangible free of property claims.

6. *The no-action rule.* The take-free rule in subsection (e) applies when both the person having control and another person each claim a property interest in the same controllable electronic record. The no-action rule in subsection (g) is meant to provide analogous protection when a purchaser obtains control of a controllable electronic record that is not the same controllable electronic record in which a third person claims a property interest but is traceable to that controllable electronic record. To qualify for protection under subsection (g), a purchaser must acquire its interest in, and obtain control of, the traceable controllable electronic record for value, in good faith, and without notice of a claim of a property interest in the traceable controllable electronic record or any related controllable account or controllable payment intangible.

> **Example:** Secured Party holds a perfected security interest in Debtor's Bitcoin unspent transaction output. Debtor contracts to sell Bitcoin to Buyer. To fulfill its obligation under the contract of sale, Debtor uses the transaction output as a transaction input to transfer Bitcoin to Buyer. Subsection (e) would protect Buyer from Secured Party's claim that the Bitcoin recorded in the transaction input are the same as the Bitcoin recorded in the transaction output. Subsection (g) would protect Buyer if the Bitcoin were recorded in a transaction output that is not the same as the claimed transaction input.

7. "*Tethered" assets.* Certain controllable electronic records may carry with them rights to other assets, *e.g.*, goods or rights to payment. By its terms, the take-free rule in subsection (e) applies to controllable electronic records, controllable accounts, and controllable payment intangibles. One might argue that the reference to controllable accounts and controllable payment intangibles is unnecessary. By taking a controllable electronic record free of property claims, wouldn't a person take not only the controllable electronic record itself but also all rights that are "carried" in the controllable electronic record free and clear?

Subsection (f) defeats that argument and limits the application of the take-free rule in subsection (e) to controllable electronic records, controllable accounts, and controllable payment intangibles. Under subsection (f), a qualifying purchaser of a controllable electronic record takes other rights to payment, rights to performance, and interests in property that are evidenced by a controllable electronic record subject to third-party property claims, unless law other than the UCC provides to the contrary.

> **Example:** *O* is the owner of a controllable electronic record. The controllable electronic record is a nonfungible token (NFT) that provides access to an electronic image file depicting LeBron James. The image file is not a controllable electronic record, and *O* does not own the copyright in the image of LeBron James. *O* granted to *SP* a security interest in all of *O*'s existing and after-acquired

property. *SP* perfected the security interest. Thereafter, *O* sold the NFT to Buyer.

Because the NFT is a controllable electronic record, a purchaser (*P*) of the NFT (here, Buyer) ordinarily would acquire only those rights that the seller had or had power to convey. Thus, Buyer would acquire its interest subject to *SP*'s perfected security interest. *See* draft § 12-104(c); UCC § 9-315(a)(1).

However, if Buyer is a qualifying purchaser, Buyer would acquire its interest in the NFT free of any claim of a property right in the NFT, including *SP*'s security interest. *See* draft § 12-104(e); UCC § 9-331. Article 9 would determine whether *SP*'s security interest attached to the image file depicting LeBron James. If it did attach, law other than Article 12 would determine whether Buyer would acquire the image file free and clear of *SP*'s security interest.

8. *Creating the functional equivalent of a negotiable instrument.* Two defining characteristics of an Article 3 negotiable instrument are that a holder in due course (1) takes free of claims of a property or possessory right to the instrument (Section 3-306) and (2) takes free of most defenses and claims in recoupment (Section 3-305). Article 3 applies only to written instruments. This draft provides a method for reaching a similar result with respect to controllable accounts and controllable payment intangibles. As regards the first characteristic, a qualified purchaser of the controllable electronic record would acquire the controllable account or controllable payment intangible free of any claim of a property interest. As regards the second, Section 9-403 ordinarily would give effect to the account debtor's agreement not to assert claims or defenses.

Section 9-403 adopts the meaning of value in Section 3-303, as does Article 12. The concept of value in Section 3-303 is narrower than the concept in Section 1-204, which applies generally to UCC transactions. Under Section 1-204, a person gives value for rights if the person acquires them in return for a promise. However, under Section 3-303, if a negotiable instrument is issued or transferred for a promise of performance, the instrument is transferred for value only to the extent that the promise has been performed.

Section 12-105. Control of Controllable Electronic Record.

(a) A person has control of a controllable electronic record if:

(1) the controllable electronic record, a record attached to or logically associated with the controllable electronic record, or the system in which the controllable electronic record is recorded, if any, gives the person:

(A) the power to avail itself of substantially all the benefit from the controllable electronic record;

(B) subject to subsection (b), the exclusive power to:

(i) prevent others from availing themselves of substantially all the benefit from the controllable electronic record; and

(ii) transfer control of the controllable electronic record to another person or cause another person to obtain control of a controllable electronic record that is traceable to the controllable electronic record; and

(2) the controllable electronic record, a record attached to or logically associated with the controllable electronic record, or the system in which the controllable electronic record is recorded, if any, enables the person to readily identify itself as having the powers specified in paragraph (1). The person may be identified in any way, including by name, identifying number, cryptographic key, office, or account number.

(b) A power specified in subsection (a)(1) is exclusive, even if:

(1) the controllable electronic record or the system in which the controllable electronic record is recorded, if any, limits the use to which the controllable electronic record may be put or has a protocol that is programmed to result in a transfer of control; or

(2) the person has agreed to share the power with another person.

Reporter's Note

1. *Why "control" matters.* Control serves two major functions Article 12. An electronic record is a "controllable electronic record" and is subject to the provisions of this article only if it can be subjected to control under this section. *See* draft §§ 12-102; 12-103. And a person having control of a controllable electronic record is eligible to become a qualified purchaser and so take free of claims of a property interest in the controllable electronic record. *See* draft § 12-104.

In addition, draft amendments to Article 9 provide that obtaining control of a controllable electronic record is one method by which a security interest in the controllable electronic record can be perfected. Under these amendments, perfection of a security interest in controllable accounts and controllable payment intangibles can be achieved by obtaining control of the related controllable electronic record.

2. *Powers; inability to exercise a power*. This section conditions control on a person's having the three powers specified in paragraph (a)(1). A person would have a power described in this paragraph if the controllable electronic record or any system in which it is recorded gives the purchaser that power, even if the characteristics of the particular purchaser disable the person from exercising the power. This would be the case, for example, when the purchaser holds the private key required to access the benefit of the controllable electronic record but lacks the hardware required to use it.

3. "*Benefit."* Subparagraphs (a)(1)(A) and (a)(1)(B)(i) condition control of a controllable electronic record on a person's relationship to the benefit of the controllable electronic record.

As used in the section, the "benefit" of a controllable electronic record refers to the rights that are afforded by the controllable electronic record and the uses to which the controllable electronic record can be put. These, in turn, depend on the characteristics of the controllable electronic record in question. For example, Bitcoin can be held or disposed of (sold). A controllable electronic record evidencing a controllable account or controllable payment intangible affords the right to collect from the account debtor (obligor).

The system in which a controllable electronic record is recorded may limit the benefit from the controllable electronic record that is available to those who interact with the system. In determining whether a person has the power to avail itself of substantially all the benefit from a controllable electronic record under subparagraph (a)(1)(A), or to prevent others from availing themselves of substantially all the benefit from a controllable electronic record under subparagraph (a)(1)(B)(i), only the benefit that the system makes available should be considered.

4. *Power to retrieve information*. By definition, the information constituting an electronic record must be "retrievable in perceivable form." UCC § 1-201. The power to retrieve the record in perceivable form is included in the benefit of a controllable electronic record. "Perceivable form" means that the contents of the record are intelligible; the ability to perceive the indecipherable jumble of an encrypted record does not give a person the power to retrieve the record in perceivable form.

To have control of a controllable electronic record under subparagraph (a)(1)(A), a person must have at least the nonexclusive power to avail itself of this benefit. If a person also has the exclusive power to decrypt the encrypted record, the person would have the exclusive power to prevent others from availing themselves of substantially all the benefit from the controllable electronic record and thereby satisfy the condition in subparagraph (a)(1)(B)(i).

5. *Exclusive powers*. Unlike the power in subparagraph (a)(1)(A), the powers in subparagraphs (a)(1)(B)(i) and (a)(1)(B)(ii) must be held exclusively by the person claiming control in order to establish control.

Subsection (b) contains two limitations on the term "exclusive" as used in subsection (a). Under subsection (b), a power can be "exclusive" if one or both of these limitations apply.

Paragraph (b)(1) takes account of the fact that the powers of a purchaser of a controllable electronic record necessarily are subject to the attributes of the controllable electronic record and the protocols of any system in which the controllable electronic record is recorded.

One effect of paragraph (b)(2) is that, under a multi-signature (multi-sig) agreement, any person that is readily identifiable under paragraph (a)(2) and shares the relevant power would be eligible to have control, even if the action of another person is a condition for the exercise of the power.

6. *Readily identify*. Paragraph (a)(2) provides that a person does not have control of a controllable electronic record unless the controllable electronic record, a record attached to or logically associated with the controllable electronic record, or any system in which the controllable electronic record is recorded enables the person to readily identify itself as the person having the requisite powers. This paragraph does not obligate a person to identify itself as having control. However, to prove that it has control, a person would need to prove that the relevant records or any system in which the controllable electronic record is recorded readily identifies the person as such. The last sentence of paragraph (a)(2) derives from Section 3-110(c). It adds "cryptographic key" as an example of a way in which a person may be identified.

Section 12-106. Discharge of Account Debtor on Controllable Account or Controllable Payment Intangible.

(a) Except as provided in this section, an account debtor on a controllable account or controllable payment intangible may discharge its obligation:

(1) by paying the person having control of the controllable electronic record that evidences the controllable account or controllable payment intangible; or

(2) by paying a person that formerly had control of the controllable electronic record.

(b) Subject to subsections (c) and (g), an account debtor may not discharge its obligation by paying a person that formerly had control of the controllable electronic record if the account debtor receives a notification, authenticated by a person that formerly had control or the person to which control was transferred, that reasonably identifies the controllable account or controllable payment intangible, notifies the account debtor that control of the controllable electronic record that evidences the controllable account or controllable payment intangible was

transferred, identifies the transferee, and provides a commercially reasonable method by which the account debtor is to pay the transferee. The transferee may be identified in any way, including by name, identifying number, cryptographic key, office, or account number. After receipt of the notification, the account debtor may discharge its obligation only by paying in accordance with the notification and may not discharge the obligation by paying a person that formerly had control.

(c) Subject to subsection (g), notification is ineffective under subsection (b):

(1) unless, before the notification is sent, the account debtor and the person that at that time had control of the controllable electronic record that evidences the controllable account or controllable payment intangible agree in an authenticated record to a commercially reasonable method by which a person can furnish reasonable proof that control has been transferred;

(2) to the extent that an agreement between the account debtor and the seller of a payment intangible limits the account debtor's duty to pay a person other than the seller and the limitation is effective under law other than this article; or

(3) at the option of the account debtor, if the notification notifies the account debtor to divide a payment and pay portions by more than one method.

(d) Subject to subsection (g), if requested by the account debtor, the person giving the notification shall seasonably furnish reasonable proof, using the agreed method, that control of the controllable electronic record has been transferred. Unless the person complies with the request, the account debtor may discharge its obligation by paying a person that formerly had control, even if the account debtor has received a notification under subsection (b).

(e) A person furnishes reasonable proof that control has been transferred if the person demonstrates, using the agreed method, that the transferee has the power to avail itself of

substantially all the benefit from the controllable electronic record, prevent others from availing themselves of substantially all the benefit from the controllable electronic record, and transfer these powers to another person.

(f) Subject to subsection (g), an account debtor may not waive or vary its option under subsection (c)(3).

(g) This section is subject to law other than this article which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes.

Reporter's Note

1. *Source of these provisions.* These provisions derive from Section 3-602, which governs the discharge of a person obligated on a negotiable instrument, and Section 9-406, which governs the discharge of an account debtor (obligor), including a person obligated on an account or payment intangible.

2. *The basic rules.* This section applies only to an account debtor that has undertaken to pay the person that has control of the controllable electronic record that evidences the obligation to pay. *See* draft § 9-102 (defining "controllable account" and "controllable payment intangible"). Section 9-406 would continue to apply to all other account debtors.

Under subsection (a)(1), an account debtor may discharge its obligation on the controllable account or controllable payment intangible by paying the person that has control of the related controllable electronic record at the time of payment. Subsections (a)(2) and (b) would remove from an account debtor the burden of determining who has control of the related controllable electronic record at any given time—a burden that, with respect to some controllable electronic records, an account debtor may be unable to satisfy. Under paragraph (a)(2), an account debtor may discharge its obligation by paying a person that formerly had control of the related controllable electronic record, which presumably would include the initial obligee.

Subsection (b) reflects the fact that a person to which control has been transferred may not wish to take the risk that the account debtor will discharge its obligation by paying the transferor. Subsection (b) would protect the transferee by providing that if the account debtor receives a notification that control has been transferred, the account debtor may discharge its obligation by paying in accordance with the notification and may not discharge its obligation by paying a person that formerly had control. The notification must be authenticated by a person formerly having control or by the transferee.

To be effective under subsection (b), a notification must reasonably identify the controllable account or controllable payment intangible, notify the account debtor that control of the controllable electronic record that evidences the controllable account or controllable payment intangible was transferred, identify the transferee in any way, and provide a commercially reasonable method by which the account debtor is to make payments to the transferee. A change in the identity of the person to which the account debtor must make payment should not, and typically will not, impose a significant burden on the account debtor. However, one can imagine a method of making payment that would be burdensome, *e.g.*, making a payment through a trading platform or payment service with which the account debtor does not have an account. For this reason, the designated method of making payment must be "commercially reasonable."

3. "*Reasonable proof."* As noted above, this section derives in large part from Section 9-406, which provides for notification that an account or payment intangible has been assigned. Account debtors that have received notification of an assignment under Section 9-406 almost always make payments in accordance with the notice. Recognizing that an account debtor may be uncertain whether a notification is legitimate, Section 9-406 affords to an account debtor the right to request proof that the account or payment intangible was assigned.

Subsection (d) contains a similar provision. Upon the account debtor's request, the person giving the notification must seasonably furnish reasonable proof that control of the controllable electronic record has been transferred. If the person does not comply with the request, the account debtor may ignore the notification and discharge its obligation by a paying a person formerly in control.

"Reasonable proof" requires evidence that would be understood by a typical account debtor to whom it is proffered as demonstrating to a reasonably high probability that control of the controllable electronic record has been transferred to the transferee. Subsection (e) provides a safe harbor for providing reasonable proof. It enables a person to satisfy the account debtor's request by demonstrating that the transferee has the power to avail itself of substantially all the benefit from the controllable electronic record, to prevent others from availing themselves of substantially all the benefit from the controllable electronic record, and to transfer these powers to another person. This demonstration would not necessarily prove that a person actually has control of a controllable electronic record because it need not show that the transferee held the last two powers exclusively. Nevertheless, such a demonstration would constitute "reasonable proof" under subsection (e). A person that has control should have little difficulty providing this proof, as a person cannot have control unless it can readily identify itself as having the requisite powers. *See* draft § 12-105(a)(2).

Reasonable proof that is seasonably furnished by a person other than the person that gave the notification would constitute compliance with the account debtor's request.

Subsection (d) requires that reasonable proof be provided "using the agreed method."

Subsection (e) requires that a person use "the agreed method" to demonstrate that the transferee has the specified powers. "Agreed method" refers to the commercially reasonable method to which the parties agreed, in an authenticated record, before the notification was sent. If parties did not so agree, the notification is ineffective under subsection (c)(1).

4. *Relationship to Section 9-406.* Section 9-406 governs the discharge of the obligation of an account debtor. It will be amended to carve out transactions covered by this section. *See* draft § 9-406.

Section 12-107. Governing Law.

[The Drafting Committee will not consider this section until after the Annual Meeting]

ARTICLE 9

SECURED TRANSACTIONS

Section 9-102. Definitions and Index of Definitions.

(a) **[Article 9 definitions.]** In this article:

* * *

(2) "Account", except as used in "account for", means a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) for services rendered or to be rendered, (iii) for a policy of insurance issued or to be issued, (iv) for a secondary obligation incurred or to be incurred, (v) for energy provided or to be provided, (vi) for the use or hire of a vessel under a charter or other contract, (vii) arising out of the use of a credit or charge card or information contained on or for use with the card, or (viii) as winnings in a lottery or other game of chance operated or sponsored by a State, governmental unit of a State, or person licensed or authorized to operate the game by a State or governmental unit of a State. The term includes <u>controllable accounts and</u> health-care-insurance receivables. * * *

* * *

<u>(27A) "Controllable account" means an account evidenced by a controllable</u>

electronic record that provides that the account debtor undertakes to pay the person that has control of the controllable electronic record under Section 12-105.

(27B) "Controllable payment intangible" means a payment intangible evidenced by a controllable electronic record that provides that the account debtor undertakes to pay the person that has control of the controllable electronic record under Section 12-105.

* * *

(61) "Payment intangible" means a general intangible under which the account debtor's principal obligation is a monetary obligation. The term includes controllable payment intangibles.

* * *

(b) **[Definitions in other articles.]** The following definitions in other articles apply to this article:

* * *

"Controllable electronic record" Section 12-102.

* * *

Reporter's Note

1. *"Controllable account"; "controllable payment intangible."* The draft affords special treatment to security interests in controllable accounts and controllable payment intangibles, *i.e.*, those accounts and payment intangibles that are evidenced by a controllable electronic record that provides that the account debtor (obligor) undertakes to pay the person having control of the controllable electronic record. This special treatment includes the following:

- Attachment of a security interest in a controllable electronic record is attachment of a security interest in a related controllable account and controllable payment intangible. Draft § 9-203(j).

- Perfection of a security interest in a controllable electronic record is perfection of a security interest in a related controllable account and controllable payment intangible. Draft § 9-308(h).

- Perfection of a security interest in a controllable account or controllable payment intangible can be achieved by filing a financing statement or obtaining control of the controllable electronic record that evidences the controllable account or controllable payment intangible. Draft §§ 9-314(a); 9-107A(b).

- A security interest in a controllable electronic record, controllable account, or controllable payment intangible that is perfected by control has priority over a conflicting security interest that is perfected by another method. Draft § 9-326A.

- A person that enjoys the benefit of the take-free and no-action rules with respect to a controllable electronic record would also enjoy those benefits with respect to a controllable account or controllable payment intangible that is evidenced by the controllable electronic record. Draft § 12-104(e), (g).

2. *"Person that has control."* An undertaking to pay the "person that has control" means an undertaking to pay the person that has control at the time payment is made. An undertaking to pay Smith, who has control of the relevant controllable electronic record at the time the undertaking was made, is not an undertaking to pay the person that has control.

Section 9-107A. Control of Controllable Electronic Record, Controllable Account, or Controllable Payment Intangible.

(a) A secured party has control of a controllable electronic record as provided in Section 12-105.

(b) A secured party has control of a controllable account or controllable payment intangible if the secured party has control of the controllable electronic record that evidences the controllable account or controllable payment intangible.

Reporter's Note

1. *Control of controllable electronic records.* This draft provides for perfection by filing and perfection by control as alternative methods of perfection with respect to a controllable electronic record. See draft §§ 9-313; 9-314. Under draft § 9-107A(a), a secured party has control of a controllable electronic record as provided in draft § 12-105. Under draft § 9-326A, a security interest in a controllable electronic record that is perfected by control has priority over a security interest perfected by another method.

2. *Consequences of control of controllable account or controllable payment intangible.* This draft provides for perfection by filing and perfection by control as alternative methods of perfection with respect to a controllable account or controllable payment intangible. See draft §§ 9-313, 9-314. Under draft § 9-107A(a), a secured party would obtain control of a controllable

account or controllable payment intangible by obtaining control of the related controllable electronic record. Under draft § 9-326A, a security interest in a controllable account or controllable payment intangible that is perfected by control would have priority over a security interest perfected by another method.

By definition, a controllable account would be an Article 9 "account," and a controllable payment intangible would be an Article 9 "payment intangible." Draft § 9-102. The fact that an account or payment intangible is a controllable account or controllable payment intangible would afford to the secured party an alternative method of perfection, *i.e.*, filing. However, that fact would not affect the applicability of other provisions of Article 9, including the provisions governing an account debtor's agreement not to assert defenses (Section 9-403) and the statutory overrides of legal and contractual restrictions on the assignability of accounts and payment intangibles (Sections 9-406 and 9-408).

Section 9-203. Attachment and Enforceability of Security Interest; Proceeds; Supporting Obligations; Formal Requisites.

* * *

(b) **[Enforceability.]** Except as otherwise provided in subsections (c) through ~~(i)~~ (j), a security interest is enforceable against the debtor and third parties with respect to the collateral only if:

(1) value has been given;

(2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and

(3) one of the following conditions is met:

* * *

(D) the collateral is controllable electronic records, controllable accounts, controllable payment intangibles, deposit accounts, electronic chattel paper, investment property, or letter-of-credit rights, or electronic documents, and the secured party has control under Section 7-106, 9-104, 9-105, 9-106, ~~or 9-107~~ 9-107, or 9-107A pursuant to the debtor's security agreement.

* * *

(j) [Controllable account or payment intangible.] The attachment of a security interest in a controllable electronic record that evidences a controllable account or controllable payment intangible is also attachment of a security interest in the controllable account or controllable payment intangible.

Section 9-207. Rights and Duties of Secured Party Having Possession or Control of Collateral.

* * *

(c) **[Duties and rights when secured party in possession or control.]** Except as otherwise provided in subsection (d), a secured party having possession of collateral or control of collateral under Section 7-106, 9-104, 9-105, 9-106, ~~or 9-107.~~ 9-107, or 9-107A:

(1) may hold as additional security any proceeds, except money or funds, received from the collateral;

(2) shall apply money or funds received from the collateral to reduce the secured obligation, unless remitted to the debtor; and

(3) may create a security interest in the collateral.

* * *

Section 9-208. Additional Duties of Secured Party Having Control of Collateral.

[The Drafting Committee will not consider this section until after the Annual Meeting]

Section 9-308. When Security Interest or Agricultural Lien Is Perfected; Continuity of Perfection.

* * *

(h) **[Controllable account or payment intangible.]** Perfection of a security interest in a

controllable electronic record that evidences a controllable account or controllable payment intangible also perfects a security interest in the controllable account or controllable payment intangible.

* * *

Section 9-312. Perfection of Security Interests in Controllable Electronic Records, Controllable Accounts, Controllable Payment Intangibles, Chattel Paper, Deposit Accounts, Documents, Goods Covered by Documents, Instruments, Investment Property, Letter-of-Credit Rights, and Money; Perfection by Permissive Filing; Temporary Perfection Without Filing or Transfer of Possession.

(a) **[Perfection by filing permitted.]** A security interest in controllable electronic records, controllable accounts, controllable payment intangibles, chattel paper, negotiable documents, instruments, or investment property may be perfected by filing.

* * *

Section 9-314. Perfection by Control.

(a) **[Perfection by control.]** A security interest in investment property, deposit accounts, letter-of-credit rights, controllable electronic records, controllable accounts, controllable payment intangibles, electronic chattel paper, or electronic documents may be perfected by control of the collateral under Section 7-106, 9-104, 9-105, 9-106, ~~or 9-107.~~ 9-107, or 9-107A.

(b) **[Specified collateral: time of perfection by control; continuation of perfection.]** A security interest in controllable electronic records, controllable accounts, controllable payment intangibles, deposit accounts, electronic chattel paper, letter-of-credit rights, or electronic documents is perfected by control under Section 7-106, 9-104, 9-105, ~~or 9-107~~ 9-107, or 9-107A when the secured party obtains control and remains perfected by control only while the secured

party retains control.

* * *

Section 9-326A. Priority of Security Interests in Controllable Electronic Record, Controllable Account, and Controllable Payment Intangible.

A security interest in a controllable electronic record, controllable account, or controllable payment intangible held by a secured party having control of the controllable electronic record, controllable account, or controllable payment intangible has priority over a conflicting security interest held by a secured party that does not have control.

Reporter's Note

1. *Priority.* This section adopts an approach to priority in controllable electronic records, controllable accounts, and controllable payment intangibles that is similar to the approach of Sections 9-327 and 9-328: A security interest perfected by control has priority over conflicting security interests that are not perfected by control. The approach taken in Section 9-330, which applies to chattel paper and instruments, would be likely to yield the same outcomes that would obtain under the provisions applicable to qualifying purchasers (draft §§ 12-104(e) and (g) and 9-331) in the vast majority of cases.

Section 9-331. Priority of Rights of Purchasers of Instruments, Documents, ~~and Securities~~ Securities, Controllable Electronic Records, Controllable Accounts, and Controllable Payment Intangibles Under Other Articles; Priority of Interests in Financial Assets and Security Entitlements Under Article 8 and Controllable Electronic Records Under Article 12.

(a) **[Rights under Articles 3, 7, ~~and 8~~ 8, and 12 not limited.]** This article does not limit the rights of a holder in due course of a negotiable instrument, a holder to which a negotiable document of title has been duly negotiated, ~~or~~ a protected purchaser of a security, or a qualifying purchaser of a controllable electronic record. These holders or purchasers take priority over an earlier security interest, even if perfected, to the extent provided in Articles 3, 7, ~~and~~ 8, and 12.

(b) **[Protection under ~~Article 8~~ Articles 8 and 12.]** This article does not limit the rights of or impose liability on a person to the extent that the person is protected against the assertion of a claim under Article 8 or 12.

(c) **[Filing not notice.]** Filing under this article does not constitute notice of a claim or defense to the holders, or purchasers, or persons described in subsections (a) and (b).

Reporter's Note

1. *Purpose of this section.* This section insures that Article 9 does not interfere with the protections that Article 12 affords to a good faith purchaser for value under the take-free and no-action rules in draft § 12-105(e) and (g).

Section 9-406. Discharge of Account Debtor; Notification of Assignment; Identification and Proof of Assignment; Restrictions on Assignment of Accounts, Chattel Paper, Payment Intangibles, and Promissory Notes Ineffective.

(a) **[Discharge of account debtor; effect of notification.]** Subject to subsections (b) through (i) and (l), an account debtor on an account, chattel paper, or a payment intangible may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee. After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor.

(b) **[When notification ineffective.]** Subject to ~~subsection~~ subsections (h) and (l), notification is ineffective under subsection (a):

(1) if it does not reasonably identify the rights assigned;

(2) to the extent that an agreement between an account debtor and a seller of a payment intangible limits the account debtor's duty to pay a person other than the seller and the

limitation is effective under law other than this article; or

(3) at the option of an account debtor, if the notification notifies the account debtor to make less than the full amount of any installment or other periodic payment to the assignee, even if:

(A) only a portion of the account, chattel paper, or payment intangible has been assigned to that assignee;

(B) a portion has been assigned to another assignee; or

(C) the account debtor knows that the assignment to that assignee is limited.

(c) **[Proof of assignment.]** Subject to ~~subsection~~ subsections (h) and (l), if requested by the account debtor, an assignee shall seasonably furnish reasonable proof that the assignment has been made. Unless the assignee complies, the account debtor may discharge its obligation by paying the assignor, even if the account debtor has received a notification under subsection (a).

* * *

(l) [Inapplicability of certain subsections.] Subsections (a) through (c) and (g) do not apply to a controllable account or controllable payment intangible.

Reporter's Note

1. *Controllable accounts and controllable payment intangibles.* For controllable accounts and controllable payment intangibles, subsections (a) through (c) and (g) will be replaced by analogous provisions in draft § 12-106.

Section 9-601. Rights After Default; Judicial Enforcement; Consignor or Buyer of Accounts, Chattel Paper, Payment Intangibles, or Promissory Notes.

* * *

(b) **[Rights and duties of secured party in possession or control.]** A secured party in possession of collateral or control of collateral under Section 7-106, 9-104, 9-105, 9-106, ~~or 9-107~~ 9-107, or 9-107A has the rights and duties provided in Section 9-207.

* * *

Section 9-605. Unknown Debtor or Secondary Obligor.

(a) ~~A~~ Subject to subsection (b), a secured party does not owe a duty based on its status as secured party:

(1) to a person that is a debtor or obligor, unless the secured party knows:

(A) that the person is a debtor or obligor;

(B) the identity of the person; and

(C) how to communicate with the person; or

(2) to a secured party or lienholder that has filed a financing statement against a person, unless the secured party knows:

(A) that the person is a debtor; and

(B) the identity of the person.

(b) Subsection (a) does not apply to a secured party that, at the time the secured party's security interest attaches to a controllable electronic record, controllable account, or controllable payment intangible, has notice that the nature of the collateral or the system in which the collateral is recorded, if any, would prevent the secured party from acquiring the knowledge specified in that subsection.

Section 9-628. Nonliability and Limitation on Liability of Secured Party; Liability of Secondary Obligor.

(a) **[Limitation of liability of secured party for noncompliance with article.]** Unless a

secured party knows that a person is a debtor or obligor, knows the identity of the person, and knows how to communicate with the person:

(1) the secured party is not liable to the person, or to a secured party or lienholder that has filed a financing statement against the person, for failure to comply with this article; and

(2) the secured party's failure to comply with this article does not affect the liability of the person for a deficiency.

(b) **[Limitation of liability based on status as secured party.]** ~~A~~ Subject to subsection (c), a secured party is not liable because of its status as secured party:

(1) to a person that is a debtor or obligor, unless the secured party knows:

(A) that the person is a debtor or obligor;

(B) the identity of the person; and

(C) how to communicate with the person; or

(2) to a secured party or lienholder that has filed a financing statement against a person, unless the secured party knows:

(A) that the person is a debtor; and

(B) the identity of the person.

(c) Subsection (b) does not apply to a secured party that, at the time the secured party's security interest attaches to a controllable electronic record, controllable account, or controllable payment intangible, has notice that the nature of the collateral or the system in which the collateral is recorded, if any, would prevent the secured party from acquiring the knowledge specified in that subsection.

Reporter's Note

1. *Liability to unknown persons.* Practices are developing under which lenders extend secured credit without knowing, or having the ability to discover, the identity of their borrowers.

Existing Sections 9-605 and 9-628 would excuse these secured parties from having duties to their debtors, including, *e.g.*, the duty to notify the debtor before disposing of the collateral and the duty to account to the debtor for any surplus arising from a disposition.

Comment 2 to Section 9-628 observes, "Without this group of provisions [in Sections 9-605 and 9-628], a secured party could incur liability to unknown persons and under circumstances that would not allow the secured party to protect itself." The draft amendments to this section reflect the policy that a secured party should not be free to avoid statutory duties or absolve itself from liability by entering into a transaction when the secured party can protect itself, *i.e.*, when the secured party has notice that the nature of the collateral or any system in which the collateral is recorded would prevent the secured party from acquiring the knowledge necessary to fulfill its statutory duties. (A person has notice of a fact if, *inter alia,* from all the facts and circumstances known to the person at the time in question, has reason to know that it exists. Section 1-202(a)(3).)

EFFECTIVE DATE AND TRANSITION PROVISIONS

[The Drafting Committee will not consider these provisions until after the Annual Meeting]

B. Money

Prefatory Note

With one exception, all of these amendments address the use of intangible fiat currency (money) as collateral under UCC Article 9.[1]

We have no way of knowing how intangible money might develop. There are indications that some countries might authorize or adopt intangible tokens as a medium of exchange (the Peoples Bank of China has been developing a digital Yuan), whereas others might authorize or adopt accounts with a central bank.[2]

Section 1-201(b)(24) defines "money" as "a medium of exchange currently authorized or adopted by a domestic or foreign government." For many purposes, there is no need for the UCC to distinguish among types of money. *See, e.g.*, UCC § 3-103(a)(12) ("'Promise' means a written undertaking to pay money . . . .") For Article 9 purposes, however, distinctions must be drawn. Only tangible money is susceptible of perfection by possession. The acts needed for perfection by control with respect to intangible tokens will not work for accounts with a central bank, and vice versa. Thus the draft draws a sharp distinction between money that is an account maintained with a bank, and other intangible money, including token-based money.

[1] The exception is an amendment to UCC § 1-201(b)(24) that would delete from the UCC's generally applicable definition of "money" a unit of account that is established by an intergovernmental organization or by agreement between two or more countries.

[2] These accounts sometimes are referred to as central bank digital currency or CBDC. Regarding El Salvador's adoption of Bitcoin as legal tender, *see supra* note 1.

The existing Article 9 provisions governing "deposit accounts" would remain suitable for accounts with a central bank, even if a government has adopted these accounts as money. The draft makes no changes with respect to Article 9's treatment of these accounts, aside from distinguishing them from other intangible money. The draft draws this distinction by excluding "deposit accounts" from the defined term "intangible money." Under the draft, a security interest in intangible money as original collateral can be perfected only by control. The requirements for obtaining control of intangible money are the same as those for obtaining control of a controllable electronic record under draft Article 12.

ARTICLE 1

GENERAL PROVISIONS

Section 1-201. General Definitions.

* * *

(b) Subject to definitions contained in other articles of the [Uniform Commercial Code] that apply to particular articles or parts thereof:

* * *

(24) "Money" means a medium of exchange currently authorized or adopted by a domestic or foreign government. ~~The term includes a monetary unit of account established by an intergovernmental organization or by agreement between two or more countries.~~

* * *

Reporter's Note

1. *"Money."* The definition of "money" applies to the term as used in the UCC. The definition does not determine whether an asset constitutes "money" for other purposes.

"Money" does not include credits in a deposit account, money market account, securities account, or payment-processor account (*e.g.*, PayPal), inasmuch as those do not constitute a medium of exchange that is authorized or adopted by a government. However, future governmental action could bring one or more of these accounts within the definition. Likewise, virtual currency that is not "money" today may become so in the future.

2. "*Monetary unit of account.*" The draft deletes the second sentence of the existing definition, which covers, *e.g.*, special drawing rights (SDRs) created by the International Monetary Fund. Despite the deletion, a monetary unit of account would be "money" if it also a medium of exchange that falls within the remaining sentence. (SDRs are not a medium of

exchange.)

ARTICLE 9

SECURED TRANSACTIONS

* * *

(29) "Deposit account" means a demand, time, savings, passbook, or similar account maintained with a bank. The term includes an account that is money under Section 1-201. The term does not include investment property or accounts evidenced by an instrument.

* * *

(47A) "Intangible money" does not include money that is a deposit account.

* * *

Reporter's Note

1. *"Deposit account."* The new sentence clarifies that an account that otherwise would fall within the definition of "deposit account" would not be excluded from the definition if the account is "money," *i.e.*, if a government adopts or authorizes such an account as a medium of exchange. The new sentence does *not* provide that all deposit accounts are "money."

2. *"Intangible money."* By excluding deposit accounts from the definition of "intangible money," the draft leaves within that category intangible token-money and other non-deposit-account intangible money that may be created in the future.

Section 9-105A. Control of Intangible Money.

(a) A person has control of intangible money if the following conditions are met:

(1) the intangible money or the system in which the intangible money is recorded, if any, gives the person:

(A) the power to avail itself of substantially all the benefit from the intangible money;

(B) subject to subsection (b), the exclusive power to:

(i) prevent others from availing themselves of substantially all the

benefit from the intangible money; and

(ii) transfer control of the intangible money to another person or cause another person to obtain control of intangible money that is traceable to the intangible money; and

(2) the intangible money, a record attached to or logically associated with the intangible money, or the system in which the intangible money is recorded, if any, enables the person to readily identify itself as having the powers under subsection (a)(1). The person may be identified in any way, including by name, identifying number, cryptographic key, office, or account number.

(b) A power specified in subsection (a) is exclusive, even if:

(1) the intangible money or the system in which the intangible money is recorded, if any, limits the use to which the intangible may be put or has protocols that are programmed to result in a transfer of control; or

(2) the person has agreed to share the power with another person.

Reporter's Note

1. "*Control.*" A security interest in intangible money as original collateral may be perfected only by control under this section. See draft § 9-312(b)(4). The requirements for obtaining control track those in draft § 12-105.

Section 9-203. Attachment and Enforceability of Security Interest; Proceeds; Supporting Obligations; Formal Requisites.

* * *

(b) **[Enforceability.]** Except as otherwise provided in subsections (c) through (i), a security interest is enforceable against the debtor and third parties with respect to the collateral only if:

(1) value has been given;

(2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and

(3) one of the following conditions is met:

(A) the debtor has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned;

(B) the collateral is not a certificated security and is in the possession of the secured party under Section 9-313 pursuant to the debtor's security agreement;

(C) the collateral is a certificated security in registered form and the security certificate has been delivered to the secured party under Section 8-301 pursuant to the debtor's security agreement; or

(D) the collateral is deposit accounts, electronic chattel paper, intangible money, investment property, letter-of-credit rights, or electronic documents and the secured party has control under Section 7-106, 9-104, 9-105, 9-105A, 9-106, or 9-107 pursuant to the debtor's security agreement.

* * *

Section 9-301. Law Governing Perfection and Priority of Security Interests. Except as otherwise provided in Sections 9-303 through 9-306, the following rules determine the law governing perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral:

(1) Except as otherwise provided in this section, while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or

nonperfection, and the priority of a security interest in collateral.

(2) While collateral is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a possessory security interest in that collateral.

(3) Except as otherwise provided in paragraph (4), while tangible negotiable documents, goods, instruments, tangible money, or tangible chattel paper is located in a jurisdiction, the local law of that jurisdiction governs:

(A) perfection of a security interest in the goods by filing a fixture filing;

(B) perfection of a security interest in timber to be cut; and

(C) the effect of perfection or nonperfection and the priority of a nonpossessory security interest in the collateral.

* * *

Section 9-310. When Filing Required to Perfect Security Interest or Agricultural Lien; Security Interests and Agricultural Liens to Which Filing Provisions Do Not Apply.

* * *

(b) **[Exceptions: filing not necessary.]** The filing of a financing statement is not necessary to perfect a security interest:

* * *

(8) in deposit accounts, electronic chattel paper, electronic documents, intangible money, investment property, or letter-of-credit rights which is perfected by control under Section 9-314;

* * *

* * *

Section 9-312. Perfection of Security Interests in Chattel Paper, Deposit Accounts, Documents, Goods Covered by Documents, Instruments, Investment Property, Letter-of-Credit Rights, and Money; Perfection by Permissive Filing; Temporary Perfection Without Filing or Transfer of Possession.

(a) **[Perfection by filing permitted.]** A security interest in chattel paper, negotiable documents, instruments, or investment property may be perfected by filing.

(b) **[Control or possession of certain collateral.]** Except as otherwise provided in Section 9-315(c) and (d) for proceeds:

(1) a security interest in a deposit account may be perfected only by control under Section 9-314;

(2) except as otherwise provided in Section 9-308(d), a security interest in a letter-of-credit right may be perfected only by control under Section 9-314; ~~and~~

(3) a security interest in tangible money may be perfected only by the secured party's taking possession under Section ~~9-313;~~ 9-313; and

(4) a security interest in intangible money may be perfected only by control under section 9-105A.

Section 9-313. When Possession by or Delivery to Secured Party Perfects Security Interest Without Filing.

(a) **[Perfection by possession or delivery.]** Except as otherwise provided in subsection (b), a secured party may perfect a security interest in tangible negotiable documents, goods, instruments, tangible money, or tangible chattel paper by taking possession of the collateral. A secured party may perfect a security interest in certificated securities by taking delivery of the certificated securities under Section 8-301.

* * *

Section 9-314. Perfection by Control.

(a) **[Perfection by control.]** A security interest in investment property, deposit accounts, intangible money, letter-of-credit rights, electronic chattel paper, or electronic documents may be perfected by control of the collateral under Section 7-106, 9-104, 9-105, 9-105A, 9-106, or 9-107.

(b) **[Specified collateral: time of perfection by control; continuation of perfection.]** A security interest in deposit accounts, electronic chattel paper, intangible money, letter-of-credit rights, or electronic documents is perfected by control under Section 7-106, 9-104, 9-105, 9-105A, or 9-107 when the secured party obtains control and remains perfected by control only while the secured party retains control.

* * *

Section 9-332. Transfer of Money; Transfer of Funds from Deposit Account.

(a) **[Transferee of money.]** A transferee of money takes the money free of a security interest unless the transferee acts in collusion with the debtor in violating the rights of the secured party.

(b) **[Transferee of funds from deposit account.]** A transferee of funds from a deposit account 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.

Reporter's Note

1. "*Transferee.*" The undefined term "transferee" has given rise to a fair number of reported cases under Section 9-332(b). The analysis and results of the cases vary considerably. The Drafting Committee plans to consider resolving the uncertainty by amending the text of, or comments to, this section.

C. Chattel Paper

Prefatory Note

These amendments to Uniform Commercial Code Article 9 address issues that have arisen with respect to transactions in chattel paper. Stripped to its essentials, chattel paper is a monetary obligation that is secured by a security interest in specific goods or that arises under a lease of specific goods. Article 9 treats chattel paper differently from accounts and other rights to payment. In particular, it provides for perfection of a security interest in chattel paper by taking possession of tangible chattel paper or control of electronic chattel paper and affords a "superpriority" to financiers that perfect in this manner.

The issues that the draft amendments address arise from the fact that:

- The definition of "chattel paper" creates uncertainty over the circumstances in which a transaction that gives rise to monetary obligations not only under a lease of goods but also with respect to software and services relating to the leased goods gives rise to chattel paper.

- The statutory distinction between "tangible chattel paper" and "electronic chattel paper" causes practical problems.

Concern #1: The definition of "chattel paper" creates uncertainty over the circumstances in which a transaction that gives rise to monetary obligations not only under a lease of goods but also with respect to software and services relating to the leased goods gives rise to chattel paper.

Section 9-102 defines "chattel paper" to include a record that evidences a monetary obligation that is owed under a lease of goods and a monetary obligation with respect to software used in the goods. Lease transactions have increasingly given rise not only to obligations for goods and related software but also for services (*e.g.*, cloud services) relating to the goods. Not infrequently, the value of the non-goods aspect of the transaction is substantially greater than the value of the lessee's rights under the lease. Those who finance chattel paper and other rights to payment have become uncertain as to whether these transactions give rise to chattel paper.

The draft resolves this issue by treating only those transactions whose predominant purpose was to give the obligor (lessee) the right to possession and use of the goods as giving rise to "chattel paper."

Consider this example: Customer agrees to pay Cable Company for 12 months of television programming and for 12 months' use of a cable box needed to access the programming. Customer agrees to pay $150 a month for the programming and the use of the cable box. The predominant purpose of this transaction is to provide television programming to Customer, not to enable Customer to use the cable box. Under the draft, this transaction does not give rise to chattel paper.

Issue #2: The statutory distinction between "tangible chattel paper" and "electronic chattel

paper" causes practical problems.

Background.

"Chattel paper" is one of several types of collateral that relate to rights to payment (receivables). Others include "accounts," "instruments," and "payment intangibles."

Until Article 9 was revised in the 1990s, chattel paper was deserving of its name. It was a writing (*paper*), that was connected with a security interest in or lease of specific goods (*chattels*). A common example is an installment sale contract, under which a buyer of goods on credit promises to pay the sale price and secures that promise with a security interest in the goods. Another common example is an equipment lease, where the lessee promises to pay rent and the lessor retains a leasehold interest in the leased goods.

The 1999 official text expanded the definition of chattel paper to allow for an electronic record instead of a writing. Traditional, written chattel paper was denominated "tangible chattel paper," whereas intangible chattel paper was denominated (despite the oxymoron) "electronic chattel paper." The principal difference between tangible chattel paper and electronic chattel paper is that a security interest in the former can be perfected by taking possession (which, of course, is impossible to do with respect to an electronic record), whereas a security interest in the latter can be perfected by having control, a concept that subsequently appeared in UETA and E-SIGN.

Shortcomings in the current Article 9 provisions.

Tangible chattel paper. Even before the 1999 revision of Article 9, "everyone" understood that the copy of the lease that constituted *the* chattel paper, *i.e.* the writing with respect to which possession was necessary and sufficient for perfection of a security interest, was the signed original. In a typical lease transaction for which the lessor receives financing, however, the lessor, the lessee, and the financier each would receive a signed copy of the lease.

When there was more than one original, litigation required judges to determine whether possession of all signed originals was necessary to perfect by taking possession of the chattel paper or whether possession of one of several originals would suffice. The comments to the 1999 revision addressed this issue.

In addition, different aspects of a single transaction may be evidenced by separate writings. For example, a transaction in which several items of equipment are leased often includes a master lease, which includes the terms applicable to all the goods, and specific schedules, which apply to specific leased goods. This issue, too, arose in litigation before the 1999 revision was promulgated and was addressed in the official comments.

Electronic chattel paper. As for electronic chattel paper, *control* was designed to function to the extent possible like *possession*. Just as Article 9 contemplated that only one person at a time can have possession of tangible chattel paper, so Article 9 defined control of electronic chattel paper by reference to a "single authoritative copy."

As secured parties tried to take advantage of the electronic-chattel-paper provisions, they confronted some difficulties.

- *First*, the rule that a secured party cannot obtain control of electronic chattel paper unless there is a "single authoritative copy" impeded system design.

- *Second*, in some cases it has proven to be commercially desirable to "convert" tangible chattel paper into electronic chattel paper or to "paper out" electronic chattel paper into tangible chattel paper. The legal consequences of doing so are thought to be uncertain.

- *Third*, existing law does not deal satisfactorily with the situation where the records referred to in the current definition comprise one or more tangible authoritative copies of the records that evidence the right to payment and rights in related property and one or more electronic authoritative copies of those records.[3] This situation might arise when, *e.g.*, electronic chattel paper is subsequently amended by a writing, such that some material terms of the chattel paper are contained in a tangible authoritative copy and some are contained in an electronic authoritative copy.

The 2010 amendments to Article 9 addressed the first issue by adding a general standard for control (borrowed from UETA and E-SIGN) and turning the 1999 conditions for control into a safe harbor. Under the general standard, a person would have control if "a system employed for evidencing the transfer of interests in the chattel paper reliably establishes the secured party as the person to which the chattel paper was assigned." UCC § 9-105(a). The amendments addressed the second and third issues in official comments.

Lawyers proved uncomfortable issuing a legal opinion to the effect that a particular system satisfied the general standard for control. As a result, their clients had strong incentives to use systems that allow for a "single authoritative copy" rather than, for example, utilizing distributed ledger technology, which always involves multiple authoritative copies. Thus, the technology for maintaining electronic chattel paper remains frozen in time.

Lawyers remain uncertain as to how a court would resolve the second and third issues described above.

Controllable electronic records v. chattel paper.

A fundamental principle underlying draft Article 12, dealing with controllable electronic records, is the distinction between a record that evidences a right (*e.g.*, a right to payment) and the right itself.

The current definitions of "chattel paper," "tangible chattel paper," and "electronic chattel paper" muddle that distinction and so would be in tension with draft Article 12. Article 9 defines "chattel paper" as a "record or records" that evidence a monetary obligation and a security

[3] The only copies that are relevant under the draft are those that are "authoritative." Regarding the meaning of the term, see the Reporter's Notes to draft § 9-314A.

interest in or lease of specific goods. A record of this kind, *e.g.*, the paper on which an installment sale contract or equipment lease is written, typically is of no value, other than as evidence of the right to payment and interest in goods.[4] For the most part, this has not presented a problem, as those who deal with chattel paper understand that even though Article 9 defines "chattel paper" as a record or records, a security interest in chattel paper is in fact a security interest in the right to payment of the monetary obligation and in the interest in related property that are evidenced by the chattel paper.

Approach taken in the draft.

The draft provides a single rule, under which a security interest in chattel paper can be perfected by taking possession of the tangible authoritative copies, if any, and obtaining control of the electronic authoritative copies, if any. This single rule would address cases where some records evidencing chattel paper are electronic and some are tangible or where a record in one medium is replaced by a record in another.

The draft also defines chattel paper more accurately, as the right to payment of a monetary obligation that is secured by a security interest in specific goods or owed under a lease of specific goods, if the right to payment and interest in the goods are evidenced by a record.

ARTICLE 1

GENERAL PROVISIONS

Section 1-201. General Definitions.

* * *

(b) Subject to definitions contained in other articles of the [Uniform Commercial Code] that apply to particular articles or parts thereof:

* * *

(2) "Account", except as used in "account for" and "on account of", means a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) for services rendered or to be rendered, (iii) for a policy of insurance issued or to be issued, (iv) for a

[4] Where a record evidencing the monetary obligation is a negotiable instrument, the paper itself is likely to have considerable value. See the Concluding Note below for a discussion of chattel paper evidenced by a negotiable instrument.

secondary obligation incurred or to be incurred, (v) for energy provided or to be provided, (vi) for the use or hire of a vessel under a charter or other contract, (vii) arising out of the use of a credit or charge card or information contained on or for use with the card, or (viii) as winnings in a lottery or other game of chance operated or sponsored by a State, governmental unit of a State, or person licensed or authorized to operate the game by a State or governmental unit of a State. The term includes health-care-insurance receivables. The term does not include (i) ~~rights to payment evidenced by chattel paper or an instrument,~~ chattel paper, (ii) commercial tort claims, (iii) deposit accounts, (iv) investment property, (v) letter-of-credit rights or letters of credit, ~~or~~ (vi) rights to payment for money or funds advanced or sold, other than rights arising out of the use of a credit or charge card or information contained on or for use with the ~~card.~~ card, or (vii) rights to payment evidenced by an instrument.

* * *

Reporter's Note

1. *"Account."* As the Prefatory Note explains, the draft redefines "chattel paper" to mean a right to payment rather than a record evidencing a right to payment. The amendments to the definition of "account" reflect the redefinition.

ARTICLE 9

SECURED TRANSACTIONS

Section 9-102. Definitions and Index of Definitions.

(a) **[Article 9 definitions.]** In this article:

* * *

~~(11) "Chattel paper" means a record or records that evidence both a monetary obligation and a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest in specific goods and license of software used in~~

~~the goods, a lease of specific goods, or a lease of specific goods and license of software used in the goods. In this paragraph, "monetary obligation" means a monetary obligation secured by the goods or owed under a lease of the goods and includes a monetary obligation with respect to software used in the goods. The term does not include (i) charters or other contracts involving the use or hire of a vessel or (ii) records that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card. If a transaction is evidenced by records that include an instrument or series of instruments, the group of records taken together constitutes chattel paper.~~

(11) "Chattel paper" means:

(A) a right to payment of a monetary obligation secured by specific goods, if the right to payment and security agreement are evidenced by a record; or

(B) a right to payment of a monetary obligation owed by a lessee under a lease agreement with respect to specific goods and a monetary obligation, if any, owed by the lessee in connection with the transaction giving rise to the lease, if:

(i) the right to payment and lease agreement are evidenced by a record; and

(ii) the predominant purpose of the transaction giving rise to the lease was to give the lessee the right to possession and use of the goods.

The term does not include (i) a right to payment arising out of a charter or other contract involving the use or hire of a vessel or (ii) a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card.

* * *

~~(31) "Electronic chattel paper" means chattel paper evidenced by a record or~~

~~records consisting of information stored in an electronic medium.~~

* * *

(47) "Instrument" means a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment. The term does not include (i) investment property, (ii) letters of credit, ~~or~~ (iii) writings that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card, or (iv) writings that evidence chattel paper.

* * *

~~(79) "Tangible chattel paper" means chattel paper evidenced by a record or records consisting of information that is inscribed on a tangible medium.~~

* * *

Legislative Note. *Replicate the formatting of the tabulated material in subsection (a)(11) exactly to ensure that the meaning of the material is preserved.*

Reporter's Note

1. *"Chattel paper."* Under the revised definition, "chattel paper" is a right to payment rather than a record evidencing a right to payment. Records evidencing chattel paper remain relevant to perfection of a security interest in chattel paper. *See* draft § 9-314A.

The right to payment that constitutes "chattel paper" under section (a)(11)(B) may include the right to payment of a variety of monetary obligations owed by a lessee of specific goods. These obligations may include obligations arising in connection with the transaction giving rise to the lease, such as obligations for software or services. However, to constitute "chattel paper," these obligations must include the right to payment of a monetary obligation owed by the lessee under the lease agreement.

A right to payment is not "chattel paper" under section (a)(11)(B) unless the predominant purpose of the transaction giving rise to the lease was to give the lessee the right to possession and use of the goods. The comments will explain the predominant-purpose test and give examples of its application. (The Prefatory Note provides one example.)

~~**SECTION 9-105. CONTROL OF ELECTRONIC CHATTEL PAPER.**~~

~~(a) **[General rule: control of electronic chattel paper.]** A secured party has control of electronic chattel paper if a system employed for evidencing the transfer of interests in the chattel paper reliably establishes the secured party as the person to which the chattel paper was assigned.~~

~~(b) **[Specific facts giving control.]** A system satisfies subsection (a) if the record or records comprising the chattel paper are created, stored, and assigned in such a manner that:~~

~~(1) a single authoritative copy of the record or records exists which is unique, identifiable, and, except as otherwise provided in paragraphs (4), (5), and (6), unalterable;~~

~~(2) the authoritative copy identifies the secured party as the assignee of the record or records;~~

~~(3) the authoritative copy is communicated to and maintained by the secured party or its designated custodian;~~

~~(4) copies or amendments that add or change an identified assignee of the authoritative copy can be made only with the consent of the secured party;~~

~~(5) each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and~~

~~(6) any amendment of the authoritative copy is readily identifiable as authorized or unauthorized.~~

Section 9-105. Control of Electronic Copy of Record Evidencing Chattel Paper.

(a) **[When secured party has control.]** A secured party has control of an electronic copy of a record evidencing chattel paper if:

(1) the electronic copy, a record attached to or logically associated with the

electronic copy, or the system in which the electronic copy is recorded, if any:

(A) enables the secured party to readily identify each electronic copy of the record as an authoritative copy or nonauthoritative copy of the record;

(B) enables the secured party to readily identify itself as the assignee of each authoritative electronic copy of the record; and

(C) subject to subsection (b), gives the secured party the exclusive power to: (i) prevent others from adding or changing an identified assignee of each authoritative electronic copy of the record; and

(ii) transfer control of the authoritative copy of the record; or

(2) another person obtains control of the electronic copy of a record evidencing chattel paper or, having previously obtained control of the electronic copy, acknowledges in an authenticated record that it has control on behalf of the secured party.

(b) **[Meaning of exclusive.]** A power specified in paragraph (a)(1) is exclusive, even if:

(1) the electronic copy or the system in which the electronic copy is recorded, if any, limits the use to which the electronic record may be put or has protocols that are programmed to result in a transfer of control; or

(2) the secured party has agreed to share the power with another person.

(c) **[Identification of secured party.]** For the purposes of subsection (a)(1)(B), a secured party may be identified in any way, including by name, identifying number, cryptographic key, office, or account number.

Reporter's Note

1. *The function of control.* Under the draft, as under current law, a secured party can perfect a security interest in chattel paper by filing. *See* Section 9-312(a). Alternatively, a secured party can perfect a security interest in chattel paper by taking possession of all tangible authoritative copies of the record evidencing the chattel paper and obtaining control of all

electronic authoritative copies. *See* draft § 9-314A.

2. *Conditions for obtaining control.* As explained in the preceding Note, control relates to perfection of a security interest in chattel paper. One method of perfecting a security interest in chattel paper is to take possession of all tangible authoritative copies of the record evidencing the chattel paper and obtain control of all electronic records. Perfection generally serves the function of enabling the public to determine that the asset in question (here, chattel paper) may be encumbered with a security interest.

The amended definition of "control" is meant to reflect the functions that possession serves with respect to writings in a more accurate and technologically flexible way than does the current definition.

To show that it has possession of all tangible authoritative copies of a record evidencing chattel paper, a secured party can produce the copies in its possession and provide evidence that these are authoritative copies and that no other tangible authoritative copies exist. (The Reporter's Note to draft § 9-314A explains the meaning of "authoritative copy.") The secured party's possession of the tangible authoritative copies gives the secured party the power to prevent others from taking possession of the copies and to transfer possession of the copies.

Under the draft, to obtain control of an electronic copy of a record evidencing chattel paper a secured party must be able to identify each electronic copy as authoritative or nonauthoritative and identify itself as the assignee of each authoritative copy. In addition, the secured party must have the exclusive power to prevent others from adding or changing an identified assignee and to transfer control of the authoritative copies.

The utility of distributed ledger technology (blockchain) depends on there being multiple authoritative copies of a record. The safe harbor under existing Section 9-105(b) contemplates a "single authoritative copy" and so is unavailable when the relevant record is maintained on a blockchain. The draft allows a secured party to obtain control when there are multiple authoritative copies.

3. *Use of singular.* The draft refers to "record" and "copy." In any given case, there may be more than one relevant record and more than one copy. Under Section 1-106, unless the statutory context otherwise requires, words in the singular number include the plural.

Section 9-203. Attachment and Enforceability of Security Interest; Proceeds; Supporting Obligations; Formal Requisites.

* * *

(b) **[Enforceability.]** Except as otherwise provided in subsections (c) through (i), a security interest is enforceable against the debtor and third parties with respect to the collateral

only if:

(1) value has been given;

(2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and

(3) one of the following conditions is met:

(A) the debtor has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned;

(B) the collateral is not a certificated security and is in the possession of the secured party under Section 9-313 pursuant to the debtor's security agreement;

(C) the collateral is a certificated security in registered form and the security certificate has been delivered to the secured party under Section 8-301 pursuant to the debtor's security agreement; ~~or~~

(D) the collateral is deposit accounts, ~~electronic chattel paper,~~ investment property, or letter-of-credit rights, and the secured party has control under Section 9-104, ~~9-105,~~ 9-106, or 9-107 pursuant to the debtor's security agreement; or

(E) the collateral is chattel paper and the secured party has possession and control under Section 9-314A pursuant to the debtor's security agreement.

* * *

Reporter's Note

1. *Substitute for authenticated security agreement.* Under existing subparagraphs (b)(3)(B) and (b)(3)(D), possession of tangible collateral and control of intangible collateral may substitute for an authenticated security agreement that provides a description of the collateral. With respect to chattel paper, some of the authoritative records that evidence the right to payment may be tangible and some electronic. Accordingly, new subparagraph (b)(3)(E) would provide that possession of the tangible authoritative records, if any, and control of the electronic

records, if any, may substitute for an authenticated security agreement.

Section 9-301. Law Governing Perfection and Priority of Security Interests.

Except as otherwise provided in Sections 9-303 through 9-306, the following rules determine the law governing perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral:

(1) Except as otherwise provided in this section, while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral.

(2) ~~While~~ Except as otherwise provided in paragraph (5), while collateral is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a possessory security interest in that collateral.

(3) Except as otherwise provided in paragraph (4), while negotiable documents, goods, instruments, or money~~, or tangible chattel paper~~ is located in a jurisdiction, the local law of that jurisdiction governs:

(A) perfection of a security interest in the goods by filing a fixture filing;

(B) perfection of a security interest in timber to be cut; and

(C) the effect of perfection or nonperfection and the priority of a nonpossessory security interest in the collateral.

(4) * * *

(5) While a tangible authoritative copy of a record evidencing chattel paper is located in a jurisdiction, the local law of that jurisdiction governs:

(A) perfection of a security interest in the chattel paper by possession and control under Section 9-314A; and

(B) the effect of perfection or nonperfection and the priority of a security

interest in the chattel paper.

Reporter's Note

1. *Choice of governing law.* Under the amended definition of chattel paper, a right to payment and rights in related property may be evidenced by one or more tangible authoritative copies and one or more electronic authoritative copies.

Draft paragraph (5) would address these cases by tying the choice-of-law rules to the authoritative tangible copy. As a consequence, the local law of the jurisdiction where the authoritative tangible copy is physically located would govern perfection of a security interest in the chattel paper by possession and control under Section 9-314A.

The location of the debtor would govern perfection by filing. *See* paragraph (1). However, under paragraph (5), if there is a tangible authoritative copy, the location of that copy would govern the effect of perfection or nonperfection and the priority of a security interest in the chattel paper.

This approach is modeled on paragraph (3), which is designed to reduce the confusion that might arise when the choice-of-law rules of a given jurisdiction result in each of two conflicting security interests in the same collateral being governed by a different priority rule. The Drafting Committee plans to reconsider the approach, as it may create difficulties when, for example, all existing tangible authoritative copies are destroyed.

2. *Multiple tangible authoritative records.* Like existing law, paragraph (5) assumes that all the tangible authoritative records are located in the same jurisdiction.

Section 9-310. When Filing Required to Perfect Security Interest or Agricultural Lien; Security Interests and Agricultural Liens to Which Filing Provisions Do Not Apply.

* * *

(b) **[Exceptions: filing not necessary.]** The filing of a financing statement is not necessary to perfect a security interest:

* * *

(8) in deposit accounts, ~~electronic chattel paper,~~ investment property, or letter-of-credit rights which is perfected by control under Section 9-314;

(9) in proceeds which is perfected under Section 9-315; ~~or~~

(10) that is perfected under Section ~~9-316.~~ 9-316; or

(11) in chattel paper which is perfected by possession and control under Section 9-314A.

* * *

Section 9-313. When Possession by or Delivery to Secured Party Perfects Security Interest Without Filing.

(a) **[Perfection by possession or delivery.]** Except as otherwise provided in subsection (b), a secured party may perfect a security interest in negotiable documents, goods, instruments, or money~~, or tangible chattel paper~~ by taking possession of the collateral. A secured party may perfect a security interest in certificated securities by taking delivery of the certificated securities under Section 8-301.

* * *

Reporter's Note

1. *Perfection by possession.* Perfection by possession of tangible chattel paper has been deleted from this section. Instead, perfection by possession and control would be governed by new Section 9-314A.

Section 9-314. Perfection by Control.

(a) **[Perfection by control.]** A security interest in investment property, deposit accounts, or letter-of-credit rights~~, or electronic chattel paper~~ may be perfected by control of the collateral under Section 9-104, ~~9-105,~~ 9-106, or 9-107.

(b) **[Specified collateral: time of perfection by control; continuation of perfection.]** A security interest in deposit accounts, ~~electronic chattel paper,~~ or letter-of-credit rights is perfected by control under Section ~~9-104, 9-105,~~ 9-104 or 9-107 when the secured party obtains control and remains perfected by control only while the secured party retains control.

* * *

Reporter's Note

1. *Perfection by control.* Perfection by control of electronic chattel paper has been deleted from this section. Instead, new Section 9-314A would govern perfection by possession and control.

Section 9-314A. Perfection by Possession and Control of Chattel Paper.

(a) **[Perfection by possession and control.]** A secured party may perfect a security interest in chattel paper by taking possession of the tangible authoritative copy, if any, of the record evidencing the chattel paper and obtaining control of the electronic authoritative copy, if any, of the electronic record evidencing the chattel paper.

(b) **[Time of perfection; continuation of perfection.]** A security interest is perfected under subsection (a) when the secured party takes possession and obtains control and remains perfected under subsection (a) only while the secured party retains possession and control.

* * *

Reporter's Note

1. *"Authoritative copy."* This section of the draft provides that to perfect a security interest in chattel paper other than by filing, a secured party must obtain control of all electronic authoritative copies and take possession of all tangible authoritative copies.

Existing Section 9-105(b) distinguishes between authoritative and nonauthoritative copies of electronic chattel paper. Like current law, the draft refers to copies that are "authoritative." And, like current law, the draft does not define the term. However, the draft would apply this concept also to tangible records that evidence chattel paper.

As explained above, perfection of a security interest in chattel paper by taking possession of the collateral was understood to mean taking possession of the wet-ink "original." Experience has shown that the concept of an original breaks down when one allows for the possibility of the same monetary obligation being evidenced in different media over time, such as where electronic records evidencing the chattel paper "papered out" (replaced with tangible records evidencing the same chattel paper) or tangible records are "converted" to electronic records.

To accommodate current practices and future technology, the draft would allow the parties considerable flexibility in determining the method used to establish whether a particular copy is authoritative, as long as third parties are able to reasonably identify the authoritative copies that must be possessed or controlled to achieve perfection. For example, the parties could develop a system or protocol where each copy is watermarked as authoritative or

nonauthoritative or where the terms of the records themselves describe how to determine which copies are authoritative and which are not.

2. *Time of perfection.* Subsection (b) is modeled on Sections 9-313(d) and 9-314(b).

Section 9-317. Interests That Take Priority Over or Take Free of Security Interest or Agricultural Lien.

* * *

(b) **[Buyers that receive delivery.]** Except as otherwise provided in subsection (e), a buyer, other than a secured party, of ~~tangible chattel paper,~~ documents, goods, instruments, or a security certificate takes free of a security interest or agricultural lien if the buyer gives value and receives delivery of the collateral without knowledge of the security interest or agricultural lien and before it is perfected.

* * *

(d) **[Licensees and buyers of certain collateral.]** A licensee of a general intangible or a buyer, other than a secured party, of accounts, ~~electronic chattel paper,~~ general intangibles, or investment property other than a certificated security takes free of a security interest if the licensee or buyer gives value without knowledge of the security interest and before it is perfected.

* * *

(f) **[Buyers of chattel paper.]** A buyer, other than a secured party, of chattel paper takes free of a security interest if, without knowledge of the security interest and before it is perfected, the buyer gives value and receives delivery of the tangible authoritative copy, if any, of the record evidencing the chattel paper and obtains control of the electronic authoritative copy, if any, of the record evidencing the chattel paper.

Section 9-330. Priority of Purchaser of Chattel Paper or Instrument.

(a) **[Purchaser's priority: security interest claimed merely as proceeds.]** A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed merely as proceeds of inventory subject to a security interest if:

(1) in good faith and in the ordinary course of the purchaser's business, the purchaser gives new value and takes possession of the tangible authoritative copy, if any, of the record evidencing the chattel paper ~~or~~ and obtains control of the electronic authoritative copy, if any, of the record evidencing the chattel paper ~~under Section 9-105~~; and

(2) the ~~chattel paper does~~ authoritative copy of the record evidencing the chattel paper does not indicate that ~~it has~~ the copy has been assigned to an identified assignee other than the purchaser.

(b) **[Purchaser's priority: other security interests.]** A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed other than merely as proceeds of inventory subject to a security interest if the purchaser gives new value and takes possession of the tangible authoritative copy, if any, of the record evidencing the chattel paper ~~or~~ and obtains control of the electronic authoritative copy, if any, of the record evidencing the chattel paper ~~under~~ ~~Section 9-105~~ in good faith, in the ordinary course of the purchaser's business, and without knowledge that the purchase violates the rights of the secured party.

* * *

Concluding Note

As noted above in footnote 2, a right to payment that is evidenced by an Article 3 negotiable instrument is different from a right to payment that is evidenced by a nonnegotiable record. This is because the obligation to pay a negotiable instrument is "embodied in" or "travels with" the negotiable instrument. For this reason, the definition of "account debtor" excludes the obligor on a negotiable instrument, even if the negotiable instrument constitutes part of chattel paper.

The reason why Article 9 distinguishes negotiable instruments that are secured by a

security interest in specific goods or relate to a lease of specific goods from other negotiable instruments is unclear. Perhaps the distinction arose because the drafters of former Article 9 wanted to create an exception to the general rule that a security interest in a negotiable instrument could not be perfected by filing. Regardless, under revised (current) Article 9, a security interest in a negotiable instrument, like a security interest in chattel paper, may be perfected by filing or possession. Many other Article 9 rules apply to both chattel paper and negotiable instruments. Perhaps the main exception appears in Section 9-330, under which the "superpriority" rules applicable to chattel paper (§ 9-330(a) through (c)) differ from the rule applicable to negotiable instruments (§ 9-330(d)).

The Drafting Committee plans to consider whether a right to payment evidenced by a negotiable instrument should be excluded from the definition of "chattel paper," even if the accompanying records evidence a security interest or lease of specific goods.

D. Payments

Prefatory Note

These amendments address issues arising under UCC Articles 3, 4, and 4A.

ARTICLE 3

NEGOTIABLE INSTRUMENTS

Section 3–104. Negotiable Instrument.

(a) Except as provided in subsections (c) and (d), "negotiable instrument" means an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:

(1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;

(2) is payable on demand or at a definite time; and

(3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, but the promise or order may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose

of collateral, ~~or~~ (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor; or (iv) an undertaking to litigate a dispute concerning the promise or order in a specified forum.

* * *

Reporter's Note

1. *Choice-of-law provisions.* The amendment does not address choice-of-law provisions, as an agreement concerning the governing law is not an undertaking or instruction.

Section 3–105. Issue of Instrument.

(a) "Issue" means the first delivery of an instrument or first transmission of an image of an item or information describing the item by the maker or drawer, whether to a holder or nonholder, for the purpose of giving rights on the instrument to any person.

* * *

Reporter's Note

1. *Source.* The phrase "transmission of an image of an item or information describing the item is derived from Section 4–110(a), dealing with electronic presentment.

Section 3–604. Discharge by Cancellation or Renunciation.

(a) A person entitled to enforce an instrument, with or without consideration, may discharge the obligation of a party to pay the instrument (i) by an intentional voluntary act, such as surrender of the instrument to the party, destruction, mutilation, or cancellation of the instrument, cancellation or striking out of the party's signature, or the addition of words to the instrument indicating discharge, or (ii) by agreeing not to sue or otherwise renouncing rights against the party by a signed record. The obligation of a party to pay the instrument is not discharged solely by the destruction of a check in connection with a process by which, initially, information is extracted from the check or an image is made and, subsequently, the information

or image is transmitted for payment.

* * *

ARTICLE 4

BANK DEPOSITS AND COLLECTIONS

Section 4–406. Customer's Duty to Discover and Report Unauthorized Signature or Alteration.

(a) A bank that sends or makes available to a customer a statement of account showing payment of items for the account shall either return or make available to the customer the items paid or provide information in the statement of account sufficient to allow the customer reasonably to identify the items paid. ~~The~~ A statement of account ~~provides sufficient information if the item is described~~ that describes each item paid by item number, amount, and date of payment and includes an image of each item showing the name of the payee and date of the item is sufficient. Whether a statement of account that does not include an image of each item is sufficient is a question of fact.

* * *

ARTICLE 4A

FUNDS TRANSFERS

Section 4A–103. Payment Order - Definitions.

(a) In this Article:

(1) "Payment order" means an instruction of a sender to a receiving bank, transmitted orally~~, electronically, or in writing~~ or in a record, to pay, or to cause another bank to pay, a fixed or determinable amount of money to a beneficiary if:

* * *

Section 4A–201. Security Procedure.

"Security procedure" means a procedure established by agreement of a customer and a receiving bank for the purpose of (i) verifying that a payment order or communication amending or cancelling a payment order is that of the customer, or (ii) detecting error in the transmission or the content of the payment order or communication. A security procedure may impose an obligation on the receiving bank or the customer and may require the use of algorithms or other codes, identifying words, ~~or~~ numbers, symbols, sounds, or biometrics, encryption, callback procedures, or similar security devices. Comparison of a signature on a payment order or communication with an authorized specimen signature of the customer or requiring that a payment order be sent from a known email address, IP address, or phone number is not by itself a security procedure.

Section 4A–202. Authorized and Verified Payment Orders.

(a) A payment order received by the receiving bank is the authorized order of the person identified as sender if that person authorized the order or is otherwise bound by it under the law of agency.

(b) If a bank and its customer have agreed that the authenticity of payment orders issued to the bank in the name of the customer as sender will be verified pursuant to a security procedure, a payment order received by the receiving bank is effective as the order of the customer, whether or not authorized, if (i) the security procedure is a commercially reasonable method of providing security against unauthorized payment orders, and (ii) the bank proves that it accepted the payment order in good faith and in compliance with the bank's obligations under the security procedure and any ~~written~~ agreement or instruction of the customer, evidenced by a record, restricting acceptance of payment orders issued in the name of the customer. The bank is

not required to follow an instruction that violates ~~a written~~ an agreement, evidenced by a record, with the customer or notice of which is not received at a time and in a manner affording the bank a reasonable opportunity to act on it before the payment order is accepted.

(c) Commercial reasonableness of a security procedure is a question of law to be determined by considering the wishes of the customer expressed to the bank, the circumstances of the customer known to the bank, including the size, type, and frequency of payment orders normally issued by the customer to the bank, alternative security procedures offered to the customer, and security procedures in general use by customers and receiving banks similarly situated. A security procedure is deemed to be commercially reasonable if (i) the security procedure was chosen by the customer after the bank offered, and the customer refused, a security procedure that was commercially reasonable for that customer, and (ii) the customer expressly agreed in ~~writing~~ a record to be bound by any payment order, whether or not authorized, issued in its name and accepted by the bank in compliance with the bank's obligation under the security procedure chosen by the customer.

* * *

Section 4A–203. Unenforceability of Certain Verified Payment Orders.

(a) If an accepted payment order is not, under Section 4A-202(a), an authorized order of a customer identified as sender, but is effective as an order of the customer pursuant to Section 4A-202(b), the following rules apply:

(1) By express ~~written~~ agreement evidenced by a record, the receiving bank may limit the extent to which it is entitled to enforce or retain payment of the payment order.

* * *

Section 4A–206. Transmission of Payment Order Through Funds-Transfer or Other

Communication System.

(a) If a payment order addressed to a receiving bank is transmitted to a funds-transfer system or other third-party communication system for transmittal to the bank, the system is deemed to be an agent of the sender for the purpose of transmitting the payment order to the bank. If there is a discrepancy between the terms of the payment order transmitted to the system and the terms of the payment order transmitted by the system to the bank, the terms of the payment order of the sender are those transmitted by the system. This section does not apply to a funds-transfer system of the Federal Reserve Banks or to a third-party communication system that is part of a security procedure.

* * *

Section 4A–207. Misdescription of Beneficiary.

* * *

(c) If (i) a payment order described in subsection (b) is accepted, (ii) the originator's payment order described the beneficiary inconsistently by name and number, and (iii) the beneficiary's bank pays the person identified by number as permitted by subsection (b)(1), the following rules apply:

(1) If the originator is a bank, the originator is obliged to pay its order.

(2) If the originator is not a bank and proves that the person identified by number was not entitled to receive payment from the originator, the originator is not obliged to pay its order unless the originator's bank proves that the originator, before acceptance of the originator's order, had notice that payment of a payment order issued by the originator might be made by the beneficiary's bank on the basis of an identifying or bank account number even if it identifies a person different from the named beneficiary. Proof of notice may be made by any admissible

evidence. The originator's bank satisfies the burden of proof if it proves that the originator, before the payment order was accepted, ~~signed a writing~~ authenticated a record stating the information to which the notice relates.

* * *

Section 4A–208. Misdescription of Intermediary Bank or Beneficiary's Bank.

* * *

(b) This subsection applies to a payment order identifying an intermediary bank or the beneficiary's bank both by name and an identifying number if the name and number identify different persons.

* * *

(2) If the sender is not a bank and the receiving bank proves that the sender, before the payment order was accepted, had notice that the receiving bank might rely on the number as the proper identification of the intermediary or beneficiary's bank even if it identifies a person different from the bank identified by name, the rights and obligations of the sender and the receiving bank are governed by subsection (b)(1), as though the sender were a bank. Proof of notice may be made by any admissible evidence. The receiving bank satisfies the burden of proof if it proves that the sender, before the payment order was accepted, ~~signed a writing~~ authenticated a record stating the information to which the notice relates.

* * *

Section 4A–210. Rejection of Payment Order.

(a) A payment order is rejected by the receiving bank by a notice of rejection transmitted to the sender orally~~, electronically,~~ or in ~~writing~~ a record. A notice of rejection need not use any particular words and is sufficient if it indicates that the receiving bank is rejecting the order or

will not execute or pay the order. Rejection is effective when the notice is given if transmission is by a means that is reasonable in the circumstances. If notice of rejection is given by a means that is not reasonable, rejection is effective when the notice is received. If an agreement of the sender and receiving bank establishes the means to be used to reject a payment order, (i) any means complying with the agreement is reasonable and (ii) any means not complying is not reasonable unless no significant delay in receipt of the notice resulted from the use of the noncomplying means.

* * *

Section 4A–211. Cancellation and Amendment of Payment Order.

(a) A communication of the sender of a payment order cancelling or amending the order may be transmitted to the receiving bank orally~~, electronically,~~ or in ~~writing~~ a record. If a security procedure is in effect between the sender and the receiving bank, the communication is not effective to cancel or amend the order unless the communication is verified pursuant to the security procedure or the bank agrees to the cancellation or amendment.

* * *

E. Miscellaneous Amendments

ARTICLE 1

GENERAL PROVISIONS

Section 1-201. General Definitions.

* * *

(b) Subject to definitions contained in other articles of the [Uniform Commercial Code] that apply to particular articles or parts thereof:

* * *

(16A) "Electronic" means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.

* * *

(27) "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government, governmental subdivision, agency, or instrumentality, public corporation, or any other legal or commercial entity. The term includes a protected series, however denominated, of an entity if the protected series is established under law that limits, or limits if conditions specified under law are satisfied, the ability of a creditor of the entity or of any other protected series of the entity to satisfy a claim from assets of the protected series.

* * *

Legislative Note: *The added second sentence would provide needed clarity as to the status of a protected series for purposes of the Uniform Commercial Code. A number of states have enacted statutes that provide for protected series within a limited liability company or other unincorporated organization. These statutes afford rights and impose duties upon a protected series and generally empower a protected series to conduct its own activities under its own name.*

By providing that a protected series is a "person" for purposes of the enacting state's Uniform Commercial Code, the sentence will expressly permit a protected series, whether created under the law of the enacting state or of another state, to be, for example, (a) a "seller" or a "buyer" under Article 2, (b) a "lessor" or a "lessee" under Article 2A, or (c) an "organization" and a "debtor" under Article 9, and (d) if the law under which the protected series is organized requires a public filing for the protected series to be recognized under that law, a "registered organization" under Article 9. These matters are not clear under the current Uniform Commercial Code.

A state should enact this amendment regardless of whether the state has enacted the Uniform Protected Series Act (2017) or otherwise recognizes a protected series under its own domestic law. Since the sentence applies only for purposes of the enacting state's Uniform Commercial Code, inclusion of the sentence in and of itself does not require the enacting state to recognize a limit on liability of a protected series organized under the law of another state or a limit on liability of the entity that established the protected series. It merely clarifies the status of a protected series as a "person" for purposes of the choice-of-law and substantive law rules of the enacting state's Uniform Commercial Code.

Reporter's Note

1. *"Electronic."* The draft adopts the standard ULC definition.

2. *"Person."* The draft retains the UCC's existing definition of "person." Although the UCC definition differs from the ULC's current standard definition, the Drafting Committee sees no reason to create uncertainty by revising the UCC definition.

As the Legislative Note explains, by enacting the draft amendment, an enacting state would treat a protected series, whether organized under the law of the enacting state or under the law of another state, as a "person" for purposes of the Uniform Commercial Code. The draft uses the ULC's standard language to accomplish this purpose.

ARTICLE 5

LETTERS OF CREDIT

Section 5-102. Definitions.

(a) In this article:

* * *

(14A) "Signed", with respect to a record that is not a writing, means to attach to or logically associate with the record an electronic sound, symbol, or process with present intent to adopt or accept the record.

* * *

Reporter's Note

1. *"Signed."* The definition of "signed" contained in Section 5-102(a)(14A) would accommodate the use of electronic signatures under Sections 5-104(i), 5-108(i)(5), 5-113(a), (b), (c) and (d), and 5-116(a) without invalidating the use of traditional, non-electronic signatures on paper documents in letter-of-credit transactions.

The Drafting Committee plans to consider more generally the definition and use of "sign" throughout the Uniform Commercial Code.

ARTICLE 9

SECURED TRANSACTIONS

Section 9-102. Definitions and Index of Definitions.

(a) **[Article 9 definitions.]** In this article:

* * *

(6A) "Assignee," in part 4 of this article, means a person (i) in whose favor a security interest that secures an obligation is created or provided for under a security agreement, whether or not an obligation to be secured is outstanding or (ii) to which accounts, chattel paper, payment intangibles, or promissory notes have been sold; and

(6B) "Assignor," in part 4 of this article, means a person that (i) under a security agreement creates or provides for a security interest that secures an obligation or (ii) sells accounts, chattel paper, payment intangibles, or promissory notes.

* * *

Reporter's Note

1. *"Assignor"; "assignee".* Instead of referring to a "debtor," "secured party," and "security interest," all of which terms are defined in the UCC, several provisions of Article 9, Part 4, refer to an "assignor," "assignee," and "assignment," or sometimes an "assigned contract," none of which terms are defined in the UCC. Some courts read the undefined terms in an unduly narrow way. In 2020, the Permanent Editorial Board for the UCC issued a Commentary clarifying the meanings of these terms and amended the official comments accordingly. *PEB Commentary No. 21, Use of the Term "Assignment" in Article 9 of the Uniform Commercial Code* (Mar. 11, 2020). New subsection (6A) incorporates the essence of the Commentary into the statutory text.

What's Happening Now with the UCC

The Uniform Law Commission and the American Law Institute authorized the Permanent Editorial Board for the Uniform Commercial Code ("PEB") to publish commentaries on the UCC regarding the correct interpretation of the Code. Between 1960, the date of the first enactments of the UCC by the various states, and 2017, only 19 commentaries were published, that is one every three years. Four have been published between 2019 through today. Three additional draft commentaries have been posted for public comment and a fourth is in the works. It is of concern to the PEB, and the ULC's UCC Committee, that too many courts are missing the mark in their UCC decisions.

The PEB's Commentaries are designed to limit the damage to the certain of outcomes of disputes governed by the UCC. Most often, a multi-page Commentary examines why a judicial decision is incorrect and offers an amendment/addition to the Official Comments for the UCC sections on which the decision turned. Remember, in Kentucky, KRS 355.1-103(3) adopts the Official Comments to the various sections of the UCC as legislative intent.

Just this year, a draft Commentary on proceeds of collateral was posted in June for public comment before it becomes final. The commentary rejects case law, particularly a decision of the Sixth Circuit, that hold proceeds of collateral are a distinct category of collateral separate from the collateral that generated the proceeds. This is particularly troublesome regarding accounts. The Commentary explains that the term proceeds relates to the source of the proceeds and not to a different type of property.

Although usually the PEB works at near glacial speed in issuing its Commentaries, it issued a draft "emergency" Commentary in August. This Commentary relates to perfection of security interests in intangible money and related choice of law rules. It was brought about primarily by El Salvador enacting a law that recognizes Bitcoin as a medium of exchange. The Commentary notes that Article 1's definition of money is based on the understanding that money is always tangible. The Commentary explains that the rules of the UCC do not work, particularly the provisions of Article 9, if a government designates intangible property as money.

Next, in September, the PEB offered a draft Commentary regarding injunctions against a noncomplying disposition of collateral under Article 9-610. This Commentary rejects several recent New York decisions that require a debtor to show irreparable injury if it attempts to enjoin a secured party's noncompliant disposition of collateral. The commentary cites Article 9-625(a) as statutory authorization for the courts to enjoin dispositions of collateral that do not comply with part Six of Article 9 without the requirement ordinarily considered in provisional remedies of immediate and irreparable harm to the plaintiff if relief is not granted.

Another commentary, in the works, and that may be put up for public comment this year, rejects the decision of the Seventh Circuit in *In re: I80 Equipment*, 938 F. 3d. 866 (2019), *Cert. Denied* 140 S. Ct. 1125 (2020). The decision held that a financing statement sufficiently indicates

collateral under 9-502 through reference to a document not filed with the financing statement, without a description on the financing statement or a record filed with the financing statement. The commentary, if adopted by the PEB, proposes to add a sentence to Official Comment 2 to 9-504:

> A financing statement that provides in the financing statement or an attachment an indication of collateral that does not itself meet the standard of Section 9-504, but refers solely to a record not attached to the financing statement for a sufficient indication does not satisfy the requirement of Section 9-504.

What has Happened in the UCC

A Summary of Recent Kentucky, Indiana, and Tennessee Cases on UCC Issues

- ***Versailles Farm, Home, and Garden, LLC v. Haynes*, No. 2020-CA-0626-MR, 2021 WL 519722, at *1 (Ky. Ct. App. Feb. 12, 2021).**
  - **Facts**: Junior creditor, Versailles Farm, Home, and Garden, LLC ("VFHG"), loaned money to a farmer and took a security interest in the farmer's 2013 tobacco crop. Another creditor, Farmer's Tobacco Warehouse, was also given a security interest in the tobacco crop from the same year. The farmer had multiple security agreements in place with Farmer's Tobacco Warehouse ("Farmer's Tobacco") that included various crops and farm equipment from 2012. Farmer's Tobacco was the first creditor to file its financing statement covering the 2013 crop. Farmer's Tobacco received the proceeds from the sale of the crop. VFHG then sued. Summary judgment was ultimately awarded in favor of Farmer's Tobacco and VFHG appealed.
  - **Holding:** The Court of Appeals affirmed the granting of summary judgment. VFHG argued that because Farmer's Tobacco's security agreement did not contain a future advances clause, Farmer's Tobacco was only entitled to what the farmer owed Farmer's Tobacco prior to the date on the security agreement. VFHG argued that based on KRS 3.55-9204(3), Official Comment 5 to UCC § 9-204, and the 1981 case *ITT Industrial Credit Company v. Union Bank and Trust Company* a security agreement must contain a future advances clause. 615 S.W.2d 2 (Ky. App. 1981). The *ITT* court held, "In our opinion, the statute [requires] this statement, and such a statement provides actual notice of the intention to a would-be subsequent creditor." However, this Court distinguished the facts at issue by deciding that *ITT* assumes that a creditor will have read the prior security agreement. Because there was no evidence that VFHG had inquired into the nature of the debtor-creditor relationship between the farmer and Farmer's Tobacco, VFHG could not argue that it had relied upon the lack of a future advances clause in Farmer's Tobacco's security agreement. Because VFHG did not read Farmer's Tobacco's security agreement or financing statement, there was no way that VFHG had relied on either of those documents to its detriment. The Court affirmed the granting of summary judgment in favor of Farmer's Tobacco.

- ***Diversified Demolition, LLC v. Rosebird Properties, LLC*, No. 2018-CA-000880-MR, 2020 WL 3124684, at *1 (Ky. Ct. App. June 12, 2020).**
    - **Facts**: A demolition company, Diversified Demolition, LLC ("Diversified"), was hired to demolish commercial buildings. The owner of Rosebird Properties, LLC ("Rosebird") agreed to salvage certain materials from the property for a price of $52,000.00. The money was due as items were sold but within 30 days of removal. The entire deal was made via text messages. After several payments were made, the balance remaining to Diversified totaled $15,300.00. Following the death of Rosebird's owner, Diversified filed suit against the Estate to recover the remaining balance. Summary judgement was granted in favor of the Estate, and Diversified's claim was dismissed.
    - **Holding**: On appeal, the Court held that Diversified was not a secured creditor. According to KRS 396.011(1), a claim against an estate must be presented within six months after the appointment of the personal representative. Because Diversified did not bring its claim against the Estate within the six months of the naming of the personal representative, it would need to rely on an exception outlined in KRS 396.011(2)(a) in order for its claim to stand. Diversified would need to be a secured creditor in order to take advantage of the exception. The court held that Diversified was not a secured creditor because text messages between the debtor and creditor would not provide sufficient notice to potential subsequent creditors, as required by KRS 355.9-203(2)(c) and Kentucky common law. Because there was no "writing" to describe the collateral or put subsequent creditors on notice, the Court of Appeals affirmed the judgment of the lower court.

- ***House v. Deutsche Bank National Trust*, 624 S.W.3d 736 (KY. Ct. App. 2021).**
    - **Facts**: Joel and Monica House ("the Houses") executed a promissory note secured by a mortgage upon real property in favor of Washington Mutual Bank in 2006. In 2007, the note was transferred to Deutsche Bank. In 2008, Deutsche Bank entered into a Loan Modification Agreement with the Houses and Deutsche Bank was listed as "note holder and mortgagee." In October 2008, JP Morgan Chase Bank ("Chase") acquired all loans from Washington Mutual Bank. The Houses executed a Home Affordable Modification Trial Period Plan in 2009 and identified Chase as the lender on the plan. Another modification was entered into between the Houses and Chase Bank in 2012. Deutsch Bank then commenced foreclosure proceedings on the property in 2014. The Houses opposed the foreclosure and argued that Deutsche Bank failed to produce the original note, and that Deutsche Bank therefore could not enforce the note. Deutsche Bank admitted the original note was lost but claimed it was able to enforce the note pursuant to KRS 355.3-309. The Circuit Court ultimately granted summary judgment in favor of Deutsch Bank and allowed the bank to enforce the note based on a Lost Note Affidavit. The Houses appealed.

- **Holding**: The Appellate Court affirmed the granting of summary judgment. The Court found that Deutsche Bank would be able to enforce the note under KRS 355.3-309, the lost instrument statute. The first requirement under the lost instrument statute required Deutsche Bank to prove it had obtained possession of the promissory note when loss of possession occurred. The bank produced an affidavit from one of the bank's document control officers alleging that Washington Mutual Bank endorsed the note directly to Deutsch Bank, therefore making Deutsche Bank the possessor of the note. The Houses then introduced an affidavit from Joel House in which he stated that he had been told by Chase Bank that the note had been transferred to Chase. The Court found that because Joel's affidavit was based on hearsay, it would not be considered, and therefore Deutsch Bank's affidavit was uncontroverted to prove that Deutsch Bank was in possession of the note at the time the instrument was lost. The Court then turned KRS 355.3-309(1)(b) and (1)(c) which require that "[t]he loss of possession was not the result of a transfer by the person of a lawful seizure" and that the whereabouts of the instrument cannot be reasonably obtained. These requirements were also met by the document control officer's uncontroverted affidavit. Turning to KRS 355.3-309(2), the Court held that Deutsche Bank had provided the Houses adequate protection by promising in a Lost Note Affidavit that the bank would "'indemnify' the Houses against 'all losses [and] damages' arising from any representations set forth in such affidavit." The Court, finding all requirements of KRS 355.3-309 met, affirmed the lower court's Amended Judgment and Order of Sale.

- ***Moore v. CitiMortgage, Inc.*, No. 2019-CA-0920-MR, 2020 WL 6538752, at *1, (Ky. Ct. App. Nov. 6, 2020).**
  - **Facts**: In 2003, Allyn and Cheryl Moore ("the Moores") executed a mortgage and promissory note in favor of ABN AMRO Mortgage Group, Inc. The note was secured by real property located in Paducah, Kentucky. ABN AMRO Mortgage Group, Inc. then merged with CitiMortgage. Following the merger, CitiBank, N.A. filed a complaint against the Moores alleging that the Moores were in default on a junior mortgage that was secured by the same property. A year later, CitiMortgage filed an amended answer and cross-claim seeking a money judgment on the 2003 note and mortgage due to a default in payment. Summary judgment was ultimately awarded in favor of CitiMortgage.
  - **Holding**: On appeal, the Moores argued that (1) CitiMortgage failed to establish that it was the assignee of the note and mortgage and (2) that summary judgment was improper because CitiMortgage failed to consider the couple's request for a loan modification. As to the first argument, the Court of Appeals found that CitiMortgage, as current possessor of the original note, was plainly entitled to enforce the note. As to the second argument, the Court found that there was nothing in the loan documents that would require CitiMortgage to consider modifying the loan. The Court held that "[t]he mere failure to offer a loan modification is not

evidence of a failure to consider the application in good faith." The Court of Appeals affirmed the summary judgment order.

- ***In re Smith*, 622 B.R. 2020 (Bankr. W.D. Tenn. 2020).**
  - **Facts**: In 2014, AgDirect obtained a purchase money security interest in a piece of farm equipment and filed a financing statement identifying the collateral as a certain Corn Head. Two years later, the debtor granted a security interest to IberiaBank in his farm equipment, including the same Corn Head. IberiaBank properly filed a financing statement. Shortly after, an individual named Walter Smith filed a termination statement as to AgDirect's original financing statement. The termination statement stated it was on behalf of "Farm Credit Services of Mid-America PCA", including acknowledgments to be sent to "Farm Credit Services of America, PCA" at the same address listed for AgDirect in its original financing statement. However, AgDirect was a separate legal entity from Farm Credit Services of Mid-America PCA and did not authorize the filing of the termination statement. The debtor filed for bankruptcy in 2018 and AgDirect was not listed as a creditor during the bankruptcy proceedings. In 2019, AgDirect, unaware of Mr. Smith's filing, filed a continuation statement as to its original financing statement. A few months later, an attorney representing IberiaBank in the debtor's bankruptcy proceeding filed a second termination statement as to AgDirect's Continued UCC-1 Financing Statement. AgDirect did not authorize the filing of that termination statement either. After the debtor filed bankruptcy a second time, the Court entered an Order Granting Motion to Sell Assets pursuant to 11 U.S.C. § 363. The Corn Head was sold to Paul Herbert "free and clear of all liens." AgDirect eventually became aware of the bankruptcy proceedings and filed a Motion for Relief from Orders.
  - **Holding**: The Court first noted that this was the first Tennessee case to analyze the effectiveness of an unauthorized termination statement. Therefore, the Court used statutes and case law from other jurisdictions to support its opinion. IberiaBank attempted to rely on a case under Florida law in which the court, in dicta, discussed that an unauthorized termination statement "releases the secured creditor's lien against the debtor's property. *Roswell Capital Partners, LLC v. Alternative Constructions Technologies*, No. 08 Civ. 10647(DLC), 2010 WL 3452378 (S.D.N.Y. Sept. 1, 2010). However, the Court disagreed with the *Roswell* court. The Court distinguished the question of whether a mistakenly filed termination statement is effective and whether a completely unauthorized termination statement is effective. The Court looked to *AEG Liquidation Trust v. Toobro N.Y. LLC*, No. 650680/10, 2011 WL 796616 (Banrk. W.D. Penn. March 4, 2013) which determined that "[s]ince a termination statement is a record 'relating to the initial financing statement,' it is part of a 'financing statement'" as defined by the UCC. The *Smith* court also cited Tenn. Code Ann. § 47-9-518, UCC Comment 2 which says that a filed record cannot be effective if the person making the filing was not entitled to do so. Therefore, if a termination statement is filed by someone who does

not have the authority to do so, the termination statement would not be effective either. The Court held that the termination statements filed without AgDirect's authority were not effective. Furthermore, the Court held that AgDirect was the priority lienholder in the Corn Head and ordered that the proceeds of the sale of the Corn Head be turned over to AgDirect.

- ***KR Enterprises, Inc. v. Zerteck, Inc.*, 999 F.3d 1044 (7th Cir. 2021).**
  - **Facts**: In the spring of 2016, Evergreen Recreational Vehicles, LLC ("Evergreen") delivered 21 new RVs to a group of affiliated dealers. In June 2016, a few months after delivering the RVs, Evergreen went out of business. The dealers never paid Evergreen or its secured creditor for any of the RVs. 1st Source, Evergreen's principal lender who had a first-priority blanket security interest in all of Evergreen's assets, filed suit. While the suit was pending, KR Enterprises, the principal owner of Evergreen, paid off Evergreen's debt to 1st Source, and 1st Source assigned its rights in Evergreen's assets to KR Enterprises. KR Enterprises was thereby substituted as plaintiff in the case, asserting 1st Source's security interest in Evergreen's collateral. The district court ultimately entered judgment for KR Enterprises in the amount of the purchase price for the RVs, minus the setoff for warranty and rebate claims. The dealers appealed, denying all liability, and KR Enterprises cross-appealed on the issue of allowing setoffs.
  - **Holding**: The Court first looked at whether KR Enterprises had standing as a secured creditor. The dealers' main argument centered around the timing and documentation of the transaction in which 1st Source assigned its rights as a secured lender to KR Enterprises. The dealers attempted to argue that because KR Enterprises paid 1st Source in full for the Evergreen account on March 2, 2018, but 1st Source did not execute the General Assignment of its rights until May 1, 2018, there was technically no security interest to assign, and thus the General Assignment was ineffective. Affirming the district court, the Court relied on well-established Indiana case law that says that the intent of the parties is the determining factor on whether or not an assignment has been made – any actions or words that show the intention of transferring rights to an assignee for valuable consideration are sufficient. Following this, the Court affirmed the district court's finding that the parties did not intend to erase the security interest, which was at the heart of the transaction, and that the General Assignment transferred a priority security interest in Evergreen's accounts receivable from 1st Source to KR Enterprises. The Court also looked at setoffs under the UCC, as adopted by Indiana. The Court affirmed the district court's finding that Ind. Code § 26-1-9.1-404, Indiana's adoption of UCC § 9-404, applied to these circumstances. As such, KR Enterprises took its assignment from 1st Source "subject to the defenses of an account debtor," i.e., the dealers, and is subject to both the claims arising from the sale of the 21 RVs as well as to any other defenses or claims of the dealers against KR Enterprises which accrues, including past-due rebates and warranties. Thus, the Court held that Ind. Code § 26-1-9.1-404 applies and the amounts the dealers owe KR Enterprises for

the unpaid invoices of the 21 RVs are to be offset by the amounts Evergreen still owed the dealers for rebates and warranties.

Other Significant UCC Cases from Around the Country

The Individual Debtor Name Issue Continues:

In re: Wynn, 627 B.R. 192 (Bankr. M.D. Ga. 2021)

The secured party filed its financing statement under Jerry W. Wynn. Mr. Wynn's driver's license listed his name as "Wilson Jerry Wynn." Although the financing statement as filed, appeared on a certified search of the records of the Georgia Secretary of State, it did not appear in a search under the standard search logic of the filing office. The secured party discovered its error and corrected the financing statement, however, there was an intervening secured party that had properly perfected in the interim. The court correctly ruled that even though the other secured party knew of the earlier security interest it was the first to file or perfect under 9-322 and its security interest had priority. The rule of 9-506 controlled. The debtor name is stated sufficiently if a standard search logic search under the debtor's correct name, as required by 9-503, disclosed the filed financing statement.

In re: Bryant, 221 WL 2326336 (Bankr. M.D. Ga. 2021)

The secured party's financing statement identified its debtor as Darren E. Bryant and as Darren E Bryant. Bryant's driver's license listed his name as Darren Eugene Bryant. The court found the financing statement was seriously misleading because it would not be disclosed in response to a search under the name on the driver's license using the Georgia Secretary of State's standard search logic.

Both of these decisions follow the rules first enunciated by the Bankruptcy Court for the Southern District of Indiana in 2017 in its decision in *In re: Nay*, 536 B.R. 537. That court was the first court in the nation to consider a case governed by Alternative A of the individual name standards in the 2010 amendments to Article 9 (effective July 1, 2013). In *Nay,* a PMSI equipment lender perfected its security interest under the name of Ronald Mark Nay. The name on the debtor's Indiana driver's license was Ronald Markt Nay. A subsequent all-asset secured party of Nay prevailed over the PMSI equipment lender because a standard search logic search in the office of the Indiana Secretary of State did not disclose the financing statement using the debtor's incorrect middle name. A good practice in filing on individual debtors is to use the precise name as it appears on the debtor's driver's license, even if there is a mistake on the license, and file as a second debtor the name using only the surname and the first personal name. This frequently satisfies the 9-506 standard of disclosure by a standard search logic search if there is a mistake made in using the name from the driver's license, or, should the debtor no longer holder a driver's license due to its expiration or revocation.

Rights in Collateral

First Dakota National Bank v. Gregg, 2021 WL 4202543 (S.D. 2021).

The South Dakota court held that a rancher who had a contract to feed cattle owned by his in-laws, and who was paid based on the weight of the cattle, did not have sufficient rights in the collateral to grant a security interest to his bank. Rights in the collateral, not ownership, is one of

the three requisites for attachment of a security interest in collateral. 9-203. These cases tend to be very fact intensive and can go either way. This case turned on the fact that the owners of the cattle had marked the cattle with a brand and ear tag. However, they did not file a bailor/bailee financing statement to notify potential secured parties of their ownership interest.

Strict Foreclosure 9-620

Stifano v. Slaga, 2021 WL 3627522 (Cal. Ct. App. 2021)

Strict foreclosure is a utilitarian remedy for secured parties that is seldom used. It involves a secured party sending a notice to its debtor, and to any other party secured by the same collateral, that it intends to accept the collateral in lieu of the debt, or, if a commercial debt, in lieu of a specified portion of the debt. The parties receiving that notice have 20 days to respond. If they do not, the secured party takes title to the collateral and the debtor is absolved of the debt or the specified portion of the debt. In this case, the debtor attempted to pay the secured party 23 days after receiving the notice. The court correctly ruled the attempt was too late.

Required Notices to a Debtor in Disposition of Collateral

Central Trust Bank v. Branch, 2021 WL 3159750 (Mo. Ct. App. 2021)

The second try doctrine has again raised its ugly head. The doctrine which existed for many years in Tennessee regarding notices of disposition of collateral, but has since been overruled by that state's courts, has reappeared in Missouri. The Missouri court held that if a secured party sends its debtor by certified mail the explanation of calculation of surplus or deficiency required by 9-616, but learns through return of the certified mail that the explanation was not delivered, it is required to take additional action to ensure receipt of the explanation by the debtor. When the secured party failed to do so, the court found it was a sufficient defense to the secured party's attempt to obtain a deficiency judgment for the balance owed following repossession sale.

A recommended procedure when sending notices of disposition, or the explanation of the deficiency, if sent by certified mail, is to send an additional copy by first-class mail. If the certified mail is returned as unclaimed, or for any other reason, but the copy sent by first-class mail is not returned, it creates a presumption that it was received.

SECTION B

CASE LAW FOR BANK COUNSEL

M. THURMAN SENN
Morgan Pottinger McGarvey
Louisville, Kentucky

M. Thurman Senn
Morgan Pottinger McGarvey
401 South Fourth Street, Suite 1200
Louisville, KY 40202
502-589-2780
mts@mpmfirm.com

Case Law For Bank Counsel

I. Introduction.

II. Covid And Insurance Coverage Under Commercial Property Insurance.

1. Santos Italian Café, LLC v. Acuity Ins. Co., ___ F.4th ___, 2021 WL 4304607 (6th Cir. 6/22/21).

a. Ohio restaurant that suffered losses because of Covid shutdown orders did not have coverage under its commercial property insurance policy, including its business interruption "additional coverage" because the damages were not "direct physical loss of or damage to Covered Property" and were not "caused by direct physical loss of or damage to property" at the restaurant.

b. One of many, many such lawsuits winding their way through the various state and federal courts.

III. Citibank's Battle Over Erroneous $893 Million Loan Payment Wire Transfer.

1. *In re Citibank August 11, 2020 Wire Transfers*, Case No. 21-487, U.S. Court of Appeals for the Second Circuit.

a. On August 11, 2020, Citibank, acting as Revlon's loan agent, wired $893 million in loan principal (using Citibank's own funds) to Revlon's lenders, appearing to prepay in full a loan not due until 2023. Citibank was implementing a "roll-up" transaction among some of Revlon's various lenders and had intended to send only a $7.8 million interest payment, and blamed human error for the excess payment. Some lenders returned the money, but 10 asset managers refused, leading to Citibank's lawsuit to recover the $501 million they received.

b. The U.S. District Court for the Southern District of New York ruled that the erroneous wire transfers by Citibank were "final and complete transactions, not subject to revocation". Decision followed a 6-day trial in December 2021 and was set out in a 101-page decision (2021 WL 606167) based upon a "discharge-for-value" affirmative defense under New York's common law doctrines relating to restitution. The trial court summarized the defense to an unjust enrichment claim as existing when the payment "discharges a valid debt, the recipient made no misrepresentations to induce the payment, and the recipient did not have notice of the mistake."

c. The claimed human error was, according to the District Court's findings, created in part "due to ... technical limitations of Citibank's system" which required Citibank's employees "to enter it in the system as if paying off the loan in its entirety, thereby triggering accrued interest payments to all Lenders, but to direct the principal portion of the payment to a 'wash account' — 'an internal Citibank account that shows journal entries . . . used for certain Flexcube transactions to account for internal cashless fund entries and . . . to help ensure that money does not leave the bank.'" Errors in implementing this process led to the excess payment. Those errors included a person who "checked off only the PRINCIPAL field, neglecting the FRONT and FUND fields" on the computer screens. Also, some members of the "team" that implemented the roll-up" were actually employees of Wipro Limited, an Indian entity that was hired to perform various back-office operations for Citibank.

d. Appeal of the S.D.N.Y's decision is pending.

e. One Lesson: Do your bank's software systems create risks that senior management do not fully appreciate?

f. Second Lesson: Do your bank's vendor contracts allocate responsibility appropriately and do the vendors have the resources to make good on mistakes of the magnitude they might make and be responsible for?

2. CFPB Enforcement Action -- California Auto And Interest On Loss Damage Waiver Fees.

a. In The Matter Of: 3rd Generation, Inc. d/b/a California Auto Finance, CFPB Administrative Proceeding, No. 2021-CFPB-003.

b. In subprime car financing program, customer agrees that if he/she fails to maintain required vehicle insurance, the seller will add a monthly loss damage waiver (LDW) fee. In the event of damage, seller will pay the repair cost and if there is a total vehicle loss, the debt is cancelled. According to the CPFB's "Consent Order", the California Auto Finance "internal system" adds the LDW fee to the unpaid principal, so the LDW fee effectively accrues interest. However, according to the CFPB's Consent Order, the CFPB contended that the sale paperwork does not adequately disclose that the LDW charge accrues interest.

c. CFPB contended that this practice was a violation of the federal Consumer Financial Protection Act of 2010, 12 U.S.C. §5531(c) and §5536(a), an unfair, deceptive or abusive act, and ordered California Auto to refund $285,744, pay a $50,000 civil money penalty, and engage in other remedial actions.

d. Question: was this practice "intentional" or the inevitable/unintended response of how California Auto's software system was structured/programed to administer any fee (or similar fees).

IV. Fannie And Freddie; CFPB Developments.

1. Collins v. Yellen, 141 S.Ct. 1761, 2021 WL 2557067 (6/23/2021).

a. The Court ruled 7–2 to uphold the Fifth Circuit's decision that, as with *Seila Law, LLC v. Consumer Financial Protection Bureau*, 140 S.Ct. 2183 (2020) and the CFPB's director, the inability for the President to terminate the director of FHFA beyond "for cause" was unconstitutional.

b. Related to the standing of the Fannie Mae and Freddie Mac shareholders to challenge the decision of the FHFA to route ongoing profits earned by Fannie Mae and Freddie Mac to the U..S Treasury Department, the Court was unanimous in that the FHFA's actions in taking over the GSEs was outlined by congressional authority in the Housing And Recovery Act of 2008, along with an "anti-injunction clause", and thus the lower courts should not have allowed their case to proceed.

2. Consumer Financial Protection Bureau's New Director.

a. By a 50-48 party line vote on September 30, 2021, the U.S. Senate confirmed Rohit Chopra as CFPB Director.

b. Mr. Chopra helped establish the CFPB following its creation through the Dodd-Frank Act and served as an Assistant Director at the CFPB from 2010 to 2015. He was also the agency's first student loan ombudsman from 2011 until his departure in 2015. Pundits predict that under Mr. Chopra's leadership, the CFPB will likely return to the vigorous use of its authority to promulgate rules, conduct examinations, and bring enforcement actions that it was known for under its first Director, Richard Cordray. The rules are expected to involve (1) relief for consumers facing

hardship due to COVID-19 and the related economic crisis and (2) racial equity. The industry focus is predicted to be the housing, auto finance, small dollar lending, small business lending, and student lending markets.

c. Mr. Chopra's confirmation clears the way for the White House to move forward on President Biden's nomination of Alvaro Bedoya to fill Mr. Chopra's seat as FTC Commissioner and on the President's nomination of Acting CFPB Director Dave Uejio to serve as Assistant Secretary for Fair Housing and Equal Opportunity at the Department of Housing and Urban Development.

V. Forbearance Agreements.

A. Lockoodd Int'l, Inc. v. Wells Fargo, N.A., 2021 WL 3624748 (5th Cir. 8/16/2021)

1. Provisions of two forbearance agreements precluded loan guarantor from avoiding guaranty based upon claims of fraudulent inducement, duress, unclean hand, and equitable estoppel.

2. Good language in response to "duress" argument:

> "No doubt Lockwood feared the looming prospect of the banks' demanding the tens of millions of dollars that he and his companies owed. The banks used that leverage to seek something they wanted … But using leverage is what negotiation is all about. And difficult economic circumstances do not alone give rise to duress. It they did, then many loans would be voidable…. Opportunities to modify – and potentially stave off financial disaster – would be few and far between if a borrower could later void the modification because of the economic pressure that prompted it in the first place."

See Lockwood, slip. op. at p. 7.

3. See also Keeney v. Billy Trent Construction, LLC, 62 S.W.3d 162 (Ky.App. 2019). Settlement agreement entered into immediately after trial court entered directed verdict against plaintiff was not avoidable on the basis of "duress". Entry of a directed verdict did not rise to "fear of great injury to person" sufficient to constitute duress to avoid a contract.

B. Twiford Enterprises, Inc. v. Rolling Hills Bank & Trust, 2021 WL 2879126 (10th Cir. 7/9/2021).

1. Waiver and release provisions in debt modification and forbearance agreements precluded borrowers from prevailing on their arguments that the lender misled them to refinance their real estate loans with the defendant bank.

C. Moore v. PCG Credit Partners, LLC, No. 2018-CA-1754 (Ky.App. 2/21/2020) (not to be published).

1. Affirming trial court's grant of summary judgment against personal guarantors of loan to purchase a hotel and restaurant. That the lender could not produce a forbearance agreement executed by all the parties did not prevent enforcement of the guaranties because KRS 371.010 only requires that the contract be signed by the party to be charged, and the guarantors signed.

VI. Various Kentucky Cases.

A. Bank Mergers. Paul Parshall v. Kentucky Bancshares, Inc., et al., U.S. District Court, Eastern District of Kentucky, Central Division, Case No. 5:21-cv-00108-REW.

1. Lawsuit, purportedly as a class action, challenging merger of Kentucky Bancshares, Inc. and Stock Yards Bancorp., Inc. and alleging misleading proxy statement and alleged director breaches of fiduciary duty.

2. Plaintiff voluntarily dismissed the lawsuit on May 25, 2021.

B. Settlement Agreements; Severance Payments. United States Liability Ins. C. v. Watson, 626 S.W.3d 569 (Ky. 2021).

1. Dram shop lawsuit filed in 2009. Statute of limitations on insurance bad faith claim depended upon when the litigants settled the underlying dispute. The Court described why it took the case:

> "[B]ecause settlement agreements occur regularly across the breadth of civil litigation their binding nature, their enforceability, is of considerable significance beyond just bad faith insurance cases. Consequently, in a larger sense this case is about what constitutes a binding settlement agreement between adverse litigants, an issue of immense concern to our civil justice system." Slip op. at p. 13.

2. The settlement process at issue:

> "The record reflects that Watson made an initial settlement demand for a sum in excess of the USLI policy limits in June 2011 but negotiations did not begin in earnest until a year later, June 2012. In a June 11, 2012 faxed letter Watson's counsel made Pure Country's counsel an "offer to settle the case" in which Watson agreed to release his claims in exchange for the remaining USLI liability policy limits. The offer was to remain open until June 19, 2012. USLI accepted Watson's offer, confirmed in a June 13, 2012 email from Watson's counsel discussing settlement language and medical liens. On July 30, 2012, Pure Country's counsel sent a written release and confirmation of the settlement amount to Watson's counsel. At that point, an agreement existed and, as USLI accurately notes, 'the parties stopped litigating.'"

3. The following language in the opinion bears some discussion:

> "As we noted in *Frear v. P.T.A. Industries, Inc.*, 103 S.W.3d 99, 105 (Ky. 2003), "'settlement agreements are a type of contract and therefore are governed by contract law.'" (Citing 15 Am. Jur. 2d, Compromise and Settlement § 9 (2000)). A formal written document is not required because "it has long been the law of this Commonwealth that the fact that a compromise agreement is verbal and not yet reduced to writing does not make it any less binding." *Motorists Ins. Co.*, 996 S.W.2d at 445. Frequently parties settle a case pretrial through verbal exchanges, in person or by phone, through the exchange of letters or emails, or by a combination of the foregoing. Lawyers and judges alike are familiar with settlements "on the

> courthouse steps," literally settlements reached just before trial starts, or even settlements reached during a trial recess. Often these settlements are not reflected in a formal written document signed by all affected parties but are established by the facts, e.g., the parties' phone calls and emails. To determine if the parties actually reached a settlement agreement courts look to the parties' negotiations. *See, e.g., General Motors Corp. v. Herald*, 833 S.W.2d 804 (Ky. 1992)." Slip op. at pp. 13-14.

and

> "This analysis [of the Court of Appeals as to when the settlement was reached" ignores longstanding Kentucky law which holds that mutual promises can, and often do, constitute the necessary consideration; the subsequent exchange of money and signing of a written release is simply the implementation of the agreement previously reached." Slip op. at p. 15.

4. Dissent by Lambert: would "hold that the determinative date for calculation of the statute of limitations was the date of the completion of the contract, i.e., the payment of the consideration."

5. Issue For Bank counsel: In making settlement offers, how important is having an executed written settlement agreement and/or delivery of the settlement funds and/or other conditions satisfied in order for there to be a "settlement"? The negotiation emails/texts/letters had better make that clear.

C. Enforcing Promissory Notes.

1. **Lost Promissory Note.** House v. Deutsche Bank National Trust As Trustee For WAMU Series 2007-HE1 Trust, 624 S.W.3d 736 (Ky.App. 2021).

a. Typical secondary mortgage loan foreclosure case. In 2006, Mr. House executed a $303,000 promissory note payable to Washington Mutual Bank, and he and his wife executed a mortgage on the subject real property. In 2007 or 2008, Deutsche Bank becomes transferee of note and assignee of the mortgage, and the assignment is recorded in 2008, but WaMu remains as service. In 2008, WaMu goes out of business and JP Morgan Chase Bank becomes it successor. The Houses claim that Chase become the owner of the loan. Deutsche Bank claims it is the owner as trustee and Chase is just the loan servicer. Between 2008 and 2012, the Houses enter into various modification agreements which are ultimately unsuccessful and Deutsche Bank commences a foreclosure action in 2014.

b. The Houses defend on the basis that Deutsche Bank does not have standing to sue and insisting that Deutsche Bank produce the original promissory note. Deutsche Bank admits that it does not have possession of the original promissory note, and claims it is a lost promissory note which can be enforced under KRS 355.3-309.

c. Ultimately, Deutsche Bank prevailed at Circuit Court level and an order of sale was entered. The Houses appealed.

d. Holding #1: Deutsche Bank was a "person entitled to enforce" the note under KRS 355.3-301 because it satisfied the "lost instrument" provisions of KRS 355.3-309.

i. To meet the threshold, Deutsche Bank had to "demonstrate that it had obtained possession of the promissory note that was appropriately indorsed by Washington Mutual when loss of possession occurred."

ii. Deutsche Bank's affidavit attesting to this could not be rebutted by the Houses when their affidavit was a submittal of hearsay statements allegedly made by a Chase Bank representative.

e. Holding #2: Deutsche Bank satisfied the requirements of KRS 355.3-309 which states:

> "(1) A person not in possession of an instrument is entitled to enforce the instrument if:
> (a) The person seeking to enforce the instrument:
> 1. Was entitled to enforce the instrument when loss of possession occurred; or
> 2. Has directly or indirectly acquired ownership of the instrument from a person who was entitled to enforce the instrument when loss of possession occurred;
> (b) The loss of possession was not the result of a transfer by the person or a lawful seizure; and
> (c) The person cannot reasonably obtain possession of the instrument because the instrument was destroyed, its whereabouts cannot be determined, or it is in the wrongful possession of an unknown person or a person that cannot be found or is not amenable to service of process.
> (2) A person seeking enforcement of an instrument under subsection (1) of this section must prove the terms of the instrument and the person's right to enforce the instrument. If that proof is made, KRS 355.3-308 applies to the case as if the person seeking enforcement had produced the instrument. The court may not enter judgment in favor of the person seeking enforcement unless it finds that the person required to pay the instrument is adequately protected against loss that might occur by reason of a claim by another person to enforce the instrument. Adequate protection may be provided by any reasonable means."

f. Holding #3: Deutsche Bank satisfied the "adequate protection" requirement of KRS 355.3-309(2) by submitting an affidavit in support of its motion for summary judgment that it would indemnify the Houses against "all losses, [and] damages" arising from any breaches of the representations set forth in the lost note affidavit.

2. **Recovering Your Attorneys' Fees.** Key v. Mariner Finance, LLC, 617 S.W.3d 819 (KyApp. 2020).

a. Lender files collection lawsuit to collect unpaid balance of $6,757.12 on promissory note plus costs of collection, including reasonable attorneys' fees. Lender's attorney was hired on a one-third contingency fee basis. Borrowers defaulted, and the Circuit Court entered a tendered default judgment which awarded the $6,757.12 plus an attorneys' fee award of $2,229.85. Lender then began garnishing wages of judgment debtor. Borrowers then hired lawyers who moved

to set aside the default judgment. Circuit court refused to set aside the default, but did amend the judgment to conform the judgment interest rate to that demanded in the complaint.

b. On appeal, the debtor sought to have the award of attorneys' fees vacated and the case remanded for a hearing on the attorney fee. The Court of Appeals held that the motion stating that the lender had referred the claim "to outside counsel … upon a contingency basis of 33.3%" was not a sufficient support for a $2,229.85 award for the following reasons:

> "Based on the Court's calculation, 33.3% of $7,129.65 (the amount financed) would total $2,374.17, while 33.3% of $6,757.12 (the amount due based on Mariner Finance's complaint) would total $2,250.12. Neither of these figures equals $2,229.85. And, the tendered judgment, which the circuit court entered without any changes, similarly failed to address if it was reasonable under the circumstances or how the $2,229.85 figure was derived."

c. The Court of Appeals also wrote:

> "The Keys did not agree to a specific percentage contingency fee or a liquidated amount for attorney's fees in the event they defaulted. Mariner Finance and its attorney, presumably, selected the one-third contingency fee amount. That agreement was independent of the Keys and may have been based on considerations other than the value of the services rendered. Certainly, a contingency fee may be reasonable when *deducted* from a client's recovery. However, in this case, the one-third contingency fee is being *added* to the debtor's judgment without objective evidence of reasonableness."

d. Court of Appeals held that "the circuit court should have required Mariner Finance to demonstrate that the one-third contingency fee was not excessive and that it accurately reflected the reasonable value of the bona fide legal expenses incurred." Case remanded for such findings.

e. Lesson #1: Do you need to re-work the attorney fee affidavits you file?

3. **Abusive Civil Litigation; Suing The Litigant's Attorney.** Seiller Waterman, LLC v. RLB Properties, Ltd., 610 S.W.3d 188 (Ky. 2020).

a. Law firm represented builder in dispute over alleged defective repairs of building, and law firm's work included preparing and filing a mechanic's lien. After law firm was permitted to withdraw from representing builder, property owner prevails against builder and then sues law firm and three of its attorneys on a litany of causes of action: wrongful use of civil proceedings; abuse of civil process; civil conspiracy; slander of title; violation of KRS 434.155 (criminal statute for filing illegal lien); negligence and negligent supervision.

b. On appeal, Kentucky Supreme Court addressed in several respects when a prevailing party in civil litigation may sue the losing party's attorney.

c. Holding #1: A professional negligence action may not be brought against an attorney by a person who is neither the client nor an intended third-party beneficiary of the attorney's work.

d. Holding #2: When pleading a wrongful use of civil proceedings claim (sometimes incorrectly called "malicious prosecution") against an attorney or law firm, an allegation that the law firm acted improperly in order to earn legal fees is insufficient "malice" to support the claim. Also, lack of probable cause to bring the action is a separate test from having an "improper purpose".

i. The example of an "improper purpose" quoted by the Court and set out in Comment d to Restatement Of Torts §674 would be the following: "for example, to put pressure upon the person proceeded against in order to compel payment of another claim of his own or solely to harass the person proceeded against by bringing a claim known to be invalid".

ii. An example of what would be permitted from the same Comment d would be: "An attorney is not required or expected to prejudge his client's claim, and although he is fully aware that its chances of success are comparatively slight, it is his responsibility to present it to the court for adjudication if his client so insists after he has explained to the client the nature of the chances."

e. Holding #3: The one-year limitations period of KRS 413.245 "applies to *any* civil action against an attorney arising out of any act or omission in rendering or failing to render professional services without regard to the identity of the claimant." (court's emphasis).

4. **Practice Sound Litigation.** Cook v. Radtke, 598 S.W.3d 593 (Ky.App. 2020).

a. Complicated lawsuit among members of limited liability company fighting over losses the company incurred on unsuccessful real estate development projects that failed during the 2008 house bubble bust. Part of the dispute related to failures of certain litigants to pay "Subordinated Promissory Notes", but the creditors. pleadings did not expressly refer to some of the makers being liable for repayment of the notes. Court of Appeals reversed the trial court's judgment against those makers.

b. Lesson: make sure your pleadings refer to all of the rights/claims/defenses you intend to litigate.

D. Real Property.

1. **Ad Valorem Tax Lien Notices.** Pleasant Unions, LLC v. Kentucky Tax Co., 615 S.W.3d 39 (Ky. 2021).

a. In a dispute over whether the purchaser of unpaid *ad valorem* tax bill presented sufficient proof of mailing statutory required notices under KRS 134.490, the affidavit of the Kentucky Tax Company's attorney was insufficient proof to justify granting summary judgment in favor of tax bill purchaser.

b. Kentucky Supreme Court holds that phrase "notices shall be sent … by first-class mail with proof of mailing" in KRS 134.490(1) and (2) to establish a rule that the tax bill purchaser must be able to prove actual mailing.

i. In dicta, the Court indicated that certified or registered mail would work since they provide proof that the piece of mail was presented to the USPS for mailing.

ii. In dicta, the Court also indicated that an affidavit from the person who actually placed the notice in the mail would be sufficient.

iii. In this case, the tax bill purchaser presented the affidavit of its attorney which only stated that, on the dates of the letter, "he caused" the notices "to be sent by first-class mail." The Court found the affidavit to be insufficient because the affidavit did not "offer proof of a standard office mailing procedure designed to ensure that the notices are properly addressed and mailed by first-class mail, sworn to by someone with personal knowledge of the business procedure, as well as proof of compliance with that regular business procedure in the specific instance.

iv. The case was remanded for further evidence as to the proof of actual sending of the notices.

2. **Mortgagee's Interest In Mortgagor's Claims Against Contractors That Allegedly Failed To Properly Construct A Residence On The Mortgaged Property.** Salyersville National Bank v. Russell, No. 2020-CA-0208 (5/14/21) (to be published) (motion for discretionary review filed 6/11/21; 2021-SC-0209).

a. Property owners financed construction of house with loan secured by mortgage on the real property on which the house was built. House foundation was allegedly defectively constructed resulting in a total loss to the building. Bank claimed (a) to have a right to have the mortgagors assign their construction defect claims to it, and (b) to have a lien and/or equitable trust interest in any recovery from the contractors.

b. Mortgagee lender has an equitable trust interest in any recovery by the mortgagors from the contractors. Citing Grafton v. Shields Mini Markets, Inc., 346 S.W.3d 306 (Ky.App. 2011).

c. Language of the mortgage requires the assignment by the mortgagors to the lender of their claims against the contractors.

3. **Foreclosure ; Manufactured Housing.** Wright v. Miller, __ S.W.3d. ___, 2021 WL 1230183 (Ky.App. 4/2/21) (to be published).

a. Dispute over who owned a 1973 Glen house trailer between (1) Mr. Wright, who purchased the underlying land from the purchaser of the land at a foreclosure sale, and (2) Mr. Miller, who purchased the trailer from the debtor in the foreclosure sale who obtained a duplicate certificate of title for the house trailer and transferred the title to Mr. Miller for nominal consideration.

b. Because the statutory process under KRS 186A.297 were not followed to make the manufactured home a part of the underlying real property, the house trailer remained personal property and the owner listed on the active certificate of title prevails. The statutory process established in 2000 for affixing a manufactured home to real property even applied to a manufactured home built and placed on land before 2000.

c. Fact that holder of certificate of title only paid nominal amount for the trailer is not a defense under the facts of the case.

4. **Mortgages; Litigation In Multiple Counties.** Lawrence v. Bingham Greenebaum Doll, L.L.P., 599 S.W.3d 813 (Ky. 2019).

a. Law firm had standing to bring a mortgage foreclosure lawsuit in the county in which the mortgage property was located (Gallatin) even though it had also filed a counterclaim based upon the underlying note in a different county (Kenton) in a malpractice lawsuit

filed against the law firm. Mortgage was given to secure repayment of the law firm's legal fees handling a criminal tax evasion matter.

b. Good summary of Kentucky law for lenders to rely upon:

> "[W]ell-settled . . . case law permits lenders to bring separate enforcement actions on [a] mortgage and [a] note. A note and a mortgage given to secure it are separate instruments, executed for different purposes, and an action for foreclosure of the mortgage and upon the note are regarded and treated, in practice as separate and distinct causes of action, although both may be pursued in a foreclosure suit. Even when a promissory note is incorporated into the mortgage, it is still independent of the mortgage and is a separate enforceable contract between the parties, and logically, even when a mortgage is incorporated into a promissory note, the note remains independent of the mortgage and is a separate, enforceable contract between the parties." In sum, a "mortgagee is allowed to choose whether to proceed on the note or guaranty or to foreclose upon the mortgage. These remedies may be pursued consecutively or concurrently.
>
> This rationale also works to reject Lawrence's argument that Bingham's claims were impermissibly split. Additionally, "the rule against splitting causes of action is an equitable rule, and it is subject to a number of exceptions." One of the exceptions to the general rule against claim splitting identified by the Restatement is when the claimant "was unable ... to seek a certain remedy or form of relief in the first action because of . . . restrictions on [the court's] authority to entertain multiple . . . demands for multiple remedies or forms of relief in a single action[.]"

c. Another lesson: sometimes it is a good decision <u>not</u> to take a case or <u>not</u> to make a loan.

5. **Boundary Dispute.** <u>Hogg v. Hogg</u>, 619 S.W.3d 921 (Ky.App. 2020).

a. Substantial evidence supported trial court's finding as to the boundary of land described in a deed as follows:

> "BEGINNING on a point in the center of Big Bottom Branch, approximately 125 feet, East of Big Bottom Branch's intersection with Kings Creek; thence up the hill some Southerly course to an iron pin; thence some easterly course around the hill to an iron pin; thence down the hill some Northerly course to a point in the center of Big Bottom Branch; thence down said Branch as it meanders to the BEGINNING; containing one acre more or less."

b. Remaindermen having interest in land after expiration of life tenancy had power to grant an easement which only became effective once the life tenancy expired.

c. By virtue of a recorded deed in the chain of title, party challenging the easement had constructive notice of its existence and was bound by it.

6. **Boundary Dispute.** <u>Bishop v. Brock</u>, 610 S.W.3d 347 (Ky.App. 2020).

a. Landowners believed that gravel road traveling to their house was on their property which they purchased in 1988, and they treated as their property (including making improvements to the road) and being a boundary of their land. When adjoining property owner surveyed the property, the surveyor concluded that the boundary line was such that the gravel road was entirely on the adjoining property owner's land. An action for adverse possession was filed.

b. Users of gravel road had requisite intent to claim the land as their own when they believed the land was their own. Also, "it is well-established that if adjoining landowners occupy their respective premises up to a certain line which they mutually recognize and acquiesce in for a long period of time — usually the time prescribed by the statute of limitations — they are precluded from claiming that the boundary line thus recognized and acquiesced in is not the true one."

7. **Call Before You Dig.** Frankfort Plant Bd. v. BellSouth Telecommunications, LLC, 610 S.W.3d 315 (Ky.App. 2020).

a. Property owner's failure to "call before you dig" in violation of KRS 367.4911 constituted "negligence per se" justifying granting summary judgment in favor of easement owner whose buried telephone facilities were damaged.

b. Trial court did not abuse its discretion in refusing to award prejudgment interest as the easement holder's damage claim was an "unliquidated claim" even though the parties stipulated as to the amount. Stipulating to the damages amount does not make the damages liquidated because without the stipulation there would need to hear expert testimony as to the amount of the damages. It is the nature of the claim not the final award that determines whether a claim is liquidated or unliquidated.

i. But see Arete Ventures, Inc. v. University of Kentucky, 619 S.W.3d 906 (Ky.App. 2020). Cost University of Kentucky paid to remedy defective construction of equine barn was liquidated because no dispute as to how much it actually paid, and the trial court properly awarded prejudgment interest).

8. **Subdivision Roads.** Elkins v. Western Shores Property Owners Assn., Inc., 616 S.W.3d 721 (Ky.App. 2021).

a. When subdivision roads were not properly completed by the developer, Homeowner's association for the subdivision sues, and includes as defendants various members of Calloway County government in their individual capacities for mistakes that resulted in the surety bonds expiring and for the county refusing to accept responsibility for completing the unfinished roads.

b. Government defendants were not protected by qualified official immunity because various of the mistakes involved ministerial duties relating to road construction bonding.

c. Related Question: When your bank issues a letter of credit to secure a road or other bond, how does your bank deal with potential changes in credit worthiness of the bond principal over the life of the project? In Elkins, the first bond was issued in April 2006, but the road work was still not completed by April 2010, when the bonds were allowed to lapse. Lawsuit over unfinished roads was not filed until September 2018.

d. Related Observation: This case appears to be continuing fallout from the Housing Bubble burst in the 2006-2008 era. How long will Covid fallout last?

9. **Tax Assessments.** Kroger Ltd. Partnership I v. Boyle County P.V.A., 610 S.W.3d 332 (KyApp. 2020).

a. Kroger prevails in its challenge to PVA's assessment of property containing a supermarket of $5.5 million, and PVA directed to set assessed value at value of Kroger's expert of $2.850 million. PVA's tendered evidence was hearsay evidence insufficient and inadmissible to rebut Kroger's evidence when Kroger challenged the PVA's evidence.

10. **Harm To Invitees.** Wal-Mart, Inc. v. Reeves, 2021-SC-0288 (motion for discretionary review pending).

a. Court of Appeals reversed trial court's dismissal of lawsuit against property owner where business invitee was criminally attacked in the store parking lot. Court of Appeals held that the decision of whether it was reasonably foreseeable that this type of criminal activity would occur was a factual issue not a legal issue.

11. **Boundary Dispute; HOA Deed Restrictions.** Phillips v. Rosquist, 628 S.W.3d 41 (Ky. 2021).

a. Unsuccessful challenge by property owner to adjacent land owner's excavation of the two lots to change lake shoreline so as to improve access to lake bordering the property. Property owner purchased his lot seven years after the excavation, learned of it one year after his purchase, and waited four more years to sue.

b. Plaintiff did not have standing to pursue his claim to submerged land because title to him never passed to Plaintiff under his deed. Discussion of interpretation of a deed, plats and legal descriptions, and how the lake lines bear upon rights transferred to Plaintiff.

c. Defendant violated subdivision restrictions by his excavation without HOA approval, but Plaintiff was not entitled to an equitable remedy of enforcement of them because Plaintiff purchased his lot knowing of the lake's boundary lines and waited four years after learning of the excavation to sue.

d. Court of Appeals judge who lived in the subdivision in question and whose wife served on the subdivision HOA should have recused him.

E. Landlord-Tenant.

1. **Tenant's Abandoned Property #1.** C&H Manufacturing, LLC v. Harlan County Industrial Development Authority, Inc., 600 S.w.3D 740 (Ky.App. 2020).

a. In 2007, commercial business tenant ceases operations and leaves equipment behind at leased premises. Premises are re-leased to new tenant who uses some, or all, of the equipment. In 2017, former tenant sues landlord and new tenant for conversion of its equipment. Also, sues for new tenant conversion of the proceeds of a utility refund check.

b. Court of Appeals holds that no valid conversion case because equipment was abandoned by old tenant.

c. Old tenant has no conversion claim for the proceeds of the refund check under KRS 355.3-420 because it was never in possession of the check.

2. **Tenant's Abandoned Property #2.** Ndzanga v. Providence Hill, LLC, 2021-SC-0304 (motion for discretionary review pending).

a. Issue: What is to be done with tenant's property left in the premises as part of a successful forcible detainer?

b. In a residential lease default case in a jurisdiction that has not adopted the Kentucky Uniform Residential Landlord And Tenant Act, Court of Appeals, in an unpublished opinion, affirmed the Circuit Court's ruling that (1) tenant breached lease and owed landlord for two month's rent of $2,610, but (2) landlord converted tenant's household property left behind and taken out to sidewalk by landlord at time of sheriff's set-out and owed damages of $17,570.

c. Relied heavily on OAG-82-553 which states (as quoted by the Court of Appeals):

> "[T]he landlord must give notice to the tenant to remove the personal property and a reasonable time in which to so remove the goods. It is suggested that the landlord act cautiously so as to avoid potential liability for conversion. One such cautious measure would be to provide notice which is reasonably calculated to inform the tenant, which under the circumstance may be by certified mail, return receipt requested. . . . If the tenant fails after notice to remove the personal property, the landlord may cause its removal in a reasonable manner. . . . The personal property may be stored, such as in a storage area on the landlord's premises or in a warehouse, until it is claimed by the tenant or until the property is abandoned."

d. Question #1: What does the lease say about personal property left behind?

e. Question #2: What does the Forcible Detainer Judgment say? AOC-217 (Rev. 3-12) says: "Defendant(s) are ordered to vacate said property within 7 (seven) days of the entry of this Judgment". Is this enough protection for landlord? Not argued by landlord in the Providence Hill case.

3. **Who Can Sign Forcible Detainer Complaint?**. Meinshausen v. Friendship House Of Louisville, Inc., 607 S.W.3d 199 (Ky.App. 2020).

a. Court of Appeals (Judges Maze, Dixon, Clayton) orders dismissal of forcible detainer complaint that was signed by property owner's "Interim Housing Manager" who was not an attorney. The housing manager is engaging in the unauthorized practice of law by doing so, and this renders the complaint legally insufficient. Cites to Hornsby v. Housing Authority Of Dry Ridge, 566 S.W.3d 587 (Ky.App. 2018) (Judges Dixon, Acree, Thompson)

4. **Lease Renewals.** Cinque v. Lexington Village, LLC, 609S.W.3d 30 (Ky.App. 2020).

a. Kentucky college students sign 1-year lease which contains an automatic renewal provision (although somewhat ambiguous) providing for automatic renewal unless either landlord or tenants provide advance notice of intention not to renew not less than 120 days before the end of the lease (which lease ended 7/31/2017). The 120-notice provision would require a notice given before April 2, 2017. Despite this, Landlord sends emails to students saying that the deadline for renewal is 10/24/2016 and saying that if tenants don't return a signed lease in October 2016, the landlord "would begin marketing your property." When students did not sign a lease in October 2016 or give a formal non-renewal notice before April 2, 2017, the Landlord filed a lawsuit to collect rent.

b. Court of Appeals holds that Landlord's emails amount to a notice of non-renewal prior to April 2, 2017, such that Landlord's lawsuit was properly dismissed.

c. Court of Appeals also held that trial court abused its discretion in not setting aside a default judgment against one of the students (from Ohio) who did not receive actual notice of the lawsuit through Secretary of State long-arm service under KRS 454.210.

d. Lesson #1: Are you reading the leases your college age children are signing? Calendaring your file?

e. Lesson #2: When leases that your bank clients are entering into (for example, for a branch) have a renewal provision or some other right triggered by giving notice (purchase option), is the bank properly calendaring its file?

F. **Joint Checking Accounts.** Wheeler v. Layton, 617 S.W.3d 830 (Ky.App. 2021).

1. Husband and wife divorce and divorce decree is entered on March 30, 2017. At the time of the divorce, they had a joint checking account at Central Bank. No change was made to the account after the divorce. Ex-husband commits suicide on June 5, 2017. At his house was a $70,000 check drawn on the account, signed by the ex-husband and payable to Suzanne Wheeler, whose relationship to ex-husband is not clear from the Court of Appeals' opinion. Suzanne sues ex-wife seeking to recover the amount of the $70,000 check.

2. Court of Appeals holds that under the Kentucky Multiple Party Accounts statute, KRS 391.315(1) and the account rules and regulations for the account, the ex-wife is the owner of the sums in the joint checking account. Also, Suzanne cannot sue to enforce the check because it was an incomplete gift on account of it never being never delivered to her. The death of the drawer of a check not delivered operates as a revocation of the check. Any claim that Suzanne might have to be paid $70,000 would be a claim against the ex-husband's account.

a. Lesson: make sure that bank account rules for joint checking accounts dovetail with the Kentucky Multiple Party account statutes (KRS 391.300 to KRS 391.355), and this should particularly include provisions addressing the right to set-off against the balance in the account.

3. In their separation agreement, ex-husband was to acquire sole ownership of the marital residence, but the was no quitclaim deed from ex-wife recorded before the ex-husband's death. Court of Appeals also held that Suzanne did not have any claim against ex-wife concerning the house jointly owned by the ex-husband and ex-wife before the divorce because Suzanne was not a third-party beneficiary of the divorce separation agreement. She might have a claim against the ex-husband's estate if it is determined that ex-husband's estate had an interest in the house after his death.

a. Lesson: implement a separation agreement as soon as possible.

G. Trusts And Estates.

1. **Trust Termination.** Garland v. Miller, 611 S.W.3d 275 (Ky. 2020).

a. Three children of Jerry Garland each inherited one-third of their father's stock in G&M Oil Co. One of the children (Becky Garland Carr) placed her stock in an irrevocable trust naming her brother (Jerry Garland II) as trustee. Apparently, Becky tired of the stock being controlled by her brother, and she filed a petition to terminate the trust. The petition was supported by Becky and all the trust beneficiaries but opposed by Jerry, the trustee, who argued that Becky should not be allowed to terminate the trust. He argued the trust needed to be maintained

because it was intended to protect control of the oil company if Becky were to get divorced and to maintain family control and experienced leadership in the operation of the oil company.

b. Kentucky Supreme Court discussed whether Becky could terminate the trust under one of two trust termination statutes: KRS 386B.4-110(1) and KRS 386.4.110(2) which state:

> "(1) Except as otherwise provided in the terms of the trust, a noncharitable irrevocable trust may be ... terminated upon consent of the settlor and all beneficiaries, without court approval, even if the ... termination is inconsistent with a material purpose of the trust….
>
> (2) A noncharitable irrevocable trust may be terminated upon consent of all of the beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust...."

c. The Court refused to permit termination under KRS 386B.4-110(1) because the "except as otherwise provided in the terms of the trust" control when the trust expressly provided that it was irrevocable. In reaching this conclusion, the Court noted that the "Except as otherwise provide" clause is not a part of the Uniform Trust Code and Kentucky is the only state that has added this language.

d. The Court permitted termination under KRS 386B.4-110(2) because the "material purpose of the trust" as stated in the trust was "to provide for the convenient administration of the assets of Becky Garland Miller without the necessity of court supervision in the event of the Trustor's incapacity or death." However, because the Trust did not include various schedules which would have specified where distributions upon settlor's death would go, upon her death, the trust assets would be distributed to the settlor's estate leading to an inevitable probate. Thus, "a result of these provisions, the Trust would not have served to conveniently administer Carr's assets at her death. Whether by design or inartful drafting, the Trust deferred to Carr's will for the distribution of her assets upon her death."

i. Court refused to consider the "purposes" of the trust presented by the brother/trustee because they were not stated in the trust and were inconsistent with the stated purpose. Had there not been a statement of purpose, the Court might have allowed parol evidence citing Best v. Melcon, 210 S.W. 662, 666 (1919); Fidelity & Columbia Trust Co. v. Gwynn, 268 S.W. 537, 538 (1925).

2. **Lawsuit Revival After Death.** In re Estate Of Benton, 615 S.W.3d 34 (Ky. 2021).

a. Executor properly revived a lawsuit by the decedent alleging that a deed from the decedent was procured by fraud and without consideration.

b. "Simply stated, the interplay between CR 25.01, KRS 395.278, and KRS 411.140 is that when a party dies, any action may be revived by substituting the personal representative, CR 25.01, within one year of the date of death, KRS 395.278, except for those actions listed in KRS 411.140 which do not survive the deceased's death, e.g., slander, libel, etc." Benton, 615 S.W.3d at fn. 19.

3. **Reaching Non-Probate Assets.** Bewley v. Heady, 610 S.W.3d 352 (Ky.App. 2020).

a. Decedent murders his ex-wife. Decedent dies having both probate assets and non-probate assets (an annuity and two pay-on-death brokerage accounts). Estate of ex-wife sues seeking to have a constructive trust imposed upon the non-probate assets so that they are paid to the estate of the ex-wife, and ultimately her children as her heirs. An alternative, but similar argument, was that the recipients of the non-probate assets would be unjustly enriched if they were allowed to acquire the assets while the heirs of the murdered ex-wife did not receive them.

b. Trial court correctly refused to impose a constructive trust or to find a viable unjust enrichment claim.

c. Murder's children were not unjustly enriched at the expense of the estate of the murderer because the non-probate assets were never part of the decedent's probate estate. Nor did the murder's children acquire the non-probate assets in any unjust way justify relief because they did not act wrongfully and the non-probate assets pre-existed the death of the ex-wife and were not created by the wrongful act.

4. **Proof Of Status As Decedent's Child.** Tucker v. Tucker, 623 S.W.3d 142 (Ky.App. 2021).

a. In child support proceeding, DNA tests proved that child born during the Tuckers' marriage was not the child of the husband. When husband died intestate, child sued to be declared an heir.

b. Prior child support proceeding was *res judicata* as to the child not being the issue of the decedent so his claim to be an heir was deficient. Also, Kentucky does not recognize a claim for "equitable adoption," and arguments of the child to be treated as an heir based upon the decedent treating the child "as his son" were insufficient.

5. **Will Contests.** Boone v. Hoskins, 613 S.W.3d 45 (Ky.App. 2020).

a. Daughter filed suit to challenge her mother's will for lack of testamentary capacity and/or undue influence by another daughter of decedent. Daughter's challenge was rejected on the basis that she did not present sufficient evidence of lack of testamentary capacity or undue influence.

b. The decedent's will had a "no-contest" provision which both the trial court and the Court of Appeals found to be enforceable against the daughter who brought the unsuccessful challenge to the will.

6. **Anti-Lapse; Documents Not Amounting To A Will.** Willett v. The Estate Of Frances J. Vessells, 2020-CA-0272, 2021 WL 3008734 (7/16/2021) (to be published).

a. Decedent's will was ineffective when it named as the sole beneficiary the decedent's husband who predeceased her and left no issue.

i. The anti-lapse statute of KRS 394.400 is of no assistance as it only applies if the devisee or legatee who predeceases the testator had issue.

b. Various other documents of the decedent's which discussed disposition of her property upon her death were not sufficient to constitute a valid will because the decedent did not sign them at the end of the document. See KRS 394.040 (not requiring a witness if entirely in the decedent's handwriting and "subscribed thereto"); KRS 446.060 (requiring signature "at the end or close of the writing").

7. **Mandy Jo's Law.** Simms v. Estate Of Brandon Michael Blake, 615 S.W.3d 14 (Ky. 2021).

a. Mandy Jo's Law (KRS 391.033 and KRS 411.137) prevented biological father from recovering an intestate share of the settlement proceeds of the wrongful death lawsuit following the death of his son. Trial court's finding that the biological father willfully abandoned the care and maintenance of his son was not clearly erroneous.

b. Trial court erred in refusing to remove child's mother and her husband (not the biological father) as co-administrators of the child's estate, but error was moot because there was no challenge to the underlying wrongful death lawsuit and the appeal would dispose of the proceeds of the settlement.

H. Business Matters.

1. **Dispute Over Computer "Source Code".** Mostert v. The Mostert Group, LLC, 606 S.W.3d 87 (Ky. 2020).

a. Developer of computer technology attempting to predict a thoroughbred horse's success by analyzing its biomechanics agrees to sell the business to a newly formed business in exchange for stock, cash, and payments over time with performance secured by a security interest in certain business assets. Dispute over whether (a) the developer was required to deliver the "source code" for the business software to the purchaser at closing or upon being fully paid the purchase price, and (b) whether the developer's security interest included rights in the "source code".

b. Reviewing the language of the parties' "Contribution Agreement" and the "Security Agreement," Kentucky Supreme Court held that the developer was required to deliver the "source code" at the time of closing and did not have a security interest in the "source code".

c. Lesson: where computer software is an essential part of the transaction or the value of a business, think carefully about how terms are used and defined in the applicable contract documents.

2. **Business Valuation And Buy-Out Dispute.** Parrish v. Schroering, ___ S.W.3d ___, 2021 WL 1431604 (Ky.App. 20121) (to be published).

a. Dispute over implementation of a very complicated dentist practice buy-out agreement requiring use of three appraisers as well as various allegations of misconduct against the two dentist owners.

b. After jury trial where the three appraisals were present, jury valued the practice buy-out price at $787,000 and in post-judgment proceedings, the trial court awarded $463,623.98 in attorneys' fees to the retiring dentist. The non-retiring dentist argued for averaging the two closest appraisals resulting in a valuation of negative $8,089.50.

c. Court of Appeals held that the test for challenging the appraiser's valuation required the challenger to prove "a showing of fraud, bad faith, a material mistake, or a lack of understanding or completion of the contractually assigned task." The Court further held that the challenger in this case had not met this burden so the jury verdict of a different valuation was reversible error. Court of Appeals's opinion would indicate that this is a test for challenging any expert/professional decision that parties contractually agree to act upon, citing *Green River Steel Corp. v. Globe Erection Co.*, 294 s.W.2d 507 (Ky. 1956) (discussing binding effect of decision of

construction engineer as to what was "extra work" under contract which set forth a test of "arbitrarily, dishonestly, or under a demonstrable mistake of fact").

d. Since the jury verdict was erroneous, the award of attorneys' fees to the retiring dentist was also set aside and the case remanded.

3. **Judicial Dissolution Of A Limited Liability Company.** Unbridled Holdings, LLC v. Carter, 607 S.W.3d 188 (Ky.App. 2020).

a Three member-managed limited liability companies are formed by two businessmen who eventually fall out and have disagreements over various aspects of operating the companies. The operating agreements do not contain dispute resolution provisions.

b. Discussion of the test under KRS 275.290(1) for dissolving a limited liability company if "it is not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement." The Court of Appeals remanded the dispute with the direction that the trial court to apply a multifactor approach to determine if it is reasonably practicable" to carry on the business. The party seeking dissolution is not required to show a "complete frustration" or "total impossibility" to operate.

c. Seven factors, which are not exclusive, to be considered are:

(1) whether the management of the entity is unable or unwilling reasonably to permit or promote the purposes for which the company was formed;

(2) whether a member or manager has engaged in misconduct;

(3) whether the members have clearly reached an inability to work with one another to pursue the company's goals;

(4) whether there is deadlock between the members;

(5) whether the operating agreement provides a means of navigating around any such deadlock;

(6) whether, due to the company's financial position, there is still a business to operate; and

(7) whether continuing the company is financially feasible.

d. Lesson: Does the LLC's operating agreement have effective procedures to deal with members who cannot work effectively together.

4. **Principal And Agent.** Sneed v. University Of Louisville Hospital, 600 S.W.3d 221 (Ky. 2020).

a. Plaintiff alleging medical malpractice could not hold hospital liable under "ostensible agency" doctrine when she was provided certain admission forms stating that physicians were not employees of the hospital.

b. Good discussion of the "ostensible agency" doctrine that banks may find useful in disputes over the authority of persons involved in actions of business entity customers or plaintiffs:

> "An apparent or ostensible agent is one whom the principal, either intentionally or by want of ordinary care, induces third persons to believe to be his agent, although he has not, either expressly or by implication, conferred authority upon him."

5. **Vicarious Liability Of Employer**. Hensley v. Traxx Mgt. Co., 622 S.W.3d 652 (Ky.App. 2020).

a. At the end of an armed robbery, robber threatened to kill employee's family if the employee reported the robbery to the police. Enraged by this threat to his family, employee followed the robber out of the store and shot and killed him. Employee was not indicted by grand jury for any crime relating to the shooting. Estate of robber sued employer alleging it was vicariously liable for the employee's actions in shooting the robber.

b. Employer was not vicariously liable because employee was motivated to protect his family and his conduct "was an independent course of conduct not intended by the employee to serve any purpose of the employer." This test for acting within the scope of employment is Restatement (Third) of Agency §7.07.

c. Vicarious liability is possible even for an intentional tort "where its purpose, however misguided, is wholly or in part to further the master's business." Citing *Papa John's Int'l, Inc. v. McCoy*, 244 S.W.3d 44 (Ky. 2008).

d. Employer was also not liable under a negligent hiring or retaining the employee because plaintiff could not show that the employer "knew or reasonably should have known that [the] employee was unfit for the job for which he was employed and that the employee's placement or retention at that job created an unreasonable risk of harm to the plaintiff."

e. Employer was also not liable under a negligent training or supervision theory because employer had a "no firearms" policy, and also plaintiff could not show that the employer "knew or had reason to know that [the employee] might shoot and kill a criminal off its premises following a robbery."

I. Employment Cases.

1. **Contracts Shortening Statute Of Limitations For Claims Against An Employer.** Crogan v. Norton Healthcare, Inc., 613 S.W.3d 37 (Ky.App. 2020).

a. Dispute over the enforceability of a provision in ex-employee's employment application paperwork which shortened the period of time to bring any claim or lawsuit relating to the employee's service against the employer or any of its subsidiaries or related entities within six months after the date of the employment action which is the subject of the claim.

b. The provision was invalid as applied to a claim under the Kentucky Civil Rights Act (which has a 5-year statute of limitations) under KRS 336.700(3)(c) which states:

> "(c) Any employer may require an employee or person seeking employment to execute an agreement to reasonably reduce the period of limitations for filing a claim against the employer as a condition or precondition of employment, provided that the agreement does not apply to causes of action that arise under a state or federal law where an agreement to modify the limitations period is preempted or prohibited, and provided that such an agreement does not reduce the period of limitations by more than fifty percent (50%) of the time that is provided under the law that is applicable to the claim;"

c. General discussion of when parties may contractually agree to shorten a statute of limitations when there is not a statute on point. Case law discussed included Dunn v. Gordon Food services, Inc., 780 F.Supp.2d 570 (W.D. Ky. 2011), which enforced a one-year contractual deadline provision because the waiver was knowing and voluntary and the contractual

limitation period was reasonable. In Dunn, the contractual period was one year. The Court in Crogan held that, as a general rule, a contractual period of limitation "is reasonable if (1) the claimant has sufficient opportunity to investigate and file an action, (2) the time is not so short as to work a practical abrogation of the right of action, and (3) the action is not barred before the loss or damage can be ascertained."

d. In the absence of KRS 336.700(3)(c), the Court of Appeals would have found that 6-months was too short to be enforceable in any event.

2.. **Wage And Hour.** Hunzkiker v. AAPPTEC, LLC, 603 S.W.3d 277 (Ky.App. 2020).

a. Dispute over wage payment practices of company that hired an employee to sell the employers medical instruments. Ex-employee sued the business and its President for allegedly making improper deductions from base salary and for not appropriately paying for overtime. Company's President defended on the basis that he was not the plaintiff's "employer" under KRS 337.010(1)(d). Company defended on the basis that the ex-employee was a "exempt" employee.

b. Court of Appeals' opinion discusses when an employer can potentially lose the benefit of the exception under KRS 337.010(2)(a)(2) for individuals "employed in a bona fide executive, administrative, supervisory, or professional capacity, or in the capacity of outside salesman, or as an outside collector as the terms are defined by administrative regulations of the commissioner" but found that the jury properly concluded that the ex-employee was treated as a "bona fide professional." However, it remanded for further proceedings as to the amount of any improper salary deductions.

c. Court of Appeals held that a company officer potentially could be classified as an "employer" and therefore personally liable under the broad definition of "employer" in KRS 337.010(1)(d) as being "any person, either individual, corporation, partnership, agency, or firm who employs an employee and includes any person, either individual, corporation, partnership, agency, or firm acting directly or indirectly in the interest of an employer in relation to an employee[.]" Court of Appeals remanded the case with instructions that the trial court evaluate the status of the company's President who hired the plaintiff under this definition.

3. **Severance Payments And Taxation.** Ridge v. Commonwealth of Kentucky, 606 S.W.3d 634 (Ky.App. 2019).

a. Tennessee resident worked at Fruit of the Loom factory in Bowling Green, Kentucky. On December 31, 2015, he entered into a severance agreement that paid him in 2016 six months of severance payments and which included non-compete and non-solicitation provisions. Ex-employee sought refund from Kentucky of tax withholdings by the company and challenged treatment of the payments as taxable by Kentucky since he was not working in Kentucky at any time in 2016.

b. Severance payments constituted either taxable "wages" specifically or "gross income" which was "derived … from or attributable to sources within" Kentucky as well as for past labor performed in Kentucky, and, therefore, taxable by Kentucky even though the taxpayer resided in Tennessee at the time of payment.

4. **Associational Discrimination**. Barnett v. Central Kentucky Hauling, LLC, 617 S.W.3d 339 (Ky. 2021).

a. Employee sued employer alleging that his employment was terminated because employer objected to his taking time off to car for this disabled spouse. Kentucky Supreme Court holds that the Kentucky Civil Rights Act does not create a cause of action based upon associational discrimination involving the disability of a person who is not the employee.

J. Arbitration; Powers Of Attorney.

1. LP Louisville East, LLC v. Patton, 621 S.W.3d 386 (Ky. 2020).

a. Holding: power of attorney executed sometime in early 2017 or earlier granted son authority to bind his father, and his father's estate, and the son to arbitration provision of contract admitting father to long-term care facility.

b. General discussion of rules governing the interpretation of a power of attorney and the nature of a wrongful death claim by an executor.

c. Kindred Nursing Centers Ltd. Partnership v. Clark, 581 U.S. ___, 137 S.Ct. 1421 (2017) (Kentucky's "clear statement rule" in interpreting powers of attorney regarding the authority of the attorney-in-fact to enter into arbitration agreements is preempted by the Federal Arbitration Act).

d. Lesson #1: How carefully is the bank's staff reviewing a power of attorney for its scope and binding effect?

e. Lesson #2: What steps are you and your bank taking to implement the Kentucky Uniform Power Of Attorney Act created in 2018 (2018 Ky. Acts. Ch. 185) and amended in 2020 (2020 Ky. Acts. Ch. 41).

2. Cambridge Place Group, LLC v. Mundy, 617 S.W.3d 838 (Ky.App. 2021).

a. Dispute over whether estate of decedent was required to arbitrate wrongful death claims against nursing care facility based upon admission documents signed by wife as decedent's power of attorney.

b. Circuit court ruled held that the power of attorney did not grant wife of decedent the authority to consent to arbitration of health care related claims.

K. Arbitration; Limitation Of Remedies; Seller's Disclosure Of Property Condition.

1. Green's Toyota Of Lexington v. Frazier, 2021-SC-0293 (motion for discretionary review filed 8/9/21).

a. Discretionary review sought of Court of Appeals' decision that car dealer's arbitration provisions were unenforceable for two reasons: (1) the sale documents had multiple provisions discussing arbitration which were inconsistent on whether a party could recover consequential or punitive damages so the dealer could not demonstrate a meeting of the minds as to arbitrability, and (2) it was unconscionable to attempt to exclude these types of damages from an arbitrator's authority because it was not done "clearly, concisely, and noticeably".

b. The Court of Appeals also noted that KRS 355.2-719(2) and (3) place limits on contractual modifications and limitations of remedies in a sale of goods case:

i. Under KRS 355.2-719(2), an exclusive or limited remedy will not be enforced if the circumstances cause it "to fail or its essential purpose".

ii. Under KRS 355.2-719(3):

(1) consequential damages may be limited or excluded unless the limitation "is unconscionable".

(2) limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable.

(3) limitation of damages where the loss is commercial is not prima face unconscionable.

2. Don Booth Of The Breland Group v. K&D Builders, Inc., 20-SC-0023-DG (6/17/21)

a. Enactment of KRS 324.360, which requires a "seller's disclosure of conditions form" in the sales and purchases involving single-family residential real estate dwelling in transaction in which a Kentucky licensed real estate agent receives a commission, was not a legislative overruling of the "merger doctrine" in Borden v. Litchford, 619 S.W.2d 715 (Ky.App. 1981), that, subject to a fraud exception, all prior statements and agreements, both written and oral, are merged in to the deed in a real estate transaction.

b. Sufficient grounds were not shown to vacate arbitrator's award in favor of seller of home in a dispute with the purchaser and the two real estate agents handling the sale over various defects in the house.

i. Discussion of the test under KRS 417.160(1)(c) – the arbitrator exceeded [his] power" – and KRS 417.160(1)(d) that the arbitrator "refused to hear evidence material to the controversy or otherwise so conducted the hearing … as to prejudice substantially the rights of a party."

c. Discussion of plaintiff's need to show "causation" – that defendant's misconduct was the "cause" of the alleged damages.

d. Discussion of the authority of an arbitrator to decide what evidence to admit or refuse to admit and whether evidence "is cumulative, immaterial, or irrelevant".

e. Discuss of need to preserve and present the record, particularly the evidence and rulings in an arbitration, as part of the appellate record.

L. Insurance Matters.

1. **Insurance Agent's Duty To Advise.** McAlpin v. American General Life Ins. Co., 601 S.W.3d 188 (Ky.App. 2020).

a. Business owner sought insurance policy providing benefits in the event of the death of his son, a part owner of the business. Insurance agent proposed a $1 million dollar term life policy, but son refused to consent to the required blood test. After son was accidentally killed, business owner sued the insurance agent and his company for not presenting a $500,000 accidental death policy that did not require a health examination as a possible alternative.

b. Kentucky Supreme Court held that, under the facts of the policy needs as presented by the business owner, the insurance agent did not act negligently in not presenting an accidental death policy option.

c. Discussion of the "scope of an insurance agent's purported 'duty to advise'". Court concluded that the plaintiff did not satisfy even the test presented by his expert of being "required to present 'possible solutions' to 'needs' or 'problems' that a customer has 'brought forward'" when the father asked for $1,000,000 coverage for any possible death and "accidental death" have fewer coverage triggers and was only available through the agent for amounts up to $500,000.

2. **Bad Faith; Civil Conspiracy.** Mosley v. Arch Specialty Ins. Co., 626 S.W.3d 579 (Ky. 2021).

a. Trial court property ruled that insurance companies did not act in bad faith in their mediation and settlement actions in a complex, multi-party dispute over death of driver of surface mine coal truck.

b. Extensive discussion of bad faith claim standards, and also the scope of discovery as to bad faith claims, including matters relating to claims files and conduct during mediation and settlement.

c. Injured party's civil conspiracy claims between the two insurance companies who had insured defendants was properly dismissed. Discussion of the standard for civil conspiracy: "a corrupt or unlawful combination or agreement between two or more persons to do by concert of action an unlawful act, or to do a lawful act by unlawful means." *Citing* Peoples Bank of N. Kentucky, Inc. v. Crowe Chizek and Co., 277 S.W.3d 255, 261 (Ky.App. 2008) (Erpenbeck fraud case; mere negligence is not enough misconduct to satisfy the requirements of civil conspiracy).

3. **Insurance – Coverage And Interpretation.** Thomas v. State Farm Fire And Casualty Co., 626 S.W.3d 504 (Ky. 2021).

a. Express exclusion in homeowners' insurance policy applied to exclude coverage for their in-home child care business.

b. Discussion of interpretation of insurance policies and exclusions.

c. Bankers: do you understand the exclusions in the insurance policies your bank purchases, including title insurance and banker's bonds?

M. Administrative Agency Subpoena Power.

1. Lassiter v. Landrum, 610 s.W.3d 242 (Ky. 2020).

a. Former Kentucky state employee ordered to comply with subpoena issued by the Secretary of the Finance And Administrative Cabinet in an investigation of suspected violations of the Kentucky Model Procurement Code relating to software contracts for various government projects.

b. Kentucky Supreme Court's opinion favorably discusses the subpoena power authority of the Kentucky Office Of Financial Institutions to investigate securities fraud in Dolomite Energy, LLC v. Commonwealth Office Of Financial Institutions, 269 S.W.3d 883 (Ky.App. 2008) and quoted the following passage:

> [e]ven if one were to regard the request for information in this case as caused by nothing more than official curiosity, nevertheless law-enforcing agencies have a legitimate right to satisfy themselves that corporate behavior is consistent with the law and the public interest ... [It] is sufficient if the inquiry is within the authority of the agency, the demand is not too indefinite and the information sought is reasonably relevant.

Dolomite Energy, 269 S.W.3d at 886.

N. Kentucky Consumer Protection Act.

1. Summit Medical Group, Inc. v. Coleman, 599 S.W.3d 445 (Ky.App. 2019).

a. Remanding to Circuit Court for further analysis of whether to certify a class action alleging a medical practice violated the Kentucky Consumer Protection Act, KRS 367.170, for allegedly improperly double-billing for same-day office visits. Case remanded for further analysis of the adequacy of the plaintiff's proposed class counsel.

O. Debt Collection.

1. University Of Kentucky v. Moore, 599 S.W.3d 798 (Ky. 2019).

a University of Kentucky is part of "the executive branch of state government" for purposes of KRS 45.237(a), and thus is able to utilize the Commonwealth's debt collection processes for unpaid medical services provided through "UK Healthcare".

b. Extensive discussion of the legal nature and status of the University of Kentucky.

P. Zoom Hearings And Due Process.

1. K.D.H. v. Commonwealth, 2020-CA-1359 (7/9/2021) (to be published).

a. In proceeding to terminate a mother's parental rights, the mother's due process rights were violated when the Spencer Family Court conducted the termination hearing via Zoom hearing because there were serious technical problems with the testimony being heard and understood.

Q. Criminal Forfeitures.

1. Commonwealth v. Doebler, 626 S.W.3d 611 (Ky. 2021).

a. Trial court properly ordered the forfeiture of $3,759 in cash that defendant had in her purse (and in a bank envelope) when she was arrested in a hotel room and pled guilty to being in possession of drug paraphernalia, a syringe allegedly used for heroin. At the time of her arrest, Defendant was in a hotel room with a male Defendant who pled guilty to trafficking methamphetamine, possession of heroin, and possession of drug paraphernalia. Defendant claimed that the cash was the proceeds of her closing out her deceased father's bank account the day before her arrest and had nothing to do with drug trafficking.

b. Commonwealth prevails because KRS 281A.410(1)(j) establishes a presumption of forfeitability for money "in close proximity to controlled substances, to drug manufacturing or distributing paraphernalia, or to records of the importation, manufacture, or distribution of controlled substances" and the Supreme Court held that Defendant had not shown "abuse of discretion" by the trial court's refusal to accept Defendant's explanation to rebut the presumption.

c. The forfeiture of $3,759 was not sufficiently excessive to violate the Eighth Amendment of the U.S. Constitution nor Section 17 of the Kentucky Constitution even though the maximum fine for the charge she pled guilty to was $500.

VII. Various Sixth Circuit Cases.

A. FDIC Refusal To Approve A Bank's "Golden Parachute Payment".

1. Wollschlager v. FDIC, 992 F.3d 574 (6th Cir. 2021).

a. FDIC did not act improperly or violate 12 U.S.C. §1828(k) when it refused to approve the second half of a "golden parachute payment" to a bank executive of the State

Bank in Fenton, Michigan, which was "in a troubled condition" (a triggering event under §1828(k)(4)(a)(ii)).

B. Arbitration.

1. AtriCure, Inc. v. Meng, 12 F.4th 516 (6th Cir. 2021).

a. State law (in this case Ohio) will govern when a third-party may be required to arbitrate a claim (or may enforce an arbitration agreement of a third-party). Various potential theories include "assumption, piercing the corporate veil, alter ego, incorporation by reference, third-party beneficiary theories, waiver and estoppel."

2. Southard v. Newcomb Oil Co., LLC, 7 F.4th 451 (6th Cir. 2021).

a. Provisions in employer's employment application and employment handbook did not establish binding arbitration to be dispute resolution mechanism, so District Court was correct in not ordering the dispute to be arbitrated.

3. Boykin v. Family Dollar Stores Of Michigan, 3 F.4th 832 (6th Cir. 2021).

a. Extensive discussion of the processes a federal court should follow when there is a dispute over whether a claim is required to be arbitrated.

b. District Court erred in dismissing case when employee filed affidavits denying that he electronically e-signed an arbitration agreement with his employer. Court should have allowed discovery on the contract formation dispute, and, if necessary, conducted a trial on that issue.

4. Ciccio v. Smile Direct Club, LLC, 2 F.4th 577 (6th Cir. 2021).

1. American Arbitration Association acted improperly when it had an AAA administrator decide that parties needed to agree to the AAA's Healthcare Due Process Protocol and Healthcare Policy Statement before arbitrating the dispute. The decision needed to be made by an arbitrator.

2. Judge Clay dissented on the ground that the parties' agreement to follow AAA rules included agreeing to the AAA's process of certain steps being handled by the AAA's administrator.

C. Fair Debt Collection Practices Act.

a. Garland v. Orlans, PC, 999 F.3d 432 (6th Cir. 2021).

1. Plaintiff did not have standing to bring a federal Fair Debt Collection Practices Act claim based upon a letter from a law firm starting a foreclosure proceeding which only confused him and made him feel anxious. Plaintiff did not allege injury "which is (a) concrete and particularized and (b) actual or imminent, not conjectural or hypothetical."

b. Ward v. National Patient Accounts Servs., 9 F.4th 357 (6th Cir. 2021)

1. Plaintiff did not have standing to bring a federal Fair Debt Collection Practices Act claim based upon debt collector's failure to properly identify itself in the phone calls which confused the plaintiff and led to him sending a cease and desist request to the wrong entity. Confusion by itself does not establish "a concrete injury for Article III purposes."

2. Also, the plaintiff's argument that he retained counsel to stop the calls and that this action constitutes a concrete harm was rejected because applying this "logic to any

plaintiff who hires counsel to affirmatively pursue a claim would nullify the limits created under Article III."

c. Rodenburg, LLP v. Cincinnati Ins. Co., 9 F.4th 1033 (8th Cir. 2021).

1. Law firm engaged in debt collection did not have coverage under its Commercial Umbrella Liability Policy for defense costs or potential liability for FDCPA claims based upon garnishing the wages of an employee who had the same name as, but was not the same person, as the judgment debtor in the judgment the law firm was attempting to collect.

2. The policy included a "Violation of Statutes Exclusion" section which excluded "[a]ny liability arising directly or indirectly out of any action or omission that violates or is alleged to violate … [a]ny statute, ordinance or regulation, other than the TCPA or CAN-SPAM Act of 2003, that prohibits or limits the sending, transmitting, communicating or distribution of material or information." The court held that based on the language in the exclusion provision, insurer was not obligated to provide coverage.

d. Hunstein v. Preferred Collection And Management Services, Inc., 2021 WL 1556069 (11th Cir. 4/21/21) (not yet final as of 10/8/21).

1. Debt collector faces potential liability under the FDCPA for transmitting a consumer's personal information to a mailing service used by the debt collector to print and mail collection letters because the mailing service was not being used to acquire location information and was not one of a set of persons the FDCPA expressly allows being a communication recipient of a communication from a debt collector.

2. Further briefing with the 11th Circuit is continuing, including based on a footnote in the new Supreme Court of the United States FCRA case TransUnion LLC v. Ramirez, 141 S.Ct. 2190 fn. 6 (6/25/21), stating that giving customer information to a mail vendor is not "dissemination" and therefore is not an injury in fact. Other amicus briefs assert commercial free speech grounds and a variety of other challenges.

D. Sale Of Goods.

1. Carhartt, Inc. v. Innovative Textiles, Inc., 998 F.3d 739 (6th Cir. 2021).

a. Jury question existed under UCC §2-607(3) as to whether buyer of waited too long to notify fabric manufacturer of claim that fabric failed to satisfy contract requirements regarding flame resistance.

E. Insurance For Damaged Car.

1. Wilkerson v. Am. Family Ins. Co., 997 F.3d 666 (6th Cir. 2021).

a. Insurer's policy provided that it would pay "actual cash value" for a damaged motor vehicle that it decided was a total loss and would not be repaired. The phrase "actual cash value" did not include the taxes and fees that would be charged to buy a replacement vehicle.

F. Sanctions; Bankruptcy Discharge.

1. In Re Ragone, 2021 WL 1923658 (6th Cir. BAP 2021).

a. Sixth Circuit BAP affirmed contempt sanctions against a creditor's lawyer for violating the bankruptcy discharge injunction by continuing garnishments and refusing to

refund garnishment proceeds after debtor's counsel notified him that the debt was discharged. The sanctions included $4,275.39 in post-discharge garnishment proceeds and $10,580 in attorneys' fees.

G. Secured Creditor Status And Priority; Bad Faith & Good Faith; Bankruptcy.

1. In re Fair Finance Company, 2021 WL 4127430 (6th Cir Sept. 10, 2021).

a. A secured lender's "later arguably bad-faith … actions [cannot] undermine its earlier perfected security interest." The Sixth Circuit affirmed the District Court's dismissal of a trustee's fraudulent transfer attack based on the lender's later conduct, the Court of Appeals reasoned that the debtor's "payments [to the lender were] not avoidable" because "a 'valid lien' encumbered the transferred assets." *Id*., at p.3.

b. The debtor had "entered into a $22 million revolving loan agreement with the lender ("Lender") and another bank in 2002", giving Lender a "perfected … security interest in all" of the debtor's assets. Shortly thereafter, "new owners (later convicted criminals) bought [the debtor] and began to run it into the ground by using the company to perpetuate a Ponzi scheme." *Id*., at p.1. In 2004, the parties "renewed and extended the revolver with conditions designed to protect [Lender's] interests", with [Lender] being paid in full by 2007." *Id*. Unsecured creditors forced the debtor into bankruptcy during 2010. The debtor's principals were later convicted "of crimes in connection with the Ponzi scheme." *Id*., at p.1. Lender knew nothing about the debtor's fraud when it made the secured loan in 2002. However, Trustee claimed that by 2003, Lender knew about the debtor's "house of cards," "shaky" related-party loans, and suspicious "financials," among other things, and it continued to lend, insuring that its loans "stay out of [the debtor's] shaky loans," making a "side deal" before extending its loan in 2004, helping to "prevent public exposure of" the debtor's "precarious financial condition," and "encouraging [the debtor] to inject more insider-loan money into failing related entities." *Id*., at *2.

c. The Sixth Circuit rejected the trustee's argument that Lender's "2002 security interest is not a 'valid lien' because [Lender] acted in bad faith after it learned about the [debtor's] Ponzi scheme." *Id*. at p.3. The Court held that that the "payments encumbered by the 2002 security interest [were] not avoidable".

d. The UCC Priority Test.

i. The Ohio version of the UCC, like its counterpart in other states, determines the validity of a lien and whether a lien would be "effective against a later judicial lien" *Id*., at p.4. "[C]onflicting perfected security interests … rank according to priority in time of … perfection [i.e., usually recording]." *Id*. "Perfection is thus the key to determining priority between a creditor's security interest and a competing lien creditor — [the] first security interest to attach … has priority.'" *Id*.

ii. "[T]he priority test is not about invalidation." *Id*., at p.6. But the trustee in *Fair Finance* argued that if the lender "acts in bad faith after perfecting his security interest he … forfeits his right to claim priority over" a later lien creditor "regardless of whether [the lender] directed his bad faith toward" that lien creditor, relying on the UCC's duty of good faith." *Id*., at p.4.

e. The Limited UCC Good Faith Test.

i. The UCC imposes an obligation of good faith in the "performance and enforcement of contracts and duties" within the article covering secured transactions. According to the Sixth Circuit, it only limits a "bad-faith actor's ability to 'enforce' its security interest priority rights." *Id*., at p.5. The Sixth Circuit stressed that "the duty of good faith does not alter the question that the UCC priority rules answer — relative priority among competing interests." *Id*., at p.5. The duty of good faith, therefore, only applies to the "performance and enforcement of contracts and duties." *Id*.

ii. Rejecting the trustee's bad faith argument, the court explained that "the only enforcement right that bad faith can impact is enforcement of a senior priority vis-à-vis a

junior creditor's rights — a question of priority, not validity." *Id*. According to the court, "the question is whether as between two or more specific competing creditor interests, a junior interest should jump in line … And that means as a practical matter that reordering based on bad faith would only ever happen based on a senior creditor's actions directed at, or taken within a relationship with, the junior creditor seeking to jump ahead of the bad actor in line." *Id*., at p.6. *See*, e.g., *Thompson* v. *United States*, 408 F. 2d 1075, 1084 (8th Cir. 1969) ("lack of good faith toward the government" justified "alter[ing] priorities ... under [UCC] Article 9.").

iii. "The analysis is necessarily specific to the relationship between the parties in the priority contest. And that means the type of bad faith needed to reorder priority is bad faith within a relationship that involves at least two competing creditors." *Id*. *See*, *e.g*., *Affiliated Foods Inc*. *v. McGinlay*, 426 N.W.2d 646, 648 (Iowa Ct. App. 1988) (senior secured creditor "estopped from asserting [its] secured interest prior to the interests of" a junior creditor because senior creditor had "induced [the junior creditor] to believe that [it] would be given" a higher priority than the senior creditor). According to the Sixth Circuit in *Fair Finance*, this "distinction between the usual priority dispute and the [Uniform Fraudulent Transfer Act] definitional one decides this case." *Id*. T's "perfected 2002 security interest would prevail over" a later judicial lien "absent priority reordering." *Id*.

f. The Inapplicable Fraudulent Transfer Test.

i. The UFTA "test[, in contrast,] requires ranking the security interest priority against a hypothetical generic subsequent judicial lien." *Id*. at *7. Because "a perfected interest is by definition a 'valid lien' under" the UFTA, the district court had "correctly rejected the trustee's bad-faith-invalidation argument at summary judgment." "[S]ubordination would never happen" in *Fair Finance* because the senior Lender never "direct[ed] its bad faith at a non-existent entity." *Id*.

SECTION C

LEGAL ISSUES IN BANKING TECHNOLOGY

WILLIAM T. REPASKY
Frost Brown Todd LLC
Louisville, Kentucky

MATTHEW J. REGAN
Federal Deposit Insurance Corporation
Chicago, Illinois

Legal Issues in Banking Technology

Bill Repasky,
Frost Brown Todd LLC
Matthew J. Regan,
Federal Deposit Insurance Corporation, Chicago

October 15, 2021

1

Regulation E Storm Clouds on the Horizon

- *Situation:* Your bank's consumer customer provides credentialling information to a fraudster over the telephone, by email, at a website or by SMS text message.
- The consumer's actions were in direct violation of our bank's written rules, the bank's specific instructions not to share this information with anyone and/or was otherwise completely negligent.
- Fraudster then uses this "shared" access information to make unauthorized electronic funds transfers ("EFTs") from the consumer's bank account.
- Consumer later realizes his/her mistake and notifies your bank disputing the EFTs.
- Now what? It was the consumer customer who blundered, but must our bank we recredit the account?

2

There is what is "right", what is "wrong" and then there is Regulation E

Electronic Fund Transfers FAQs

~ June 4, 2021, by the Consumer Financial Protection Bureau

1. If a third party fraudulently induces a consumer into sharing account access information that is used to initiate an electronic fund transfer from the consumer's account, does the transfer meet Regulation E's definition of "unauthorized electronic fund transfer"?

3

CFPB's Answer to FAQ #1

Yes. Regulation E defines an unauthorized electronic fund transfer (EFT) as an EFT from a consumer's account initiated by a person other than the consumer without actual authority to initiate the transfer and from which the consumer receives no benefit. 12 CFR § 1005.2(m). Comment 1005.2(m)-3 explains further that an unauthorized EFT includes a transfer initiated by a person who obtained the access device from the consumer through fraud or robbery. Similarly, when a consumer is fraudulently induced into sharing account access information with a third party, and a third party uses that information to make an EFT from the consumer's account, the transfer is an unauthorized EFT under Regulation E.

For example, the Bureau is aware of the following situations where a third party has fraudulently obtained a consumer's account access information: (1) a third party calling the consumer and pretending to be a representative from the consumer's financial institution and then tricking the consumer into providing their account login information, texted account confirmation code, debit card number, or other information that could be used to initiate an EFT out of the consumer's account, and (2) a third party using phishing or other methods to gain access to a consumer's computer and observe the consumer entering account login information. EFTs stemming from these situations meet the Regulation E definition of unauthorized EFTs.

4

Reg E's "Dispute Resolution" and "Consumer Liability" provisions are less than models of clarity

Other considerations regarding the consumer's liability for the unauthorized transfer:

- Was an access device involved?
- Did the consumer notify us within 2 business days of knowledge of the theft of the access device?

  How is this knowledge determined? Do we count from the day of the event, or from the day the consumer reviewed account information and made a determination of the theft of the access device?
- Was the access device issued by a third party and not our bank?
  - For instance, if we are not a Zelle bank, but the transfer occurred through Zelle; then the Regulation E matter is between Zelle and the consumer.

5

The next wave of copy-cat class actions lawsuits?

JENNA GRANADOS, *on behalf of herself and all others similarly situated,*

Plaintiff,

v.

ONPOINT COMMUNITY CREDIT UNION,

Defendant.

Case No. 3:21-cv-00847

CLASS ACTION COMPLAINT (Electronic Funds Transfer Act; Breach of Contract; Oregon Unlawful Trade Practices Act; Restitution)

JURY TRIAL DEMANDED

Plaintiff Jenna Granados, by her attorneys, brings the following Class Action Complaint on behalf of herself and all others similarly situated and alleges and complains of Defendant as follows:

PRELIMINARY STATEMENT

1. Jenna Granados ("Plaintiff" or "Ms. Granados") is a victim of fraud.

2. The perpetrator, who is unknown to Plaintiff, fraudulently misrepresented himself as OnPoint Community Credit Union ("OnPoint" or "Defendant") in a phone call in a successful effort to obtain Plaintiff's debit card pin number.

3. The perpetrator then used the pin to fraudulently charge and withdraw a total of $3,474.28 from Plaintiff's checking and savings account with OnPoint after unauthorized transfers were made between said accounts.

4. Plaintiff promptly disputed the charges with Defendant.

5. Despite its obligation under the EFTA to promptly credit Plaintiff's account in full, Defendant refused to credit Plaintiff's account for the stolen funds.

6. Plaintiff brings claims against OnPoint for violations of the Electronic Fund Transfer Act ("EFTA"), 15 U.S.C § 1693, *et seq.*, which protects consumers from liability for unauthorized transfers.

7. Specifically, as set forth herein, OnPoint's standard account agreement, its dispute resolution process, and its form correspondence violates the EFTA: OnPoint has an overt and stated policy of denying claims involving unauthorized transactions where it maintains that the consumer's PIN, Debit Card or other access device was provided to the criminal as a result of fraud or where OnPoint views the consumer as having been insufficiently protective of his or her account information.

6

Proposed Interagency Guidance on Third-Party Relationships: Risk Management, *released on July 19, 2021*

Proposed Guidance's 6 steps for managing third-party vendors and service providers' risks:

1. **Planning** – Identify the bank's strategy, list the risks arising from its dealings with T-P vendors and planning how to identify, evaluate, select and supervise those vendors.
2. **Due Diligence and Selection** – Appropriate due diligence in selecting the T-P vendors commensurate with the level of risk and complexity of the activity associated with the vendor relationship.
3. **Contract Negotiation** – Create contracts that articulate the responsibilities of all parties.
4. **Oversight and Accountability** – Responsibility for the risk management processes:
    1. Board of directors
    2. Management
    3. Independent reviews
    4. Documentation and reporting
5. **Ongoing Monitoring** – Plan for oversight and recording a vendor's activities, performance and deficiencies.
6. **Termination** – Planning for terminating the relationship

7

Conducting Due Diligence on Financial Technology Companies ~ A Guide for Community Bank

(Publication August of 2021)

Key areas when evaluating potential FinTech vendors:

- Business Experience and Qualifications
- Financial Condition
- Legal and Regulatory Compliance

  "*Some fintech companies may have limited experience working within the legal and regulatory framework in which a community bank operates.*"
- Risk Management and Controls
- Information Security
- Operational Resilience

8

Ransomware and the Regulators

Ransomware is malicious software that encrypts computer files without the computer owner's consent. A ransom payment is demanded from the target of an attack in exchange for the decryption software "key".

- Ransomware attacks are serious and growing
  - June of 2021 ~ > 149,000 document attacks
  - 966% increase over past year
  - Nearly 1/3 of all businesses reporting attack or threatened attack

Source: *Fortinet's FortiGuard Labs 1H 2021 Global Threat Landscape Report*

Ransomware 1.0 Encryption
Ransomware 2.0 Encryption Plus Exfiltration

9

Ransomware Payments and the Regulators

- Paying a ransom to a threat actor is not illegal *per se*, although discouraged by law enforcement agencies.

- When a ransom must be paid, the transaction flow typically sees the victim instructing its bank to wire funds to a cryptocurrency exchange, or to an intermediary, for the purpose of buying cryptocurrency in the amount of the ransom demanded, for subsequent transfer to the threat actor's crypto-wallet account.

10

- On October 1, 2020, the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) issued its "**Advisory on Potential Sanctions Risk for Facilitating Ransomware Payments**." Premised upon the belief that paying ransoms enables and encourages criminal actors and can undermine our nation's security and foreign policy objectives, FinCEN's Advisory reminds financial institutions, insurance companies and those who assist victims in negotiating with threat actors, that paying funds to individuals or entities who appear on the OFAC List (*infra*) can be unlawful and can lead to the assessment of material civil money penalties.

- OFAC's Specially Designated Nationals and Blocked Persons List, other blocked persons, and those covered by comprehensive country or region embargoes (e.g., Cuba, the Crimea region of Ukraine, Iran, North Korea, and Syria) are collectively the "OFAC List". Further, any transaction that violates the International Emergency Economic Powers Act (IEEPA), such as a transaction by a U.S. person which violates any IEEPA-based sanctions, is also prohibited.

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- OFAC can impose civil penalties for sanctions violations based on strict liability. This means a person or business may be civilly liable even if it did not know or have reason to know it was engaging in a transaction with a person on the OFAC Lists.
- Under existing Enforcement Guidelines, OFAC will consider the existence, nature and adequacy of an OFAC compliance program as mitigating factors when determining an appropriate enforcement response (including the amount of civil monetary penalty, if any).
- OFAC considers a company's self-initiated and timely report of a ransomware attack to law enforcement, and also the company's full cooperation with law enforcement, to be significant mitigating factors in determining an appropriate enforcement outcome, if the situation is later determined to have a sanctions nexus.
- OFAC encourages/requires financial institutions to implement a risk-based compliance program to mitigate exposure to sanctions-related violations. Financial institutions, who knowingly are involved in facilitating ransomware payments on behalf of victims, such as a situation where a customer accesses its deposit account at the bank to fund the negotiated ransom payment, must evaluate whether they have disclosure or other obligations under FinCEN's regulations.

12

Incident Response Planning

- The White House's June 2nd Memo, *What We Urge You To Do to Protect Against the Threat of Ransomware*, lists as 1 of its 5 points, "**Test your incident response plan**."

Tomorrow's forecast: Expect increasing regulatory scrutiny of your bank or credit union's Incident Response Plan.

13

All FI's have a "Disaster Recovery Plan." So, take yours off the shelf and look at it anew in the context of a cyber-attack disaster.

Joint Statement on Heightened Cybersecurity Risk

~ FDIC/OCC, 1/16/2020, pp. 2-3.

"Additional response, recovery, and resilience controls and principles can include the following:

- Maintain comprehensive, documented, and current incident and business resilience plans that include responding to and recovering from a destructive cyber attack.
- Integrate elements necessary for recovering from a cyber event into the business continuity management program.
- Develop and maintain relationships with federal and local law enforcement cybersecurity resources.
- Identify cybersecurity forensic and recovery expertise that can be engaged to assist with an event.
- Conduct periodic cyber recovery exercises or plan testing to demonstrate that recovery capabilities function as expected.
- Consider the use of cyber insurance as a component of a broader risk management strategy that includes identifying, measuring, mitigating, and monitoring cyber risk exposure."

14

Final Guidance on Response Programs
Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice

Back in 2005, the Federal Financial Institutions Examination Council (FFIEC) issued interpretive guidance that all FIs should develop and implement a response program "designed to address **incidents of unauthorized access to sensitive customer information** maintained by the financial institution or its service provider".

Components of a Response Program

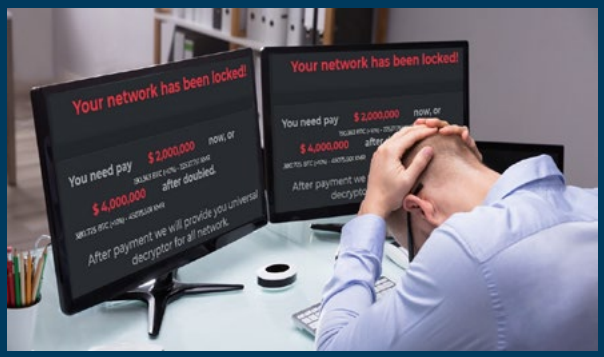
At a minimum, an institution's response program should contain procedures for:

- Assessing the nature and scope of an incident and identifying what customer information systems and types of customer information have been accessed or misused;
- Notifying its primary federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of sensitive customer information;
- Consistent with the agencies' Suspicious Activity Report (SAR) regulations, filing a timely SAR, and in situations involving federal criminal violations requiring immediate attention, such as when a reportable violation is ongoing, promptly notifying appropriate law enforcement authorities;
- Taking appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information; and
- Notifying customers when warranted in a manner designed to ensure that a customer can reasonably be expected to receive it.

~FIL-27-2005; April 1,2005 (emphasis added)

15

When Bad Things Happen to Good Companies



16

To Pay or Not to Pay?

Considering the question as business proposition:

❖ Multiple considerations will be in play:

- Perhaps the #1 variable – How good was your pre-event planning, including your ability to recover from BACKUP resources.
- Perhaps #2 – If exfiltration occurred, value of data and reputation of threat actor to honor any deal made.
- Work as a team: IRP Team, Bank's leadership, cyber insurance carrier, legal counsel, T-P intermediary vendors and other stakeholders.
- Direct Costs (Threat Actor's price demand) and Consequential Damages scope, such as brand reputation, business interruption, value of data that may be lost, value of data that was exfiltrated, etc.
- Knowledge of decryption tool's effectiveness and Threat Actor's reputation.
- Data breach notification costs can be the proverbial "tail that wags the dog".

17

"You," he said, "are a terribly real thing – in a terribly false world, and that, I believe, is why you are in so much pain."

– Alice's Adventures in Wonderland

Each negotiation has its own dynamics

- The high-principled people need to leave the room.
- They know more than you think.
  - ~ *"We cannot afford that,"* likely will not work.
  - ~ But what facts don't they know?
- Always remember ~ **They have shot their one shot.**
- The count-down clock is a tool to create urgency.
- A current strategy is for Threat Actors to claim that a victim's use of T-P negotiators, or disclosure to regulators or law enforcement, will terminate the negotiation process.

18

Authentication and Access to Financial Institution Services and Systems

- Issued by FFIEC on August 11, 2021
  - First major Guidance since 2011!
- Promulgated due to fact there are many new/additional digital access points for internet-based financial services that can lead to unauthorized transactions.
- Focuses on the cybersecurity threat environment, including remote access by customers, threats from leverage compromised credentials and risks from "push payment" functionality.
- Emphasizes the importance of a financial institution's risk assessment to determine appropriate user access and authentication practices.
- Supports adoption of layered security.
- Addresses how multi-factor authentication or similar controls can mitigate risks more effectively than single-factor authentication.

19

UCC Article 4A and the Pursuit of the "Commercially Reasonable Method of Providing Security against Unauthorized Payment Orders"

- Courts tend to view the "Guidance", not as recommendations as FFIEC writes, but as the legally required standards in Article 4A lawsuits.
  - *Choice Escrow and Land Title, LLC v. BancorpSouth Bank* (8th Cir. 2014)
  - *Essgekay Corp. v. TD Bank, N.A.*, 2018 WL 6716830 (Dist.N.J. 2018).
  - *Rodriguez v. Branch Banking & Trust Co.,* 2021 U.S. Dist. LEXIS 63606 (S.D. Fla. 2021)
- Among its other points, the Guidance lists various security features which legal counsel should be familiar with when negotiating FinTech vendor contracts, drafting account agreements with an FI's commercial customers and when handling Payment Order disputes.

20

2021 cocktail party banter to impress your FinTech friends

"Ghosting Coasting"

Hint: See FRB's "The Beige Book", Sept. 8, 2021, page F-1.

"Salami Attack"

Hint: Think the opposite of Whale Phishing.

For all who know what these phrases mean, Matt Regan promises a CAMEL Rating of 1 for their bank with the next Report of Exam.

… OK, just kidding!

21

Questions?

22

Conducting Due Diligence on Financial Technology Companies

A Guide for Community Banks

AUGUST 2021

Board of Governors of the Federal Reserve System

Federal Deposit Insurance Corporation

Office of the Comptroller of the Currency

Introduction

Innovation and evolving customer preferences are changing the financial services landscape, including the way financial products and services are delivered. Some banks are exploring ways in which third-party relationships may assist them in responding to the changing landscape. These relationships are particularly relevant in situations in which community banks may benefit from additional expertise. By providing access to new or innovative technologies, companies specializing in financial technologies (or "fintech") can provide community banks with many benefits, such as enhanced products and services, increased efficiency, and reduced costs, all bolstering competitiveness. Like other third-party relationships, arrangements with fintech companies can also introduce risks.[1] Assessing the benefits and risks posed by these relationships is key to a community bank's due diligence process.

This guide is intended to be a resource for community banks when performing due diligence on prospective relationships with fintech companies. Use of this guide is voluntary and it does not anticipate all types of third-party relationships and risks. Therefore, a community bank can tailor how it uses relevant information in the guide, based on its specific circumstances, the risks posed by each third-party relationship, and the related product, service, or activity (herein, activities) offered by the fintech company. While the guide is written from a community bank perspective, the fundamental concepts may be useful for banks of varying size and for other types of third-party relationships. Banks should reference federal banking agencies' relevant guidance.[2]

Due diligence is an important component of an effective third-party risk management process, as highlighted in the federal banking agencies' respective guidance. During due diligence, a community bank collects and analyzes information to determine whether third-party relationships would support its strategic and financial goals and whether the relationship can be implemented in a safe and sound manner, consistent with applicable legal and regulatory requirements. The

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[1] Engaging a third party does not diminish a bank's responsibility to operate in a safe and sound manner and to comply with applicable legal and regulatory requirements, including federal consumer protection laws and regulations, just as if the bank were to perform the service or activity itself.

[2] For institutions supervised by the Office of the Comptroller of the Currency (OCC), see OCC Bulletin 2013-29, Third-Party Relationships: Risk Management Guidance (October 30, 2013), https://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html. For institutions supervised by the Federal Deposit Insurance Corporation (FDIC), see FDIC Financial Institution Letter-44-2008 (June 6, 2008), https://www.fdic.gov/news/financial-institution-letters/2008/fil08044.html. For institutions supervised by the Board of Governors of the Federal Reserve System (Board), see SR letter 13-19 "Guidance on Managing Outsourcing Risk" (December 5, 2013), https://www.federalreserve.gov/supervisionreg/srletters/sr1319.htm.

On July 19, 2021, the Board, FDIC, and OCC (federal banking agencies) published for comment proposed interagency guidance for third-party relationships. See "Proposed Interagency Guidance on Third-Party Relationships: Risk Management," 86 Fed. Reg. 38,182 (July 19, 2021). This guide draws from the federal banking agencies' existing guidance and is consistent with the proposed interagency guidance.

scope and depth of due diligence performed by a community bank will depend on the risk to the bank from the nature and criticality of the prospective activity. Banks may also choose to supplement or augment their due diligence efforts with other resources as appropriate, such as use of industry utilities or consortiums that focus on third-party oversight.

The guide focuses on six key due diligence topics, including relevant considerations, potential sources of information and illustrative examples. There may be other topics, considerations, and sources of information to consider, depending on the unique relationship and the role of the fintech company.

Topics to Consider When Conducting Due Diligence of a Fintech Company

Business Experience and Qualifications

Evaluating a fintech company's business experience, strategic goals, and overall qualifications allows a community bank to consider a fintech company's experience in conducting the activity and its ability to meet the bank's needs.

Business Experience

Relevant Considerations

Operational history provides insight into a fintech company's ability to meet a community bank's needs, including, for example, the ability to adequately provide the activities being considered in a manner that enables a community bank to comply with regulatory requirements and meet customer needs.

Client references and complaints about a fintech company provide useful information when considering, among other things, whether a fintech company has adequate experience and expertise to meet a community bank's needs and resolve issues, including experience with other community banking clients.

Legal or regulatory actions against a fintech company can be indicators of the company's track record in providing activities.

Potential Sources of Information

- Company overview
- Organization charts
- List of client references using the activities being considered
- Volume and types of complaints, including those available from the fintech company, regulatory agencies, and other public sources
- Public records of any legal or regulatory actions and to establish corporate standing, if applicable
- Media reports mentioning the fintech company
- Summary of any past operational failures of the fintech company

Business Strategies and Plans

Relevant Considerations

Discussing a fintech company's strategic plans can provide insight on key decisions it is considering, such as plans to launch new products or pursue new arrangements (such as acquisitions, joint ventures, or joint marketing initiatives). A community bank may subsequently consider whether the fintech company's strategies or any planned initiatives would affect the prospective activity.

Inquiring about a fintech company's strategies and management style may help a community bank assess whether a fintech company's culture, values, and business style fit those of the community bank.

Potential Sources of Information

- Mission statement, service philosophy, and quality initiatives
- Geographic footprint information (such as locations of offices and operations)
- Overview of strategic plans and/or expansion strategies
- Patents and licenses
- Summary of key personnel and subcontractors (if utilized)
- Employment policies, including background check and hiring practices
- Fintech company website and social media sites

Qualifications and Backgrounds of Directors and Company Principals

Relevant Considerations

Understanding the background and expertise of a fintech company's directors and executive leadership may provide a community bank useful information on the fintech company's board and management knowledge and experience related to the activity sought by the community bank.

A community bank may also consider whether the company has sufficient management and staff with appropriate expertise to handle the prospective activity.

Potential Sources of Information

- Ownership information
- Biographical and professional information on board of directors' and executive directors' backgrounds, often available on company websites and in public records
- Resource plans (including succession plans)

Illustrative Example

A fintech company, its directors, or its management may have varying levels of expertise conducting activities similar to what a community bank is seeking. A fintech company's historical experience also may not include engaging in relationships with community banks. As part of due diligence, a community bank might therefore consider how a fintech company's particular experiences could affect the success of the proposed activity and overall relationship.

Understanding a fintech company's qualifications and strategic direction will help a community bank assess the fintech company's ability to meet the community bank's expectations and support a community bank's objectives. When evaluating the potential relationship, a community bank may consider a fintech company's willingness and ability to align the proposed activity with the community bank's needs, its plans to adapt activities for the community bank's regulatory environment, and whether there is a need to address any integration challenges with community bank systems and operations.

Financial Condition

Evaluating a fintech company's financial condition helps a community bank to assess the company's ability to remain in business and fulfill any obligations created by the relationship.

Financial Analysis and Funding

Relevant Considerations

Financial reports provide useful information when evaluating a fintech company's capacity to provide the activity under consideration, remain a going concern, and fulfill any of its obligations, including its obligations to the community bank.

Understanding funding sources provides useful information in assessing a fintech company's financial condition. A fintech company may be able to fund operations and growth through cash flow and profitability or it may rely on other sources, such as loans, capital injections, venture capital, or planned public offerings.

Potential Sources of Information

- Financial statements and auditors' opinions as available
- Annual reports
- U.S. Securities-related filings, often available from the Securities and Exchange Commission
- Internal financial reports and projections
- List of funding sources

Market Information

Relevant Considerations

Information about a fintech company's competitive environment may provide additional insight on the company's viability.

Information on a fintech company's client base provides insight into any reliance a fintech company may have on a few significant clients. A few critical clients may provide key sources of operating cash flow and support growth but may also demand much of a fintech company's resources. Loss of a critical client may negatively affect revenue and hinder a fintech company's ability to fulfill its obligations with a community bank.

A community bank may consider a fintech company's susceptibility to external risks, such as geopolitical events that may affect the company's financial condition.

Potential Sources of Information

- Publicly available market information on competitors
- Information on client base

Illustrative Example

Some fintech companies, such as those in an early or expansion stage, have yet to achieve profitability or may not possess financial stability comparable to more established companies. Some newer fintech companies may also be unable to provide several years of financial reporting, which may impact a community bank's ability to apply its traditional financial analysis processes.

When audited financial statements are not available, a community bank might seek other financial information to gain confidence that a fintech company can continue to operate, provide the activity satisfactorily, and fulfill its obligations. For example, a community bank may consider a fintech company's access to funds, its funding sources, earnings, net cash flow, expected growth, projected borrowing capacity, and other factors that may affect a fintech company's overall financial performance.

Legal and Regulatory Compliance

Evaluating a fintech company's legal standing, its knowledge about legal and regulatory requirements applicable to the proposed activity, and its experience working within the legal and regulatory framework enables a community bank to verify a fintech company's ability to comply with applicable laws and regulations.

Legal

Relevant Considerations

Organizational documents and business licenses, charters, and registrations provide information on where a fintech company is domiciled and authorized to operate (for example, domestically or internationally) and legally permissible activities under governing laws and regulations.

Reviewing the nature of the proposed relationship, including roles and responsibilities of each party involved, may also help a community bank identify legal considerations.

Assessing any outstanding legal or regulatory issues may provide insight into a fintech company's management, its operating environment, and its ability to provide certain activities.

Potential Sources of Information

- Charters, articles of incorporation, certificates of good standing, and licenses, such as those recorded with the relevant state
- Other relevant public information, such as records related to patents and intellectual property
- Lawsuits, settlements, remediation, enforcement actions, fines, and consumer complaints
- Form 10-K filing
- Form 10-Q filing

Regulatory Compliance

Relevant Considerations

Reviewing a fintech company's risk and compliance processes helps a community bank to assess the fintech company's ability to support the community bank's legal and regulatory requirements, including privacy, consumer protection, fair lending, anti-money-laundering, and other matters.

A fintech company's experience working with other community banks may provide insight

Potential Sources of Information

- Policies, procedures, training, and internal controls pertaining to compliance with legal and regulatory requirements
- Proposed contract terms that specify performance of legal and compliance duties
- Information regarding customer-facing delivery channels or applications (for example, mail, online, and telephone)

Regulatory Compliance—continued

Relevant Considerations	Potential Sources of Information
into the fintech company's familiarity with the community bank's regulatory environment. Reviewing information surrounding any consumer-facing applications, delivery channels, disclosures, and marketing materials for community bank customers can assist a community bank to anticipate and address potential consumer compliance issues. Considering industry ratings (for example, Better Business Bureau) and the nature of any complaints against a fintech company may provide insight into potential customer-service and compliance issues or other consumer protection matters.	• Proposed marketing materials and regulatory disclosures with product details such as fees, interest rates, or other terms • Methods used to monitor, remediate, and respond to customer complaints • Customer complaint records involving the fintech company

Illustrative Example

Some fintech companies may have limited experience working within the legal and regulatory framework in which a community bank operates.

To protect its interests, community banks may consider including contract terms requiring

- compliance with relevant legal and regulatory requirements, including federal consumer protection laws and regulations, as applicable;
- authorization for a community bank and the bank's primary supervisory agency to access a fintech company's records; or
- authorization for a community bank to monitor and periodically review or audit a fintech company for compliance with the agreed-upon terms.

Other approaches might include

- instituting approval mechanisms (for example, community bank signs off on any changes to marketing materials related to the activity), or
- periodically reviewing customer complaints, if available, related to the activity.

Risk Management and Controls

Evaluating the effectiveness of a fintech company's risk management policies, processes, and controls helps a community bank to assess the company's ability to conduct the activity in a safe and sound manner, consistent with the community bank's risk appetite and in compliance with relevant legal and regulatory requirements.

Risk Management and Control Processes

Relevant Considerations

Reviewing a fintech company's policies and procedures governing the applicable activity provides insight into how the fintech company outlines risk management responsibilities and reporting processes, and how the fintech company's employees are responsible for complying with policies and procedures. A community bank may also use this information to assess whether a fintech company's processes are in line with its own risk appetite, policies, and procedures.

Information about the nature, scope, and frequency of control reviews, especially those related to the prospective activity, provides a community bank with insight into the quality of the fintech company's risk management and control environment. A community bank may also want to consider the relative independence and qualifications of those involved in testing.

A fintech company may employ an audit function (either in-house or outsourced). In these cases, evaluating the scope and results of relevant audit work may help a community bank determine how a fintech company ensures that its risk management and internal control processes are effective.

Potential Sources of Information

- Policies, procedures, and other documentation related to the prospective activity
- Policies and procedures related to the fintech company's internal control environment and overall risk management processes
- Information on risk and compliance staffing
- Recent results of control reviews and audit reports related to the prospective activity
- Issue management policies, procedures, and reports
- Schedule of planned control reviews and audits
- Self-assessments
- Training materials and training schedule
- Inventory of key risk, performance, and control indicators
- Sample key risk, performance, and control indicator reports

Risk Management and Control Processes—continued

Relevant Considerations

The findings, conclusions, and any related action plans from recent control reviews and audits provide insight into the effectiveness of a fintech company's program and the appropriateness and timeliness of any related action plans.

Evaluating a fintech company's reporting helps a community bank to consider how the fintech company monitors key risk, performance, and control indicators; how those indicators relate to the community bank's desired service-level agreements; and how the fintech company's reporting processes identify and escalate risk issues and control testing results. A community bank may also consider how it would incorporate such reporting into the bank's own issue management processes.

Information on a fintech company's staffing and expertise, including for risk and compliance, provide a means to assess the overall adequacy of the fintech company's risk and control processes for the proposed activity.

Information on a fintech company's training program also assists in considering how the fintech company ensures that its staff remains knowledgeable about regulatory requirements, risks, technology, and other factors that may affect the quality of the activities provided to a community bank.

Potential Sources of Information

- Project plans associated with any plannedchanges to systems or reporting capabilities
- Sample reports to the fintech company's board of directors

Illustrative Example

A fintech company's audit, risk, and compliance functions will vary with the maturity of the company and the nature and complexity of activities offered. As a result, a fintech company may not have supporting information that responds in full to a community bank's typical due diligence questionnaires. In other cases, a fintech company may be hesitant to provide certain information that is considered proprietary or a trade secret (for example, their development methodology or model components). In these situations, a community bank might take other steps to identify and manage risks in the third-party relationship and gain confidence that the fintech company can provide the activity satisfactorily.

For example, a community bank might consider on-site visits to help evaluate a fintech company's operations and control environment, or a community bank's auditors (or another independent party) may evaluate a fintech company's operations as part of due diligence.

Other approaches might include

- accepting due diligence limitations, with any necessary approvals and/or exception reporting, compared to the community bank's normal processes, commensurate with the criticality of the arrangement and in line with the bank's risk appetite and applicable third-party risk management procedures;
- incorporating contract provisions that establish the right to audit, conduct on-site visits, monitor performance, and require remediation when issues are identified;
- establishing a community bank's right to terminate a third-party relationship, based on a fintech company's failure to meet specified technical and operational requirements or performance standards. Contract provisions may also provide for a smooth transition to another party (for example, ownership of records and data by the community bank and reasonable termination fees); or
- outlining risk and performance expectations and related metrics within the contract to address a community bank's requirements.

Information Security

Evaluating a fintech company's information security measures allows a community bank to assess the adequacy and integrity of a fintech company's processes for handling and protecting sensitive information, including community bank customer information, depending on the third-party relationship and activity proposed.

Information Security Program

Relevant Considerations

It is important to understand any security framework that a fintech company employs to manage cybersecurity risk.

A fintech company's information security control assessments (for example, penetration testing, vulnerability assessments, etc.) highlights the fintech company's approach to identifying, mitigating, or correcting vulnerabilities in its security posture.

A fintech company's information security policies can provide insight into the company's ability to perform the proposed activity in a safe and sound manner and how or whether the fintech company trains and tests employees and subcontractors (for example, phishing or vishing exercises).

Assessing a fintech company's policies and practices related to privacy and information security is important in understanding the relevant controls in place to support a community bank's ongoing ability to comply with safeguarding requirements and its privacy and information security requirements.

Understanding a fintech company's security incident response and notification procedures may assist a community bank in determining any challenges to comply with its own incident response requirements.

Potential Sources of Information

- Completed information security controls assessments
- Incident management and response policies
- Incident reports with associated post-mortem and remediation activities
- Information security policies (for example, access management, data center security, backup management, change management, and anti-malware policies)
- Information security and privacy awareness training requirements for staff
- Policies addressing relevant safeguarding and privacy laws and regulations

Information Systems

Relevant Considerations

Understanding a fintech company's operations infrastructure and the security measures for managing operational risk may help a community bank evaluate whether those measures are appropriate for the prospective activity.

A community bank may evaluate whether the proposed activity can be performed using existing systems, or if additional IT investment would be needed at the community bank or at the fintech company to successfully perform the activity. For example, a community bank may evaluate whether the fintech company's systems can support the bank's business, customers, and transaction volumes (current and projected).

A fintech company's procedures for deploying new hardware or software, and its policy toward patching and using unsupported (end-of-life) hardware or software, will provide a community bank with information on the prospective third party's potential security and business impacts to the community bank.

Potential Sources of Information

- Information technology policies (for example, data protection including data classification, retention, and disposal)
- Overview of the fintech company's technology and processes supporting the prospective activity
- Completed controls or standards assessments

Illustrative Example

Fintech companies' information security processes may vary, particularly for fintech companies in an early or expansion stage. Community banks may evaluate whether a fintech company's information security processes are appropriate and commensurate with the risk of the proposed activity. Depending on the activity provided, community banks may also seek to understand a fintech company's oversight of its subcontractors, including data and information security risks and controls.

For a fintech company that provides transaction processing or that accesses customer data, for example, community banks may request information about how the fintech company restricts access to its systems and data, identifies and corrects vulnerabilities, and updates and replaces hardware or software. The bank may also consider risks and related controls pertaining to its customers' data, in the event of the fintech company's security failure. Also, contractual terms that authorize a community bank to access fintech company records can better enable the bank to validate compliance with the laws and regulations related to information security and customer privacy.

Operational Resilience

A community bank may evaluate a fintech company's ability to continue operations through a disruption.[3] Depending on the activity, a community bank may look to the fintech company's processes to identify, respond to, and protect itself and customers from threats and potential failures, as well as recover and learn from disruptive events. It is important that third-party continuity and resilience planning be commensurate with the nature and criticality of activities performed for the bank.

Business Continuity Planning and Incident Response

Relevant Considerations

Evaluating a fintech company's business continuity plan, incident response plan, disaster recovery plan and related testing can help a community bank determine the fintech company's ability to continue operations in the event of a disruption.

Evaluating a fintech company's recovery objectives, such as any established recovery time objectives and recovery point objectives, helps to ascertain whether the company's tolerances for downtime and data loss align with a community bank's expectations.

How a fintech company considers changing operational resilience processes to account for changing conditions, threats, or incidents, as well as how the company handles threat detection (both in-house and outsourced) may provide a community bank with additional information on incident preparation.

Discussions with a fintech company, as well as online research, could provide insights into how the company responded to any actual cyber events or operational outages and any impact they had on other clients or customers.

Potential Sources of Information

- Business continuity plans
- Disaster recovery plans
- Incident response plan
- Documented system backup processes
- Business continuity, disaster recovery, and incident response test results
- Cybersecurity reports and audits
- Insurance documents

[3] Disruptive events could include technology-based failures, human error, cyber incidents, pandemic outbreaks, and natural disasters.

Business Continuity Planning and Incident Response—continued

Relevant Considerations

Understanding where a fintech company's data centers are or will reside, domestically or internationally, helps a community bank to consider which laws or regulations would apply to the community bank's business and customer data.

A community bank may consider whether a fintech company has appropriate insurance policies (for example, hazard insurance or cyber insurance) and whether the fintech company has the financial ability to make the community bank whole in the event of loss.

Service Level Agreements

Relevant Considerations

Service level agreements between a community bank and a fintech company set forth the rights and responsibilities of each party with regard to expected activities and functions. A community bank may consider the reasonableness of the proposed service level agreement and incorporate performance standards to ensure key obligations are met, including activity uptime.

A community bank may also consider whether to define default triggers and recourse in the event that a fintech company fails to meet performance standards.

Potential Sources of Information

- Proposed service level agreements
- Evidence of status meeting existing service level agreements

Reliance on Subcontractors

Relevant Considerations

A fintech company's monitoring of its subcontractors (if used) may offer insight into the company's own operational resilience. For example, a community bank may inquire as to whether the fintech company depends on a small number of subcontractors for operations, what activities they provide, and how the fintech company will address a subcontractors' inability to perform.

A community bank may assess a fintech company's processes for conducting background checks on subcontractors, particularly if subcontractors have access to critical systems related to the proposed activity.

Potential Sources of Information

- The fintech company's policies on outsourcing and its use of subcontractors
- Independent reports or certifications regarding subcontractors
- List of third parties used by the fintech company

Illustrative Example

As with previous due diligence scenarios, fintech companies may exhibit a range of resiliency and continuity processes, depending on the activities offered. Community banks may evaluate whether a fintech company's planning and related processes are commensurate with the nature and criticality of activities performed for the bank.

For example, community banks may evaluate a fintech company's ability to meet the community bank's recovery expectations and identify any subcontractors the fintech company relies upon for recovery operations. A fintech company may have recovery time objectives for the proposed activity that exceed the desired recovery time objectives of a community bank. If a fintech company can meet the community bank's desired recovery time objectives, the bank may consider including related contractual terms, such as a contract stipulation that the community bank can participate in business continuity testing exercises and that provides appropriate recourse if the recovery time objective is missed in the event of an actual service disruption.

A community bank may also consider appropriate contingency plans, such as the availability of substitutable service providers, in case the fintech company experiences a business interruption, fails, or declares bankruptcy and is unable to perform the agreed-upon activities. In addition to potential contractual clauses and requirements, a community bank's management may also consider how it might wind down or transfer the activity in the event the fintech company fails to recover in a timely manner.

3501 Fairfax Drive • Room B7081a • Arlington, VA 22226-3550 • (703) 516-5588 • FAX (703) 562-6446 • www.ffiec.gov

Authentication and Access to Financial Institution Services and Systems

Introduction

The Federal Financial Institutions Examination Council (FFIEC) on behalf of its members[1] is issuing this guidance titled *Authentication and Access to Financial Institution Services and Systems* (the Guidance) to provide financial institutions with examples of effective risk management principles and practices for access and authentication. These principles and practices address business and consumer customers, employees, and third parties that access digital banking services[2] and financial institution information systems.

The Guidance replaces the FFIEC-issued *Authentication in an Internet Banking Environment (2005)* and the *Supplement to Authentication in an Internet Banking Environment (2011)*, which provided risk management practices for financial institutions offering Internet-based products and services. This Guidance acknowledges significant risks associated with the cybersecurity threat landscape that reinforce the need for financial institutions to effectively authenticate users and customers[3] to protect information systems, accounts, and data. The Guidance also recognizes that authentication considerations have extended beyond customers and include employees, third parties, and system-to-system communications.

This Guidance highlights risk management practices that support oversight of identification, authentication, and access solutions as part of an institution's information security program. Periodic risk assessments inform financial institution management's decisions about authentication solutions and other controls that are deployed to mitigate identified risks. When a risk assessment indicates that single-factor authentication with layered security is inadequate, multi-factor authentication (MFA) or controls of equivalent strength, combined with other layered security controls, can more effectively mitigate risks associated with authentication.

Financial institutions are subject to various safety and soundness standards, such as the standard to have internal controls and information systems that are appropriate to the institution's size and complexity and the nature, scope, and risk of its activities.[4] Applying the principles and

[1] The Council has six voting members: a member of the Board of Governors of the Federal Reserve System, the Chairman of the Federal Deposit Insurance Corporation; the Chairman of the National Credit Union Administration; the Comptroller of the Currency of the Office of the Comptroller of the Currency; the Director of the Consumer Financial Protection Bureau; and the Chairman of the State Liaison Committee.
[2] Digital banking refers to any banking service or platform that utilizes Internet or mobile cellular network communications for providing customers with banking services or transactions.
[3] For purposes of this Guidance only, the terms "users" and "customers" are defined in section 1 of this Guidance.
[4] See, for example, Interagency Guidelines Establishing Standards for Safety and Soundness: 12 CFR 30, Appendix A, II(A) (OCC); 12 CFR 208, Appendix D-1, II(A) (FRB); and 12 CFR 364, Appendix A, II(A) (FDIC). See also 12 CFR § 741.3 (NCUA).

practices in this Guidance, as appropriate to a financial institution's risk profile, can support alignment with such safety and soundness standards.

An effective authentication program also can support alignment with the *Interagency Guidelines Establishing Information Security Standards*[5] and with other laws and regulations. For example, a financial institution's authentication program can support compliance with consumer financial protection laws, and with laws that address Customer Identification Program (CIP) and Customer Due Diligence (CDD) requirements, identity theft prevention,[6] and the enforceability of electronic agreements. This Guidance does not interpret or establish a compliance standard for these laws or impose any new regulatory requirements on financial institutions.

This Guidance is not intended to serve as a comprehensive framework for identity and access management programs and does not endorse any specific information security framework or standard. This Guidance is relevant whether the financial institution or a third party, on behalf of the financial institution, provides the accessed information systems and authentication controls.

Management may refer to the appropriate FFIEC member issuances and resources referenced in the "Additional Resources" section of this Guidance to learn more about sound authentication and information technology risk management practices. This Guidance also contains references to other authentication risk management resources, including publications from the National Institute of Standards and Technology (NIST), National Security Agency (NSA), Cybersecurity and Infrastructure Security Agency (CISA), Center for Internet Security (CIS), and other public and private industry organizations. Updates to these resources can assist financial institution management in evaluating new authentication threats and control practices.

Section 1. Highlights of Guidance

This Guidance sets forth risk management principles and practices that can support a financial institution's authentication of (a) users accessing financial institution information systems, including employees, board members, third parties, service accounts, applications, and devices (collectively, users) and (b) consumer and business customers (collectively, customers)[7] authorized to access digital banking services. The application of these principles and practices may vary at financial institutions based on their respective operational and technological complexity, risk assessments, and risk appetites and tolerances.

[5] The Interagency Guidelines Establishing Information Security Standards, which implement section 501(b) of the Gramm–Leach–Bliley Act, 15 USC 6801, require banks and other financial institutions to safeguard the information of persons who obtain or have obtained a financial product or service to be used primarily for personal, family or household purposes, with whom the institution has a continuing relationship. Credit unions are subject to a similar rule. 12 CFR 30, Appendix B (OCC); 12 CFR 208, Appendix D-2 and 225, Appendix F (FRB); 12 CFR 364, Appendix B (FDIC); and 12 CFR 748, Appendix A (NCUA). These principles also are consistent with resources provided by the FFIEC members, and the "Joint Statement on Heightened Cybersecurity Risk" issued by the OCC and FDIC.

[6] See, for example, the Identity Theft Red Flags Rule. 12 CFR § 334.90 (FDIC); 12 CFR 222, subpart J (FRB); and 12 CFR 41, subpart J (OCC).

[7] For purposes of this Guidance only, the term "customers" includes credit union members.

Topics of this Guidance include:

- Conducting a risk assessment for access and authentication to digital banking and information systems.
- Identifying all users and customers for which authentication and access controls are needed, and identifying those users and customers who may warrant enhanced authentication controls, such as MFA.
- Periodically evaluating the effectiveness of user and customer authentication controls.
- Implementing layered security to protect against unauthorized access.
- Monitoring, logging, and reporting of activities to identify and track unauthorized access.
- Identifying risks from, and implementing mitigating controls for, email systems, Internet access, customer call centers, and internal IT help desks.
- Identifying risks from, and implementing mitigating controls for, a customer-permissioned entity's access to a financial institution's information systems.
- Maintaining awareness and education programs on authentication risks for users and customers.
- Verifying the identity of users and customers.

Section 2. Threat Landscape

The system entry or access points (known as the attack surface) where an attacker can compromise a financial institution have expanded with the evolution of new technologies and broadly-used remote access points. For example, the number of digital banking services and information system access points has expanded with mobile computing, smart phone applications, "bring your own" devices, voice-activated capabilities, and cellular communications. These technologies and access points provide attackers with more opportunities to obtain unauthorized access, commit fraud and account takeover, or exfiltrate data. Authentication risks may arise from: (a) expanded remote access to information systems; (b) the types of devices and third parties accessing information systems; (c) the use of application programming interfaces (APIs); and (d) financial institutions' increased connectivity to third parties, such as cloud service providers.

Data breaches at financial institutions, their service providers, and nonbanks, such as credit bureaus, have exposed information and credentials of customers and employees. Attackers use technologies, such as automated password cracking tools, and these compromised credentials in their attacks against financial institutions. In addition, older or unsupported information systems may be especially vulnerable to attacks because security patches and upgrades for authentication controls can be more difficult to obtain.

These types of attacks demonstrate that certain authentication controls, previously shown effective, no longer provide sufficient defense against evolving and increasingly sophisticated methods of attack. In particular, malicious activity resulting in compromise of customer and user accounts and information system security has shown that single-factor authentication, either alone or in combination with layered security, is inadequate in many situations.

While the financial sector continues to expand the number of systems and services that require effective authentication, advances in technologies and control frameworks can support financial institution management's risk assessment and selection of authentication controls. For example, some authentication controls use out-of-band communication and encryption protocols to support secure authentication. Various standard-setting organizations and other cybersecurity resources have identified MFA, in conjunction with other layered security controls, to be an effective practice to secure against financial loss and data compromise caused by various threats.[8] For example, MFA, when combined with network segmentation and least privilege user access, can assist in mitigating the risk of unauthorized access that can result in a threat actor changing system configurations, exfiltrating data, or moving laterally within a network or system.

Section 3. Risk Assessment

A risk assessment[9] evaluates risks, threats, vulnerabilities, and controls associated with access and authentication, and supports decisions regarding authentication techniques and access management practices.[10] Risk assessments conducted prior to implementing a new financial service, such as a faster payment product, as well as periodic risk assessments, have been shown to be effective in identifying reasonably foreseeable risks.[11] A non-current risk assessment may result in unidentified risks or insufficient controls.

An integrated, enterprise-wide approach to a risk assessment includes inputs from a range of business functions or units. For example, fraud research, customer service, and cybersecurity can provide data and perspectives to enhance the risk assessment. Data from these business functions, as well as from customer reports of attempted and actual fraud, may yield useful information for identifying emerging authentication threats. Moreover, data from actual fraud events may enable financial institutions to identify certain authentication controls that are ineffective or degraded.

Examples of effective risk assessment practices include:

- *Inventory of Information Systems*. Inventory all information systems and their components, such as the hardware, operating systems, applications, infrastructure devices, APIs, data, and other assets, that require authentication and access controls. This inventory includes information systems provided by the financial institution's third parties, such as cloud service providers.

[8] See for example, NIST Special Publication 800-63B, Digital Identity Guidelines - Selecting Assurance Levels; CISA and Multi-State Information Sharing and Analysis Center (MS-ISAC), "Joint Ransomware Guide" (September 2020); NSA, "Top Ten Cybersecurity Mitigation Strategies" (March 2018).

[9] While this Guidance refers to a single risk assessment, a financial institution may have more than one risk assessment to evaluate threats and controls at different levels, such as the enterprise, system, or application levels, consistent with the financial institution's internal practices and policies.

[10] The *Interagency Guidelines Establishing Information Security Standards,* paragraph III.B (*Assess Risk*) and paragraph III.C (*Manage and Control Risk*) states that a financial institution subject to the Guidelines shall assess risk and shall consider among other things whether access controls on customer information systems, encryption controls, and monitoring systems are appropriate. For more information on risk assessments, see *FFIEC IT Examination Handbook*, "Information Security" booklet; and FFIEC Cybersecurity Assessment Tool. See NIST Special Publication 800-30, Revision 1 – "Guide for Conducting Risk Assessments" (2012).

[11] *FFIEC IT Examination Handbook*, "Management" booklet, section III, IT Risk Management.

- *Inventory of Digital Banking Services and Customers*. Inventory digital banking services, customers, and transactions that may warrant authentication and access controls. This includes such elements as: customer types (e.g., business or consumer), transactional capabilities (e.g., bill payment, wire transfer, loan origination), customer information accessed, and transaction volumes. Some digital banking services may have unique risk profiles. For example, financial institutions may benefit from considering risks arising from digital payment services that have shorter processing windows, push-payment capabilities, and limited fraud management functionality.[12]

- *Identify Customers Engaged in High-Risk Transactions*. Identify digital banking customers engaged in transactions that present higher risk of financial loss or potential breach of information for which enhanced authentication controls are warranted. [13] Elements considered in identifying high-risk transactions have included the dollar amount and volume of transactions, the sensitivity and amount of information accessed, the irrevocability of the transaction, and the likelihood and impact of fraud.

- *Identify Users.* Identify all users, including employees, service accounts,[14] and users at third parties, that access financial institution information systems and data. Considerations have included the functionality, criticality, and associated risk of information systems and data, and user access rights or permissions.

- *High-Risk User Identification*. Identify users who represent a high risk and for which enhanced authentication controls are warranted to protect information systems. Elements considered when identifying high-risk users have included: access to critical systems and data; privileged users,[15] including security administrators; remote access to information systems; and key positions such as senior management. For purposes of this Guidance, this subset of users that warrant enhanced controls are referred to as "high-risk users."

- *Threat Identification*. Identify threats with reasonable probability of impacting financial institution information systems, data, and user and customer accounts. Common threats include, but are not limited to, malware including ransomware, man-in-the middle (MIM) attacks, credential abuses, and phishing attacks. Threat identification typically includes intelligence from Information Sharing and Analysis Organizations,[16] and a review of actual or attempted incidents of security breaches, identity theft, or fraud experienced by the institution or the financial industry. Refer to NIST and other resources set forth in the

[12] In traditional payment transfers, the entity receiving funds initiates a transfer to pull funds from a customer account using payment credentials. In contrast, some payment products—particularly newer faster products—allow paying customers to log into their accounts and initiate a credit "push" of funds to another account.
[13] Financial institution management may decide to apply enhanced authentication more broadly across the institution's customer base, regardless of the relative risks associated with different customers' transactions.
[14] A service account is a "dedicated account with escalated privileges used for running applications and other processes. Service accounts may also be created just to own data and configuration files. They are not intended to be used by people, except for performing administrative operations." Glossary, CIS Controls, version 8.
[15] NIST SP 800-53 Rev. 5 defines a "privileged user" as a "user that is authorized (and therefore, trusted) to perform security-relevant functions that ordinary users are not authorized to perform."
[16] These organizations include the Financial Services Information Sharing and Analysis Center (FS-ISAC) and the United States Computer Emergency Readiness Team (US-CERT) of CISA.

"Additional Resources" section of this Guidance for additional threat identification and mitigation information.[17]

- *Controls Assessment*. Initially and periodically assess the design and effectiveness of access and authentication controls employed, including the availability of more advanced security options and configuration settings. Based on control assessments, residual risk is considered for acceptance or additional corrective action according to internal policies that define risk appetite and tolerance. Examples of assessment areas include source code and supply chain management controls for authentication factors, and service level agreements (SLAs) with measurement and reporting controls for outsourced authentication services.

Section 4. Layered Security

Layered security incorporates multiple preventative, detective, and corrective controls, and is designed to compensate for potential weaknesses in any one control.[18] Consistent with the assessed level of risk, the application of these controls can mitigate inherent risk associated with, and protect against unauthorized access to, information systems and digital banking services. Layered security controls can include, but are not limited to, MFA, user time-out, system hardening, network segmentation, monitoring processes, and transaction amount limits. Layered security controls also can include assigning users' access rights to information systems based on the principle of least privilege provisioning. Refer to the Appendix and the "Additional Resources" section of this Guidance for further examples and information regarding authentication and access controls.

Relying only on a single control or authentication solution can increase risk to information systems and digital banking services. In a layered security approach, authentication controls are applied commensurate with the increasing risk level associated with a transaction or access to an information system. Authentication controls with increased strength have been shown to be effective for customers and users engaged in high-risk transactions and activities, for example, when a customer initiates a payment transaction or when a privileged user accesses an information system.

Section 5. Multi-Factor Authentication as Part of Layered Security

Attacks against systems and users protected with single-factor authentication often lead to unauthorized access resulting in data theft or destruction, adverse impacts from ransomware, customer account fraud, and identity theft. Accordingly, use of single-factor authentication as the only control mechanism has shown to be inadequate against these threats. Furthermore,

[17] For example, see NIST SP 800-63B - Digital Identity Guidelines – Authentication Lifecycle Management, section 8.1. The "Threats and Considerations" section contains a list of "Authenticator Threats" and "Mitigating Authenticator Threats."

[18] See *FFIEC IT Examination Handbook*, "Information Security" booklet, section II.C.15(c) ("Remote Access"), and section II.C.16 ("*Customer Remote Access to Financial Services*") for information about layered security.

single-factor authentication with layered security has shown to be inadequate for customers engaged in high-risk transactions and for high-risk users.[19]

When a financial institution management's risk assessment indicates that single-factor authentication with layered security is inadequate, MFA or controls of equivalent strength as part of layered security can more effectively mitigate risks. When selecting an authentication solution, such as MFA, effective risk assessment practices consider whether any residual risk associated with the authentication solution is consistent with the financial institution's risk appetite and security policies.[20]

MFA is defined by NIST as:

> *An authentication system that requires more than one distinct authentication factor for successful authentication. Multi-factor authentication can be performed using a multi-factor authenticator or by a combination of authenticators that provide different factors. The three authentication factors are something you know, something you have, and something you are.*[21]

MFA factors may include memorized secrets, look-up secrets, out-of-band devices, one-time-password devices, biometrics identifiers, or cryptographic keys. The attributes, including usability, convenience, and strength, of various authentication factors can differ and each may exhibit different vulnerabilities which may be exploited. For example, certain MFA factors may be susceptible to MIM attacks, such as when a hacker intercepts a one-time security code sent to a customer.

The following are some considerations when evaluating or implementing MFA:

- For digital banking customers engaging in high-risk transactions, MFA solutions and other layered security controls may vary depending upon the different risks presented by various services and customer segments, such as business or consumer customers.

- For high-risk users, strong authentication, such as MFA solutions using hardware and cryptographic factors, can mitigate risks associated with unauthorized access to information systems. When cryptographic MFA solutions are used, cryptographic keys are stored securely and protected from attack, for example by storing keys in a hardware security module. For remote users, remote access software (e.g., virtual private network software) can be protected with MFA user credentials in order to improve the security of the encrypted access channel.

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[19] See discussion regarding identifying high-risk scenarios in the "Risk Assessment" section of this Guidance.
[20] See *FFIEC IT Examination Handbook*, "Information Security" booklet, section I.B. "Responsibility and Accountability" for more information about the role of management conducting a risk assessment and acceptance of risk for certain activities.
[21] NIST SP 800-63-3, Appendix A – Definitions and Abbreviations. Definition of "Multi-factor Authentication." The NIST Digital Identity Guidelines also describe different types of multi-factor authentication solutions and their relative levels of security.

- The use of standards and controls can protect the integrity of authentication factors (e.g., tokens, keys, passwords, or passphrases) and communication channels (e.g., out-of-band devices, encrypted communications). Controls can include implementation of validated cryptographic tools to mitigate the risk of authenticator modification, replay, or bypass by a malicious actor.

Section 6. Monitoring, Logging, and Reporting

Monitoring, activity logging, and reporting processes and controls assist financial institution management in determining if attempted or realized unauthorized access to information systems and accounts has occurred. They also facilitate timely response and investigation of unusual or unauthorized activity. Transaction and audit logs assist with identification of unauthorized intrusion or suspicious internal activities, help reconstruct adverse events, and promote employee and user accountability. Refer to the Appendix and the "Additional Resources" section of this Guidance for examples of these controls.

Section 7. Email Systems and Internet Browsers

Users' email accounts and Internet browsers are common access points used by threat actors to gain unauthorized access, obtain or compromise sensitive data, or initiate fraud. These attacks frequently take advantage of misconfigured applications, operating systems, and unpatched vulnerabilities by using social engineering and phishing campaigns. Examples of risk management practices shown to be effective for a financial institution's email systems include implementing secure configurations, MFA or equivalent access techniques, continuing education of users, patching vulnerabilities, and the implementation of software vendor and service provider recommended controls for outsourced services. Examples of risk management practices shown to be effective for Internet browsers include blocking browser pop-ups and redirects and limiting the running of scripting languages. Refer to the Appendix and the "Additional Resources" section of this Guidance for examples of these controls.

Section 8. Call Center and IT Help Desk Authentication

Threat actors frequently have used social engineering and other techniques to deceive customer call center and IT help desk representatives into resetting passwords and other credentials, thereby granting threat actors access to information systems, user and customer accounts, or confidential information. A comprehensive risk assessment supports mitigation of this risk by identifying emerging threats, setting secure processes, employee training, and establishing effective controls for the customer call center and IT help desk operations. Refer to the Appendix and the "Additional Resources" section of this Guidance for examples of these controls.

Section 9. Data Aggregators and other Customer-Permissioned Entities

Data aggregators and other customer-permissioned entities (collectively, CPEs) provide data aggregation and other services to business and consumer customers.[22] CPEs access financial institutions' customer account information directly, or through a third or fourth party. CPEs typically use this accessed data to provide financial institutions' customers a variety of services, such as personal financial management, consumer lending, and payments facilitation. With credential-based access, the CPE obtains and, in some cases, retains the customer's credentials to access the institution's digital banking service on an ongoing basis. Alternatively, with API-based or token-based access, the CPE interfaces directly with the financial institution's information systems using authentication credentials provided by the financial institution.

A comprehensive risk management program includes an assessment of risks and effective mitigating controls for credential and API-based authentication when CPEs access a financial institution's information systems and customer information. For example, a financial institution may assess how the controls applicable to different types of CPE access compare to the controls applicable to customers when directly accessing its digital banking service.

Section 10. User and Customer Awareness and Education

A comprehensive customer awareness program educates customers about a range of authentication risks and other security considerations when using digital banking services. The customer awareness program can complement the layered security controls implemented to protect customers and can lower access and authentication risks. Failure to update customer awareness programs and resources to reflect changes in risks, such as the introduction of a faster payments service, has been shown to cause such programs to become ineffective over time. Any related marketing that is inconsistent with the description of security risks in customer awareness programs could raise legal compliance risks.

In developing a customer awareness program, management may consider the following examples of program elements:

- An explanation of how customers can determine the legitimacy of communications from the financial institution, particularly communications that seek information that could be used to access the customer's account.
- An explanation of controls the financial institution offers that customers can use to mitigate risk, such as MFA.
- An explanation of communication mechanisms that customers may use to monitor account activity, such as transaction alerts.

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[22] This Guidance does not address other risks or policy issues that may be associated with CPEs and data aggregation services, such as regulatory liability of parties for data breach. This Guidance should not be used to circumscribe or discourage customers' appropriate customer-permissioned access to their data through CPEs. For a discussion of risks and policy issues related to data aggregation services, see CFPB Advanced Notice of Proposed Rulemaking: Consumer Access to Financial Records, (October 22, 2020). For a discussion of different types of business arrangements associated with CPEs, see OCC Bulletin 2020-10, "Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29," (March 5, 2020).

- A listing of financial institution contacts that customers may use to report suspicious account activity or information security-related events.
- Educational information regarding prevalent external threats and methods used to illegally access accounts and account information, such as phishing, social engineering, mobile-based trojans, and business email compromise.
- An explanation of situations in which the institution uses enhanced authentication controls, such as call center contact or certain types of account activity like password reset.
- An explanation of the legal and other rights and protections a customer may have in the event of unauthorized access to an account, including protections under Regulation E.

For employees, board members, and other users accessing a financial institution's information systems, education can include training and testing programs on authentication-related scenarios such as phishing and social engineering.

Section 11. Customer and User Identity Verification

Reliable identity verification methods can help reduce risk when establishing new customer accounts and when access is first requested for new users of information systems. Identity verification can reduce the risk of identity theft, fraudulent account applications, and unenforceable account agreements or transactions. Identity verification also occurs periodically thereafter based on risk factors, such as the granting of new authorities or access rights to a user within an information system. For customers, financial institutions are required by USA PATRIOT Act regulations to have a process to verify customer identity when establishing a customer account. Verification methods that detect fraudulent activities, such as synthetic identities[23] and instances of impersonation, have been shown to be effective in minimizing risk associated with identity verification. Reliable verification methods generally do not depend solely on knowledge-based questions to verify identity.

Financial institution management may consult their primary federal regulator or state supervisor, or FFIEC and Financial Crimes Enforcement Network guidance and resources for information about customer identity verification. Sources in the "Additional Resources" section of this Guidance include information on identity verification.

[23] Unlike typical identity theft fraud where a fraudster steals the identity of a real person and uses it to commit fraud, a synthetic identity is a completely fabricated identity that does not correspond to any actual person.

Appendix

The Appendix lists examples of practices or controls related to access management, authentication, and supporting controls. Practices and controls are part of the continuously evolving security landscape and the effectiveness of the listed practices and controls may change. This Appendix is provided as a reference and does not represent an all-inclusive list of practices or controls or characterize a comprehensive information security program. Additional control examples are contained in the resources listed in the "Additional Resources" section.

Authentication Solutions

- *Device-Based Public Key Infrastructure (PKI) Authentication.* PKI authentication solutions use private key/public key cryptography that is built into computers, smartphones, and other devices. A customer or employee uses a personal identification number, biometrics, or other identification methods on the device to trigger the encryption-based authentication process with the financial institution.[24]
- *One Time Passwords (OTP).* OTPs are generated using a specific hardware or software application installed on a mobile phone or other device and may be more secure than static passwords that are only changed at defined intervals.[25]
- *Behavioral Biometrics Software*. Software analyzes the behavioral biometrics or characteristics of a customer, such as the customer's interaction with a mobile phone or other access device, in order to authenticate the customer. Behavioral biometric analysis can include data such as the customer's finger swipes, taps, keystrokes, and mouse usage.
- *Device Identification and Enrollment*. Unique identifiers or characteristics of the customer's or user's device are identified and used to authenticate by obtaining a complex digital "fingerprint" of the device or by other secure identification techniques. Some device identifiers, such as device cookies, geo-location, and Internet Protocol (IP) address matching, are considered insecure and ineffective if used alone, but can be combined with other controls for additional protection.

Password Controls

- *Password Protection.* Passwords are stored in a manner that makes them resistant to attack and possible compromise. Protections are applied for static storage of passwords or the placement of passwords within an application or API. For example, passwords can be "salted" with a random or static value and hashed with a suitable hashing algorithm. This process is designed to mitigate the threat of a brute force or a pre-computed hash attack.
- *Unique Passwords.* Policies and standards address unique passwords for customers and users to minimize the risk of account takeover.

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[24] See NIST Special Publication 800-63B, Digital Identity Guidelines - Authentication and Lifecycle Management for descriptions of "Single-Factor Cryptographic Devices" and "Multi-Factor Cryptographic Devices;" and NIST Special Publication 1800-17, Multifactor Authentication for E-Commerce: Risk-Based, FIDO Universal Second Factor Implementations for Purchasers.

[25] See NIST Special Publication 800-63B, Digital Identity Guidelines - Authentication and Lifecycle Management for descriptions of "Single-Factor OTP Devices" and "Multi-Factor OTP Devices."

- *Password Strength.* Policies and standards address password strength, such as password length, defined character combinations, and the use of passphrases.[26] A passphrase is a series of words or other text that is generally longer than a traditional password.
- *Prohibited Password Lists.* Customers' or users' password choices are checked against databases of prohibited or weak passwords, including dictionary words, common passwords, and passwords associated with prior account or data breaches.

Access and Transaction Controls

- *Account Maintenance Controls*. Enhanced authentication controls are applied for account maintenance activities (e.g., changes to physical or email address, password, contact information, or enrolled devices) performed or requested by customers or users.
- *Transaction Value, Frequency, and Timing Controls.* Transaction controls, such as transaction value limits, restrictions on devices for adding payment recipients, limits on the number of transactions allowed per day, and allowable payment windows (i.e., permissible days and times during which transactions can be initiated) are applied for certain account and digital banking activities.
- *Rate Limit on Log-in Attempts.* Rate limits, which represent the number of log-in submissions over a set timeframe, are applied for correct and incorrect log-in attempts from the same user or from different users from the same IP address. These controls limit the overall volume of authentication requests and can slow potential attacks.
- *Incorrect Log-in Attempts.* Customers and users are locked out of accounts after a certain number of incorrect log-in attempts. Passwords are reset only after requiring strong authentication of the customer or user.
- *Application Timeouts*. Customers and users are re-authenticated after a period of inactivity within a service or a system.
- *Automatic Suspension or De-provisioning of User Credentials*. Policies and system controls are in place to de-provision or suspend access credentials after a certain period of account inactivity.
- *Notification to Security Administrators of Change in User Status*. System administrators are informed in a timely manner of changes (e.g., alteration, removal, or suspension) to user status.

Customer Call Centers and IT Help Desks Controls

- *Enhanced Authentication for Credential Reset*. Enhanced authentication controls are applied to customer and user credential resets, such as sending an OTP to a pre-established communication device; using an authenticator application to provide an OTP; biometric voice recognition; enabling secure video chat features to confirm identity; and call-backs to a pre-established phone number.

[26] See discussion of "Memorized Secret Authenticators" in NIST Special Publication 800-63B, Digital Identity Guidelines - Authentication and Lifecycle Management; and Section 3.7 – "Identification and Authentication - Authenticator Management" of NIST Special Publication 800-53 Revision 5, Security and Privacy Controls for Information Systems and Organizations.

- *Identify Unauthorized Access Attempts*. Controls identify deviations from a customer's or user's usual geographic location or method of communication for the account, such as an Internet-based communication application or an unidentifiable phone number.
- *Lost, Stolen, or Changed Information and Devices.* Controls establish processes for handling lost, stolen, or changed information and devices, including changes to established phone numbers or carriers.
- *Training on Password Reset Process*. Call center personnel are trained on verification and authentication processes for password resets.

Customer Controls

- *Positive Pay and Other Transaction Blocks.* Positive pay,[27] debit blocks, and other techniques are available to business customers to monitor and control transactions on their accounts.
- *Transaction Alerts.* Automated alerts are sent to customers based on transaction size or risk parameters established by customers or the financial institution.
- *Business Customer - System Administrators.* Supplementary controls are available for a business customer's system administrators who are granted privileges to change digital banking configurations, such as the establishment of a new employee with transactional access on the account.
- *Dual Control Transactions.* Controls are available to business customers to require more than one employee to authorize and approve certain transactions.

Transaction Logging and Monitoring Controls

- *Transaction and Audit Logs*. Transaction and audit logs monitor and record system and account activity to identify unauthorized activities, detect intrusions, reconstruct events, and promote customer and user accountability.
- *Fraud and Anomaly Detection Monitoring.* Processes detect fraud and other anomalies, such as changes in user or customer behavior or transaction velocity and increases in login or account lockout activity. These processes also alert management to unauthorized access and/or fraud in a timely manner.
- *Suspicious Behavior Monitoring*. Processes monitor and report customer and user access, especially privileged and remote access users, for suspicious behavior.
- *Fraud Response Policies*. Response policies address situations where customer or user devices are identified as potentially compromised and where customers or users may be facilitating fraud.
- *Monitoring and Reporting of Unauthorized Access by Third Parties*. Processes are in place for third-party service providers to report, and the financial institution to log and monitor, unauthorized access to critical outsourced systems.

[27] "Positive pay" is a technique in which a business customer sends electronic files of information to the financial institution on all checks the business customer has issued. The financial institution compares this information against electronic information regarding checks presented for payment. If a check presented for payment is not included in the positive-pay information, the institution requests the business customer to make a pay/no pay decision.

System Access Controls for Users

- *Access Approval Policies*. Policies establish approval and documentation standards for defining users' authority to access financial institution information systems.
- *Least Privilege Access Provisioning*. User access is limited to those information systems and resources related to the user's job function or role. This can include limitation of users' access rights across multiple information systems.
- *Single Sign-On Capability*. Single sign-on capability is established for users to allow access to multiple internal information systems with a single authentication solution. Single sign-on capability can mitigate risk by reducing the number of passwords and credentials employees must manage and allow the application of strong authentication and risk monitoring to the single sign-on process.
- *Service Accounts.* Service accounts are inventoried, and employees or departments are assigned responsibility for managing service accounts according to the financial institution's password management and other security policies.[28]
- *User Communication and Training*. Users periodically receive authentication security awareness training.

Privileged User Controls

- *Change Defaults*. Default passwords and other credentials for privileged users or system, service, or administrative accounts are changed or disabled.
- *Dedicated Devices or Accounts*. Privileged users have dedicated devices or accounts for all privileged or administrative activities. The dedicated devices cannot access the Internet.[29]
- *Log and Alert.* Systems are configured to log and alert when a privileged user account is added or removed and when unsuccessful logins or other anomalous behavior occurs.[30]
- *Log Access.* Privileged user access is limited and defined between log-related privileges and other privileges. The logs of privileged user activity cannot be modified or deleted by the privileged user.[31]
- *Periodic Review of Privileged User Activity*. Staff independent of the privileged user's organization or business unit is alerted of, and periodically reviews, privileged user activity for anomalous behavior.
- *Dual Controls for Certain Critical Systems or Administrative Changes*. More than one privileged user at the financial institution must approve access to certain critical systems or certain requests for administrative changes.
- *Enhanced Authentication for System and Software Update*s. Privileged users are re-authenticated with MFA prior to making system configuration changes, uploading or updating software or firmware, or executing significant system processes.[32]

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[28] Additional information regarding controls for service accounts users is available in the CIS Security Controls.
[29] Id.
[30] Id.
[31] NIST Special Publication 800-53 (Rev. 5), Control AU-9.4, Security and Privacy Controls for Federal Information Systems and Organizations.
[32] NIST Special Publication 800-160 Vol. 2 - Developing Cyber Resilient Systems: A Systems Security Engineering Approach.

System and Network Design and Architecture Controls

- *Endpoint / Device Authentication.* Controls are in place to ensure only authorized devices can connect to the financial institution's information systems, networks, or services.
- *Device Blocking or Network Indicators.* Connections to the financial institution's systems or servers are blocked based on devices, networks, or IP addresses known or suspected to be associated with fraudulent or malicious activities.
- *Network Segmentation*. Networks, systems, services, and data are physically and logically segmented based on the financial institution's asset classification and risk assessment.
- *Remote Access Software Controls*. Remote access software, which allows remote access to a user's computer or enterprise network or system, is disabled if it is not being used. If remote access software is used, controls to mitigate threats can include placing a firewall in front of systems that use remote access software, having remote users connect with a virtual private network (VPN) or other secure channel, and implementing strong passwords with MFA.[33] Software is updated periodically.
- *Configure and Update Security Devices and Software*. Network security devices and software are securely configured (e.g., implement firewall, router, or end-point security). Software and firmware are updated to address vulnerabilities.
- *Limit Access to Certain Automated Command Features.* Only authorized users and accounts have access to configuration management frameworks that utilize command-line shells. A user's access to these features is logged.
- *Transport Layer Security.* Transport Layer Security (TLS) protocols that utilize encryption and authentication to create private, secure channels between machines are implemented. TLS protocols are periodically updated to address vulnerabilities and implement additional security.
- *Digital Certificates*. An inventory of machines that utilize digital certificates is maintained, and digital certificates and the underlying protocols are continually updated to address emerging threats.[34]
- *Device Credentials*. Controls are in place to preserve the authenticity of machine (servers and clients) credentials in the form of digital keys and certificates, and to protect these credentials from compromise while in transit.

Email Systems Controls

- *Service Provider Recommended Configuration.* Email service vendor-recommended controls are implemented (e.g., MFA, anti-phishing, and anti-ransomware). Systems are monitored for unauthorized configuration changes.
- *Patch Management*. Email systems are updated and patched periodically, and the email system vendor is monitored for email system end-of-life.

[33] CISA Alert – "Microsoft Releases Security Update for Remote Desktop Services Vulnerability;" CIS, "Intel Insights: How to Disable Remote Desktop Protocol."
[34] NSA, Cybersecurity Information, "Eliminating Obsolete Transport Layer Security (TLS) Protocol Configurations."

- *Layered Security and MFA Consideration*. Layered security controls, to include the use of MFA or equivalent techniques, are applied for the email user population.
- *Monitoring*. Email systems are monitored to detect suspicious activity.
- *Anti-Phishing Controls*. Anti-phishing controls are applied to identify and block malicious emails and attachments. Specific controls may include:
    - "Watermarks" are in place to detect unauthorized emails;
    - Domain-based Message Authentication Reporting and Conformance (DMARC) policy and verification are enabled;
    - Macro scripts transmitted via email are disabled; and
    - Malicious email attachments are blocked and moved to a segregated environment.
- *External Email Alerts*. External email messages are labeled with a prominent notice or banner to alert the receiver that the email message comes from outside the financial institution.
- *User Education*. Users are educated on common email compromise tactics and techniques and offered ways to avoid or mitigate attacks.
- *Testing and Training Users*. Social engineering campaigns are administered to test users' comprehension of and adherence to security policies. User training techniques are adjusted based on test results.

Internet Browser Controls

- *Use of Current Updated Browsers.* Vendor-supported and management-approved Internet browsers are installed on systems and updated to the most current version in a timely manner**.**
- *Blocks on Certain Browser Features*. Internet browser pop-ups and redirects are blocked to protect against malware. Browser plug-ins and add-on applications are evaluated, with unnecessary plug-ins/applications disabled or removed.
- *Blocking of Certain Scripting Languages.* Scripting languages (i.e., JavaScript) that are run in Internet browsers are evaluated, and allowed or blocked. Cross-Site Scripting is an example where the attacker uses a scripting language to execute malware within a victim's browser.
- *Limit User Access.* Domains inconsistent with the financial institution's risk profile and policies are blocked.
- *Domain Filtering*. Domain Name System filtering services are implemented to prevent access to known malicious domains.[35] Institutions consider the use of a reputation service or similar technology for remaining domains.

[35] Additional information regarding controls for service accounts users is available in the CIS Security Controls.

Additional Resources

FFIEC	FFIEC IT Examination Handbook - Information Security Booklet FFIEC Statement - FFIEC Encourages Standardized Approach to Assessing Cybersecurity Preparedness FFIEC Cybersecurity Assessment Tool FFIEC Joint Statement - Destructive Malware FFIEC Joint Statement - Cyber Attacks Compromising Credentials FFIEC Joint Statement Security in a Cloud Computing Environment
FDIC and OCC	Joint Statement on Heightened Cybersecurity Risk
Conference of State Bank Supervisors (CSBS)	Ransomware Self-Assessment Tool
NIST	Special Publication 800-63 - Digital Identity Guidelines Cybersecurity Framework Computer Security Resource Center Glossary Special Publication 800-53, Revision 5 - Security and Privacy Controls for Federal Information Systems and Organizations Special Publication 800-177, Revision 1 - Trustworthy Email Special Publication 1800-16 - TLS Server Certificate Management Practice Guide Special Publication 800-46, Revision 2 - Guide to Enterprise Telework, Remote Access, and Bring Your Own Device (BYOD) Security Special Publication 800-30, Revision 1 - Guide for Conducting Risk Assessments Special Publication 800-207 - Zero Trust Architecture Special Publication 1800-17 – Multifactor Authentication for E-Commerce: Risk-Based, FIDO Universal Second Factor Implementations for Purchasers

CISA	CISA Cyber Essentials CISA INSIGHTS - Enhance Email & Web Security Security Tip (ST04-002) - Choosing and Protecting Passwords Security Tip (ST04-014) - Avoiding Social Engineering and Phishing Attacks Ransomware Guide (September 2020) Alert AA20-014a - Critical Vulnerabilities in Microsoft Windows Operating Systems Alert AA20-120a - Microsoft Office 365 Security Recommendations Alert AA20-006A - Potential for Iranian Cyber Response to U.S. Military Strike in Baghdad Security Tip (ST18-001) - Securing Network Infrastructure Devices
Center for Internet Security (CIS)	Intel Insights: How to Disable Remote Desktop Protocol CIS Security Controls EI-ISAC Cybersecurity Spotlight – Principle of Least Privilege Cybersecurity Spotlight – Defense in Depth (DiD)
National Security Agency	Mitigating Recent VPN Vulnerabilities Top Ten Cybersecurity Mitigation Strategies Segment Networks and Deploy Application-Aware Defenses Detecting Abuse of Authentication Mechanisms
Federal Trade Commission	Cybersecurity for Small Business

1. Conduct periodic asset quality reviews to identify problem assets;
2. Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;
3. Compare problem asset totals to capital;
4. Take appropriate corrective action to resolve problem assets;
5. Consider the size and potential risks of material asset concentrations; and
6. Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

H. *Earnings.* An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves. The institution should:

1. Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;
2. Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;
3. Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expense;
4. Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering the institution's asset quality and growth rate; and
5. Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

I. *Compensation, fees and benefits.* An institution should maintain safeguards to prevent the payment of compensation, fees, and benefits that are excessive or that could lead to material financial loss to the institution.

III. PROHIBITION ON COMPENSATION THAT CONSTITUTES AN UNSAFE AND UNSOUND PRACTICE

A. Excessive Compensation

Excessive compensation is prohibited as an unsafe and unsound practice. Compensation shall be considered excessive when amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder, considering the following:

1. The combined value of all cash and noncash benefits provided to the individual;
2. The compensation history of the individual and other individuals with comparable expertise at the institution;
3. The financial condition of the institution;
4. Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the loan portfolio or other assets;
5. For postemployment benefits, the projected total cost and benefit to the institution;
6. Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and
7. Any other factors the agencies determine to be relevant.

B. *Compensation Leading to Material Financial Loss*

Compensation that could lead to material financial loss to an institution is prohibited as an unsafe and unsound practice.

[1] Section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p–1) was added by section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Pub. L. 102–242, 105 Stat. 2236 (1991), and amended by section 956 of the Housing and Community Development Act of 1992, Pub. L. 102–550, 106 Stat. 3895 (1992) and section 318 of the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103–325, 108 Stat. 2160 (1994).

[2] For the Office of the Comptroller of the Currency, these regulations appear at 12 CFR Part 30; for the Board of Governors of the Federal Reserve System, these regulations appear at 12 CFR Part 263; and for the Federal Deposit Insurance Corporation, these regulations appear at 12 CFR Part 308, subpart R.

[3] In applying these definitions for savings associations, pursuant to 12 U.S.C. 1464, savings associations shall use the terms ''savings association'' and ''insured savings association'' in place of the terms ''member bank'' and ''insured bank''.

[4] See footnote 3 in section I.B.4. of this appendix.

[5] See footnote 3 in section I.B.4. of this appendix.

APPENDIX B TO PART 364—INTERAGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

TABLE OF CONTENTS

C. Manage and Control Risk
D. Oversee Service Provider Arrangements
E. Adjust the Program
F. Report to the Board
G. Implement the Standards

I. INTRODUCTION

The Interagency Guidelines Establishing Information Security Standards (Guidelines) set forth standards pursuant to section 39 of the Federal Deposit Insurance Act, 12 U.S.C. 1831p–1, and sections 501 and 505(b), 15 U.S.C. 6801 and 6805(b), of the Gramm-Leach-Bliley Act. These Guidelines address standards for developing and implementing administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of customer information. These Guidelines also address standards with respect to the proper disposal of consumer information pursuant to sections 621 and 628 of the Fair Credit Reporting Act (15 U.S.C. 1681s and 1681w).

A. *Scope.* The Guidelines apply to customer information maintained by or on behalf of, and to the disposal of consumer information by or on the behalf of, entities over which the Federal Deposit Insurance Corporation (FDIC) has authority. Such entities, referred to as ''insured depository institution'' or ''institution'' are banks insured by the FDIC (other than members of the Federal Reserve System), state savings associations insured by the FDIC, insured state branches of foreign banks, and any subsidiaries of such entities (except brokers, dealers, persons providing insurance, investment companies, and investment advisers).

B. *Preservation of Existing Authority.* Neither section 39 nor these Guidelines in any way limit the authority of the FDIC to address unsafe or unsound practices, violations of law, unsafe or unsound conditions, or other practices. The FDIC may take action under section 39 and these Guidelines independently of, in conjunction with, or in addition to, any other enforcement action available to the FDIC.

C. *Definitions.* 1. Except as modified in the Guidelines, or unless the context otherwise requires, the terms used in these Guidelines have the same meanings as set forth in sections 3 and 39 of the Federal Deposit Insurance Act (12 U.S.C. 1813 and 1831p–1).

2. For purposes of the Guidelines, the following definitions apply:

a. *Board of directors*, in the case of a branch or agency of a foreign bank, means the managing official in charge of the branch or agency.

b. *Consumer Information* means any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report and that is maintained or otherwise possessed by or on behalf of the institution for a business purpose. Consumer information also means a compilation of such records. The term does not include any record that does not personally identify an individual.

i. *Examples:* (1) *Consumer information* includes:

(A) A consumer report that an institution obtains;

(B) information from a consumer report that the institution obtains from its affiliate after the consumer has been given a notice and has elected not to opt out of that sharing;

(C) information from a consumer report that the institution obtains about an individual who applies for but does not receive a loan, including any loan sought by an individual for a business purpose;

(D) information from a consumer report that the institution obtains about an individual who guarantees a loan (including a loan to a business entity); or

(E) information from a consumer report that the institution obtains about an employee or prospective employee.

(2) *Consumer information* does not include:

(A) aggregate information, such as the mean score, derived from a group of consumer reports; or

(B) blind data, such as payment history on accounts that are not personally identifiable, that may be used for developing credit scoring models or for other purposes.

c. *Consumer report* has the same meaning as set forth in the Fair Credit Reporting Act, 15 U.S.C. 1681a(d).

d. *Customer* means any customer of the institution as defined in §332.3(h) of this chapter.

e. *Customer information* means any record containing nonpublic personal information, as defined in §332.3(n) of this chapter, about a customer, whether in paper, electronic, or other form, that is maintained by or on behalf of the institution.

f. *Customer information systems* means any methods used to access, collect, store, use, transmit, protect, or dispose of customer information.

g. *Service provider* means any person or entity that maintains, processes, or otherwise is permitted access to customer information or consumer information through its provision of services directly to the institution.

II. STANDARDS FOR INFORMATION SECURITY

A. *Information Security Program.* Each insured depository institution shall implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the size and complexity of the institution and the nature and scope of its activities. While all parts of the institution are not required to implement a uniform set of policies, all elements of the information security program must be coordinated.

B. *Objectives.* An institution's information security program shall be designed to:

1. Ensure the security and confidentiality of customer information;

2. Protect against any anticipated threats or hazards to the security or integrity of such information;

3. Protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer; and

4. Ensure the proper disposal of customer information and consumer information.

III. DEVELOPMENT AND IMPLEMENTATION OF INFORMATION SECURITY PROGRAM

A. *Involve the Board of Directors.* The board of directors or an appropriate committee of the board of each insured depository institution shall:

1. Approve the institution's written information security program; and

2. Oversee the development, implementation, and maintenance of the institution's information security program, including assigning specific responsibility for its implementation and reviewing reports from management.

B. *Assess Risk.*

Each institution shall:

1. Identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems.

2. Assess the likelihood and potential damage of these threats, taking into consideration the sensitivity of customer information.

3. Assess the sufficiency of policies, procedures, customer information systems, and other arrangements in place to control risks.

C. *Manage and Control Risk.* Each institution shall:

1. Design its information security program to control the identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of the institution's activities. Each institution must consider whether the following security measures are appropriate for the institution and, if so, adopt those measures the institution concludes are appropriate:

a. Access controls on customer information systems, including controls to authenticate and permit access only to authorized individuals and controls to prevent employees from providing customer information to unauthorized individuals who may seek to obtain this information through fraudulent means.

b. Access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records storage facilities to permit access only to authorized individuals;

c. Encryption of electronic customer information, including while in transit or in storage on networks or systems to which unauthorized individuals may have access;

d. Procedures designed to ensure that customer information system modifications are consistent with the institution's information security program;

e. Dual control procedures, segregation of duties, and employee background checks for employees with responsibilities for or access to customer information;

f. Monitoring systems and procedures to detect actual and attempted attacks on or intrusions into customer information systems;

g. Response programs that specify actions to be taken when the institution suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies; and

h. Measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures.

2. Train staff to implement the institution's information security program.

3. Regularly test the key controls, systems and procedures of the information security program. The frequency and nature of such tests should be determined by the institution's risk assessment. Tests should be conducted or reviewed by independent third parties or staff independent of those that develop or maintain the security programs.

4. Develop, implement, and maintain, as part of its information security program, appropriate measures to properly dispose of customer information and consumer information in accordance with each of the requirements of this paragraph III.

D. *Oversee Service Provider Arrangements.* Each institution shall:

1. Exercise appropriate due diligence in selecting its service providers;

2. Require its service providers by contract to implement appropriate measures designed to meet the objectives of these Guidelines; and

3. Where indicated by the institution's risk assessment, monitor its service providers to confirm that they have satisfied their obligations as required by paragraph D.2. As part of this monitoring, an institution should review audits, summaries of test results, or other equivalent evaluations of its service providers.

E. *Adjust the Program.* Each institution shall monitor, evaluate, and adjust, as appropriate, the information security program in light of any relevant changes in technology, the sensitivity of its customer information, internal or external threats to information, and the institution's own changing business arrangements, such as mergers and

acquisitions, alliances and joint ventures, outsourcing arrangements, and changes to customer information systems.

F. *Report to the Board.* Each institution shall report to its board or an appropriate committee of the board at least annually. This report should describe the overall status of the information security program and the institution's compliance with these Guidelines. The report, which will vary depending upon the complexity of each institution's program should discuss material matters related to its program, addressing issues such as: Risk assessment; risk management and control decisions; service provider arrangements; results of testing; security breaches or violations, and management's responses; and recommendations for changes in the information security program.

G. *Implement the Standards.* 1. *Effective date.* Each institution must implement an information security program pursuant to these Guidelines by July 1, 2001.

2. *Two-year grandfathering of agreements with service providers.* Until July 1, 2003, a contract that an institution has entered into with a service provider to perform services for it or functions on its behalf, satisfies the provisions of paragraph III.D., even if the contract does not include a requirement that the servicer maintain the security and confidentiality of customer information as long as the institution entered into the contract on or before March 5, 2001.

3. *Effective date for measures relating to the disposal of consumer information.* Each institution must satisfy these Guidelines with respect to the proper disposal of consumer information by July 1, 2005.

4. *Exception for existing agreements with service providers relating to the disposal of consumer information.* Notwithstanding the requirement in paragraph III.G.3., an institution's contracts with its service providers that have access to consumer information and that may dispose of consumer information, entered into before July 1, 2005, must comply with the provisions of the Guidelines relating to the proper disposal of consumer information by July 1, 2006.

SUPPLEMENT A TO APPENDIX B TO PART 364 INTERAGENCY GUIDANCE ON RESPONSE PROGRAMS FOR UNAUTHORIZED ACCESS TO CUSTOMER INFORMATION AND CUSTOMER NOTICE

I. BACKGROUND

This Guidance[1] interprets section 501(b) of the Gramm-Leach-Bliley Act (GLBA) and the Interagency Guidelines Establishing Information Security Standards (the Security Guidelines)[2] and describes response programs, including customer notification procedures, that a financial institution should develop and implement to address unauthorized access to or use of customer information that could result in substantial harm or inconvenience to a customer. The scope of, and definitions of terms used in, this Guidance are identical to those of the Security Guidelines. For example, the term ''customer information'' is the same term used in the Security Guidelines, and means any record containing nonpublic personal information about a customer, whether in paper, electronic, or other form, maintained by or on behalf of the institution.

A. Interagency Security Guidelines

Section 501(b) of the GLBA required the Agencies to establish appropriate standards for financial institutions subject to their jurisdiction that include administrative, technical, and physical safeguards, to protect the security and confidentiality of customer information. Accordingly, the Agencies issued Security Guidelines requiring every financial institution to have an information security program designed to:

1. Ensure the security and confidentiality of customer information;

2. Protect against any anticipated threats or hazards to the security or integrity of such information; and

3. Protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer.

B. Risk Assessment and Controls

1. The Security Guidelines direct every financial institution to assess the following risks, among others, when developing its information security program:

a. Reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems;

b. The likelihood and potential damage of threats, taking into consideration the sensitivity of customer information; and

c. The sufficiency of policies, procedures, customer information systems, and other arrangements in place to control risks.[3]

2. Following the assessment of these risks, the Security Guidelines require a financial institution to design a program to address the identified risks. The particular security measures an institution should adopt will depend upon the risks presented by the complexity and scope of its business. At a minimum, the financial institution is required to consider the specific security measures enumerated in the Security Guidelines,[4] and adopt those that are appropriate for the institution, including:

a. Access controls on customer information systems, including controls to authenticate and permit access only to authorized

individuals and controls to prevent employees from providing customer information to unauthorized individuals who may seek to obtain this information through fraudulent means;

b. Background checks for employees with responsibilities for access to customer information; and

c. Response programs that specify actions to be taken when the financial institution suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies.[5]

C. Service Providers

The Security Guidelines direct every financial institution to require its service providers by contract to implement appropriate measures designed to protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customers.[6]

II. RESPONSE PROGRAM

Millions of Americans, throughout the country, have been victims of identity theft.[7] Identity thieves misuse personal information they obtain from a number of sources, including financial institutions, to perpetrate identity theft. Therefore, financial institutions should take preventative measures to safeguard customer information against attempts to gain unauthorized access to the information. For example, financial institutions should place access controls on customer information systems and conduct background checks for employees who are authorized to access customer information.[8] However, every financial institution should also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems[9] that occur nonetheless. A response program should be a key part of an institution's information security program.[10] The program should be appropriate to the size and complexity of the institution and the nature and scope of its activities.

In addition, each institution should be able to address incidents of unauthorized access to customer information in customer information systems maintained by its domestic and foreign service providers. Therefore, consistent with the obligations in the Guidelines that relate to these arrangements, and with existing guidance on this topic issued by the Agencies,[11] an institution's contract with its service provider should require the service provider to take appropriate actions to address incidents of unauthorized access to the financial institution's customer information, including notification to the institution as soon as possible of any such incident, to enable the institution to expeditiously implement its response program.

A. Components of a Response Program

1. At a minimum, an institution's response program should contain procedures for the following:

a. Assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused;

b. Notifying its primary Federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of *sensitive* customer information, as defined below;

c. Consistent with the Agencies' Suspicious Activity Report (''SAR'') regulations,[12] notifying appropriate law enforcement authorities, in addition to filing a timely SAR in situations involving Federal criminal violations requiring immediate attention, such as when a reportable violation is ongoing;

d. Taking appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information, for example, by monitoring, freezing, or closing affected accounts, while preserving records and other evidence;[13] and

e. Notifying customers when warranted.

2. Where an incident of unauthorized access to customer information involves customer information systems maintained by an institution's service providers, it is the responsibility of the financial institution to notify the institution's customers and regulator. However, an institution may authorize or contract with its service provider to notify the institutions' customers or regulator on its behalf.

III. CUSTOMER NOTICE

Financial institutions have an affirmative duty to protect their customers' information against unauthorized access or use. Notifying customers of a security incident involving the unauthorized access or use of the customer's information in accordance with the standard set forth below is a key part of that duty. Timely notification of customers is important to manage an institution's reputation risk. Effective notice also may reduce an institution's legal risk, assist in maintaining good customer relations, and enable the institution's customers to take steps to protect themselves against the consequences of identity theft. When customer notification is warranted, an institution may not forgo notifying its customers of an incident because the institution believes that it may be potentially embarrassed or inconvenienced by doing so.

A. Standard for Providing Notice

When a financial institution becomes aware of an incident of unauthorized access

to sensitive customer information, the institution should conduct a reasonable investigation to promptly determine the likelihood that the information has been or will be misused. If the institution determines that misuse of its information about a customer has occurred or is reasonably possible, it should notify the affected customer as soon as possible. Customer notice may be delayed if an appropriate law enforcement agency determines that notification will interfere with a criminal investigation and provides the institution with a written request for the delay. However, the institution should notify its customers as soon as notification will no longer interfere with the investigation.

1. Sensitive Customer Information

Under the Guidelines, an institution must protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customer. Substantial harm or inconvenience is most likely to result from improper access to *sensitive customer information* because this type of information is most likely to be misused, as in the commission of identity theft. For purposes of this Guidance, *sensitive customer information* means a customer's name, address, or telephone number, in conjunction with the customer's social security number, driver's license number, account number, credit or debit card number, or a personal identification number or password that would permit access to the customer's account. *Sensitive customer information* also includes any combination of components of customer information that would allow someone to log onto or access the customer's account, such as user name or password or password and account number.

2. Affected Customers

If a financial institution, based upon its investigation, can determine from its logs or other data precisely which customers' information has been improperly accessed, it may limit notification to those customers with regard to whom the institution determines that misuse of their information has occurred or is reasonably possible. However, there may be situations where the institution determines that a group of files has been accessed improperly, but is unable to identify which specific customers' information has been accessed. If the circumstances of the unauthorized access lead the institution to determine that misuse of the information is reasonably possible, it should notify all customers in the group.

B. Content of Customer Notice

1. Customer notice should be given in a clear and conspicuous manner. The notice should describe the incident in general terms and the type of customer information that was the subject of unauthorized access or use. It also should generally describe what the institution has done to protect the customers' information from further unauthorized access. In addition, it should include a telephone number that customers can call for further information and assistance.[14] The notice also should remind customers of the need to remain vigilant over the next twelve to twenty-four months, and to promptly report incidents of suspected identify theft to the institution. The notice should include the following additional items, when appropriate:

a. A recommendation that the customer review account statements and immediately report any suspicious activity to the institution;

b. A description of fraud alerts and an explanation of how the customer may place a fraud alert in the customer's consumer reports to put the customer's creditors on notice that the customer may be a victim of fraud;

c. A recommendation that the customer periodically obtain credit reports from each nationwide credit reporting agency and have information relating to fraudulent transactions deleted;

d. An explanation of how the customer may obtain a credit report free of charge; and

e. Information about the availability of the FTC's online guidance regarding steps a consumer can take to protect against identity theft. The notice should encourage the customer to report any incidents of identity theft to the FTC, and should provide the FTC's Web site address and toll-free telephone number that customers may use to obtain the identity theft guidance and report suspected incidents of identity theft.[15]

2. The Agencies encourage financial institutions to notify the nationwide consumer reporting agencies prior to sending notices to a large number of customers that include contact information for the reporting agencies.

C. Delivery of Customer Notice

Customer notice should be delivered in any manner designed to ensure that a customer can reasonably be expected to receive it. For example, the institution may choose to contact all customers affected by telephone or by mail, or by electronic mail for those customers for whom it has a valid email address and who have agreed to receive communications electronically.

[1] This Guidance was jointly issued by the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). Pursuant

to 12 U.S.C. 5412, the OTS is no longer a party to this Guidance.

[2] 12 CFR part 30, app. B (OCC); 12 CFR part 208, app. D–2 and part 225, app. F (Board); and 12 CFR part 364, app. B (FDIC). The ''Interagency Guidelines Establishing Information Security Standards'' were formerly known as ''The Interagency Guidelines Establishing Standards for Safeguarding Customer Information.''

[3] *See* Security Guidelines, III.B.

[4] *See* Security Guidelines, III.C.

[5] *See* Security Guidelines, III.C.

[6] *See* Security Guidelines, II.B, and III.D. Further, the Agencies note that, in addition to contractual obligations to a financial institution, a service provider may be required to implement its own comprehensive information security program in accordance with the Safeguards Rule promulgated by the Federal Trade Commission (FTC), 12 CFR part 314.

[7] The FTC estimates that nearly 10 million Americans discovered they were victims of some form of identity theft in 2002. *See* The Federal Trade Commission. *Identity Theft Survey Report* (September 2003), available at *http://www.ftc.gov/os/2003/09/synovatereport.pdf*.

[8] Institutions should also conduct background checks of employees to ensure that the institution does not violate 12 U.S.C. 1829, which prohibits an institution from hiring an individual convicted of certain criminal offenses or who is subject to a prohibition order under 12 U.S.C. 1818(e)(6).

[9] Under the Guidelines, an institution's *customer information systems* consist of all of the methods used to access, collect, store, use, transmit, protect, or dispose of customer information, including the systems maintained by its service providers. *See* Security Guidelines, I.C.2.d.

[10] *See* FFIEC Information Technology Examination Handbook, Information Security Booklet, Dec. 2002 available at *http://ithandbook.ffiec.gov/it-booklets/information-security.aspx*. Federal Reserve SR 97–32, Sound Practice Guidance for Information Security for Networks, Dec. 4, 1997; OCC Bulletin 2000–14, ''Infrastructure Threats—Intrusion Risks'' (May 15, 2000), for additional guidance on preventing, detecting, and responding to intrusions into financial institutions computer systems.

[11] *See* Federal Reserve SR Ltr. 13-19, Guidance on Managing Outsourcing Risk, Dec. 5, 2013; OCC Bulletin 2013–29, ''Third-Party Relationships—Risk Management Guidance,'' Oct. 30, 2013; and FDIC FIL 44–08, Guidance for Managing Third Party Risk, June 6, 2008 and FIL 68–99, Risk Assessment Tools and Practices for Information System Security, July 7, 1999.

[12] An institution's obligations to file a SAR is set out in the Agencies' SAR regulations and Agency guidance. *See, for example, 12 CFR 21.11* (national banks, Federal branches and agencies); 12 CFR 163.180 (Federal savings associations); 12 CFR 208.62 (State member banks); 12 CFR 211.5(k) (Edge and agreement corporations); 12 CFR 211.24(f) (uninsured State branches and agencies of foreign banks); 12 CFR 225.4(f) (bank holding companies and their nonbank subsidiaries); and 12 CFR part 353 (FDIC-supervised institutions). National banks must file SARs in connection with computer intrusions and other computer crimes. *See* OCC Bulletin 2000–14, ''Infrastructure Threats—Intrusion Risks'' (May 15, 2000); Advisory Letter 97–9, ''Reporting Computer Related Crimes'' (November 19, 1997) (general guidance still applicable though instructions for new SAR form published in 65 FR 1229, 1230 (January 7, 2000)). *See also* Federal Reserve SR 01–11, Identity Theft and Pretext Calling, Apr. 26, 2001.

[13] *See* FFIEC Information Technology Examination Handbook, Information Security Booklet, Dec. 2002, pp. 68–74.

[14] The institution should, therefore, ensure that it has reasonable policies and procedures in place, including trained personnel, to respond appropriately to customer inquiries and requests for assistance.

[15] Currently, the FTC Web site for the ID Theft brochure and the FTC Hotline phone number are *http://www.consumer.gov/idtheft* and 1–877–IDTHEFT. The institution may also refer customers to any materials developed pursuant to section 151(b) of the FACT Act (educational materials developed by the FTC to teach the public how to prevent identity theft).

PART 365—REAL ESTATE LENDING STANDARDS

Subpart A—Real Estate Lending Standards

Sec.

Subpart B—Registration of Residential Mortgage Loan Originators

AUTHORITY: 12 U.S.C. 1828(o) and 5101 *et seq.*

SOURCE: 57 FR 62896, 62900, Dec. 31, 1992, unless otherwise noted.

SECTION D

BANKRUPTCY: IF YOU'RE NOT AT THE TABLE, YOU'RE ON THE TABLE

(INSOLVENCY AND WORKOUT UPDATE FOR BANK COUNSEL)

Materials by:

LEA PAULEY GOFF
Stoll Keenon Ogden PLLC
Louisville, Kentucky

Presented by:

ADAM M. BACK
Stoll Keenon Ogden PLLC
Louisville, Kentucky

TIMOTHY R. WISEMAN
Stoll Keenon Ogden PLLC
Louisville, Kentucky

Materials Submitted September 21, 2021

Lea Pauley Goff
Stoll Keenon Ogden PLLC
500 West Jefferson Street, Suite 2000
Louisville, KY 40202
502-568-5731
lea.goff@skofirm.com

I. BANKRUPTCY NEWS AND LEGISLATION[1]

A. Case Filing Statistics

- The American Bankruptcy Institute reports that in July, 2021, business bankruptcy filings were down 62% from the same time last year, with consumer filings down 23% in the same period.

- The Administrative Office of the Courts, , has reported that June, 2020, through June, 2021, had the lowest rate of bankruptcy filings since 1985.

- The emergence of Houston as a bankruptcy filing center is very significant and it now rivals Delaware and New York for those filings. Large public company filings more than doubled, from 25 to 57, for 2019 to 2020, with Houston as the most popular venue. Houston filings in this case category went from 11 in 2019 to 27 in 2020 -- double that of Delaware. Law.com, April 2, 2021, citing UCLA-LoPucki Bankruptcy Research Database.

B. Recent and Pending Legislation

1. Recently Enacted Bankruptcy Legislation

a. 11 U.S.C. Section 366 (Utilities).

The Consolidated Appropriations Act, 2021 ("CAA"), effective December 27, 2020, provides as follows with respect to Section 366 of the Bankruptcy Code ("Code"):

(h) TERMINATION OF UTILITY SERVICES.

(1) IN GENERAL. Section 366 of title 11, United States Code, is amended by adding at the end the following:

> (d) Notwithstanding any other provision of this section, a utility may not alter, refuse, or discontinue service to a debtor who does not furnish adequate assurance of payment under this section if the debtor –
>
> (1) is an individual;
>
> (2) makes a payment to the utility for any debt owed to the utility for service provided during the 20-day period beginning on the date of the order for relief; and

[1] Many thanks to our invaluable assistant Emily Keith, without whom we would not have these materials.

> (3) after the date on which the 20-day period beginning on the date of the order for relief ends, makes a payment to the utility for services provided during the pendency of case when such a payment becomes due.
>
> (2) SUNSET. Effective on the date that is 1 year after the date of enactment of this Act, Section 366 of title 11, United States Code, is amended by striking subsection (d).

As an initial matter, it appears that Section 366(d) only applies to individual debtors. The term "individual" is not defined in the Code. However, Section 101(41) of the Code defines "person" as including individuals, partnerships and corporations suggesting that an individual cannot be a partnership or a corporation. Existing case law has also held that "'individual' as that term is used in the Code, means a human being. It does not include a corporation." *In re BWP Transp., Inc.*, 462 B.R. 225, 234 n. 18 (Bankr. E.D. Mich. 2011).

b. Small Business Debtors.

The Small Business Reorganization Act ("SBRA"), signed into law on August 23, 2019, added a new subchapter to the Code for small business reorganizations. This is at 11 U.S.C. Sections 1181 – 1195. As enacted, debtors using this subchapter had to have non-contingent, non-disputed debt of no more than approximately $2.8 million. That debt cap was extended to $7.5 million by legislation enacted on March 27, 2020, with the increased cap to expire March 27, 2021. That expiration date was extended to March 27, 2022 so the $7.5 million debt threshold for Subchapter V bankruptcy was extended for another year. There are now multiple cases interpreting aspects of this legislation, discussed in Section J, Small Business Chapter 11 case developments below.

c. Preference Claims.

A new law may permit suppliers and landlords to retain money received from bankrupt customers and tenants that they previously would have had to repay to the bankruptcy estate.

Section 547 of the Code permits a bankruptcy trustee (or a debtor in possession) to claw-back certain transfers, i.e. payments, made by a debtor prior to its bankruptcy filing. In general, these are payments made during a relatively short period before the bankruptcy filing and are known as "preferences" in the bankruptcy world. In theory, clawing back these preferences prevents a debtor from preferring or taking care of its most important business partners ahead of other creditors who would otherwise be left to foot the bill during the debtor's slide into bankruptcy.

The Code, however, provides a number of defenses to preference actions. In addition to the existing defenses, the CAA amends the preference statute to add another. This amendment provides an additional defense to landlords and suppliers who receive transfers in connection

with deferred payment agreements. Specifically, it limits the bankruptcy trustee's ability to recover deferred payments made by a debtor to a landlord or supplier during the prescribed lookback period under certain circumstances. To qualify, the following conditions must be met:

(1) The payment was made in connection with an agreement between the debtor and the landlord or supplier to defer or postpone payments due under a lease of non-residential real property or an executory contract for goods or services;
(2) The agreement was made or entered into on or after March 13, 2020;
(3) The amount paid pursuant to the new agreement does not exceed the amount that would have otherwise been due under the existing lease or executory contract before March 13, 2020; and
(4) The amount paid does not include any fees, penalties or interest in an amount greater than what would have been due before March 13, 2020 absent the parties' arrangement.

This amendment, codified in Sections 547(j)(1) and (2) of the Code, became effective on December 27, 2020 and will sunset on December 27, 2022 unless otherwise extended.

d. Pending Legislation

Among other subjects there is currently pending bankruptcy legislation to widen dischargeability of student loan debt, limit non-debtor releases, and provide venue reform.

II. GENERAL CASE UPDATE

A. The Supreme Court

***City of Chicago v. Fulton, et al.,* 141 S.Ct. 585 (Jan. 14, 2021) (Retention of Property of the Estate)**

Key Takeaway:

In a unanimous decision (with Barret recusing), the United States Supreme Court held that the passive retention of possession of a debtor's property does not violate the automatic stay. The automatic stay only prohibits affirmative acts that would disturb the status quo of estate property at the time the bankruptcy petition was filed. Section 362(a)(3)'s prohibition of the exercise of control over estate assets is implicated by affirmative activity, not just retention.

Summary:

The court addressed the issue of "whether an entity violates [the automatic stay] by retaining possession of a debtor's property after a bankruptcy petition is filed," holding that "mere retention of property does not violate [the automatic stay]." The City of Chicago impounded the Debtors' vehicles for failure to pay tickets. The Debtors then filed Chapter 13

bankruptcy petitions and requested the return of their vehicles, which the City refused. In each case, the relevant bankruptcy court held that the City's refusal violated the automatic stay, and the Seventh Circuit Court of Appeals affirmed the decisions. Ultimately, the Supreme Court overruled the Court of Appeals, explaining that "mere retention of estate property after the filing of a bankruptcy petition does not violate [Section] 362(a)(3) of the Bankruptcy Code." The Court concluded that a holding otherwise would render Section 542 – requiring turnover of estate property – superfluous. While this ruling occurs in a Chapter 13 case, there is no indication that it would be limited to Chapter 13, or to a consumer context, since Section 362(a)(3) and Section 542 apply in all chapters of the Code and to both business and consumer cases.

Justice Sotomayor wrote a separate concurring opinion, emphasizing the importance of vehicles to Chapter 13 debtors and noting that other avenues for the return of property may be available to debtors like Section 542, but acknowledging that recovery processes under that section can be slower and more cumbersome.

B. Automatic Stay

***Windstream Holdings Inc. v. Charter Communs. Inc. (In re Windstream Holdings Inc.)* 2020 Bankr. LEXIS 708 (Bankr. S.D.N.Y. Mar. 17, 2020); *Windstream Holdings Inc. v. Charter Communs. Inc. (In re Windstream Holdings Inc.)*, Nos. 19-22312, 19-08246, 2021 Bankr. LEXIS 926 (Bankr. S.D.N.Y. Apr. 8, 2021) (Stay Violation Sanctions)**

Key Takeaway:

A creditor found to have violated the automatic stay is held strictly liable and is not excused from violation based upon mere ignorance and/or failure to use reasonable efforts to monitor post-petition efforts. Here, the court imposed a $19 million penalty on a contract counter-party and competitor of the Debtor for the creditor's activity terminating prepetition contracts and advertising designed to convince Debtor's customers to switch to the competitor.

Summary:

In an earlier decision, *Windstream Hldgs., Inc. v. Charter Communs. Inc. (In re Windstream Hldgs., Inc.)* 2020 Bankr. LEXIS (Bankr. S.D.N.Y. Mar. 17, 2020) the court held that Charter breached the automatic stay by its termination of connectivity services to certain of Windstream's customers despite having received notice of Windstream's bankruptcy filing. The Court then addressed whether Charter was liable for civil contempt for such breaches, and if so, the proper compensatory sanction.

The court held that when Charter terminated the service to Windstream's customers, it breached the prepetition agreements because Charter did not comply with the prepetition agreement itself, which provided that Charter was required to give Windstream customers thirty-days' notice before service cancellation. The court also found that Charter conducted an advertising campaign intended to create the impression that Windstream was going out of business as a result of the pending bankruptcy.

In doing so, the court interpreted Section 362(a)(3) as clearly encompassing and protecting a debtor's executory contracts, which are property of the debtor's estate under Section 541. The court further interpreted Section 362(a)(3) as protecting a debtor's goodwill, too, which also is recognized property of the estate under Section 541(a)(1). The court determined that goodwill is an asset of a bankrupt like any other asset, and to hold that, upon the bankruptcy of the business, the goodwill vanishes would be to deprive the creditors of the bankrupt of what might be a substantial asset. The court reasoned that, consistent with Section 362(a)(3), which automatically stays not only actions directly against the debtor but all action to obtain property of or from the estate or to exercise control over property of the estate, Section 362(a)(3) also stays acts that impair, interfere with or destroy the estate's interest in contracts or goodwill.

The court held Charter in civil contempt for violating the automatic stay for Charter's termination of connectivity service. The Court reasoned that Charter's choice of systems that are incapable of complying with the stay is not tantamount to an inability to comply nor with making a diligent effort to comply in a reasonable manner. The court further held Charter in contempt for running a campaign that wrongfully interfered with Windstream's customer contracts and goodwill through what the court concluded were Charter's false and intentionally misleading advertising intended to create the impression that Windstream was going out of business. Lastly, the Charter entities were found jointly and severally liable for over $19 million for the losses the court considered to be caused by the violation of the automatic stay. The court also equitably subordinated some, but not all, of Charter's claims.

C. Preferences and Fraudulent Transfers

***Hooker v. Wanigas Credit Union,* 835 Fed. App'x 110 (6th Cir. 2021) (Wage Garnishment)**

Key Takeaway:

The Sixth Circuit Court of Appeals held that all amounts obtained by garnishment during the ninety-day preference period, including those retained by the creditor's attorney under a charging lien (and which never touched the creditor's accounts), were recoverable as a preference by the bankruptcy estate.

Summary:

A prepetition creditor opposed the avoidance of funds recovered from garnishment of the debtor's wages. The creditor had garnished about $900 of the debtor's wages during the ninety-day preference period. These funds were delivered to the creditor's attorney, who kept about half of the wages in accordance with its fee agreement and remitted the remainder to the creditor. The debtor then filed a Chapter 7 petition. After demand by the trustee, the creditor returned its portion of the $900 but not that retained by its counsel which was subject to an attorney charging lien. The trustee filed a preference action against the creditor to recoup the approximately $450 retained by its attorney.

On appeal, the creditor argued that the funds retained by its attorney were not recoverable because two of the preference statute's requirements were not satisfied. First, the creditor argued that it was not a transfer "to or for the benefit of a creditor." Second, the creditor argued that the transfer did not enable it to recover more than it would recover through the bankruptcy process.

The Sixth Circuit found that the creditor's arguments failed for three reasons. First, the court found that the transfer of the garnisheed wages was "to" a creditor even though it was sent to the creditor's attorney, rather than directly to the creditor. The court explained that the attorney acted as the creditor's agent, and agents stand in the place of their principals. Furthermore, the court explained that the attorney was "merely the conduit" through which the debtor's employer transferred money to the creditor.

Second, the court found that the entire transfer (about $900) was "for" the creditor's benefit because:

> Although the garnishment writ directed [the debtor's] employer to send the garnished wages to [the creditor's] attorney rather than [the creditor], the purpose of the transfer was clearly not to benefit [the creditor's] law firm; it was to satisfy [the creditor's] judgment against [the debtor]. And because payment to [the law firm] discharged [the debtor's] debt to [the creditor], the payment was for [the creditor's] benefit under the preference statute.

Id. at 112.

Third, the court was unpersuaded by the creditor's argument that the trustee was not entitled to recover the amount retained by the creditor's counsel because that amount did not enable the creditor to receive more than it would have in the bankruptcy proceeding. Rather, the court found that the creditor could not sidestep avoidance simply because its agent (the attorney) received a transfer on the creditor's behalf and then retained a portion of it to satisfy the creditor's obligation to it. Furthermore, the court found that it was immaterial that the wages retained by the attorney were subject to a valid attorney's charging lien because, "[e]xcept in circumstances not applicable here, 'an attorney's lien is not enforceable against a third party.'" *Id.* at 114 (quoting *Doxtader v. Siversten*, 455 N.W.2d 437, 439 (Mich. App. 1990)). Ultimately, the court held that the transferred wages were recoverable as a preference.

***INSYS Liquidation Trust v. McKesson Corporation, et al. (In re INSYS Therapeutics, Inc.)*, Adv. Pro. No. 21-50176 (U.S. Bankr. Del. July 21, 2021) (Intersection of Critical Vendor Treatment and Preference Liability)**

Key Takeaway:

A creditor being included in a critical vendor order does not by itself protect that creditor from preference liability on prepetition transfers.

Summary:

One *prima facia* element of preference liability under 11 U.S.C. § 547 is that the payment allowed the creditor to receive more than it would have received in a Chapter 7 liquidation. 11 U.S.C. § 547(b)(5). A critical vendor order generally allows some early case post-petition payment of prepetition debt to a small number of creditors who are important vendors to the debtor.

Here, the Bankruptcy Court entered a critical vendor order authorizing the Debtors to make payments to certain creditors on prepetition obligations, which the Debtors did. The Trustee later sued some of those creditors to avoid and recover payments that the debtor had made prepetition.

The Defendants moved to dismiss the preference claims on the ground that, since the critical vendor order authorized the Debtors to pay prepetition obligations to those creditor defendants, if the amounts had not been paid prepetition, the Debtors would have paid them post-petition, as authorized, so they did not get more than they would have gotten in a Chapter 7 liquidation.

The Court rejected this contention, on bases including that the order authorized, but did not mandate, the critical vendor payments, and the order had language preserving preference claims. The Court acknowledged the result might be different where the creditor held priority claims, the creditor contract was assumed, or the critical vendor payments were mandatory.

D. Forward Contracts

***Official Comm. of Unsecured Creditors of Arcapita Bank B.S.C.(c) v. Bahr. Islamic Bank (In re Arcapita Bank B.S.C.(c))*, No. 12-11076, 2021 Bankr. LEXIS 1098 (Bankr. S.D. NY. Apr. 23, 2021) (Requirements for a Forward Contract)**

Key Takeaway:

An agreement is not a forward contract, and therefore is not entitled to safe harbor protections of the Bankruptcy Code, where: (1) there is no relationship between the agreement and the broader financial markets since the agreement does not shift the risk of the price of the commodity from one party to the other; and (2) the maturity date was not more than two days after the contract was entered into where the agreement called for the immediate delivery of the commodity.

Summary:

The Debtor, Arcapita Bank B.S.C., filed for relief under Chapter 11. Prior to bankruptcy, Arcapita made investments with two investment banking firms, BisB and Tadhamon ("Defendants"). Specifically, Arcapita entered into master investment agreements ("Agreements") with each of the Defendants, under which the parties engaged in several investment transactions. In these transactions, Arcapita acted as the agent for the investment of

Defendants' funds for the purchase of commodities from a third party in the Defendants' name, with Arcapita then purchasing those same commodities from Defendants on a deferred payment basis. Under the structure of these investment transactions, the Defendant that was the investing party first deposited funds with Arcapita, which Arcapita then used to purchase commodity investments on behalf of Defendant. Arcapita then immediately repurchased those same commodities from the Defendant for the original investment amount plus an agreed upon return to be paid to the Defendant on an agreed-upon maturity date.

After the bankruptcy filing, there were attempts to recover the funds derived from those investments ("Transaction Proceeds") from both Defendants, reasoning that the Transaction Proceeds were property of Arcapita's bankruptcy estate, pursuant to Section 542 of the Code (the turnover provision). The Official Committee of Unsecured Creditors ("Committee") asserted that a total of $10,002,291.66 was outstanding. The Defendants refused to turn over the Transaction Proceeds to the bankruptcy estate.

Subsequently the Committee filed an adversary proceeding against Defendants to seek damages for breach of contract and violation of the automatic stay and turnover of the Transaction Proceeds. The Committee argued that the Defendants breached the terms of their respective Agreements with Arcapita and sought turnover of the balance of the Transaction Proceeds. The Committee also argued that the Defendants' failure to return the balance of the Transaction Proceeds constituted a willful violation of the automatic stay. In their cross-motions for summary judgment, the Defendants asserted that they are not required to return the Transaction Proceeds to Arcapita because their actions in retaining the funds were safeguarded by the safe harbor provisions of the Bankruptcy Code. In response, the Committee contended that none of the asserted safe harbors of the Code protected the transactions. One of the so-called "safe harbors" the Defendants pointed to as a basis to protect the Transaction Proceeds was the safe harbor for forward contracts. Specifically, the Defendants argued that the payments on the Agreements at issue "were protected, as they were made under forward contracts under the safe harbor provisions of the Bankruptcy Code."

Section 101(25) of the Code defines a forward contract as "a contract . . . for the purchase, sale, or transfer of a commodity . . . with a maturity date more than two days after the date the contract is entered into . . .." 11 U.S.C. Section 101(25)(A). Courts apply a four-factor test originally set out by *In re National Gas Distributors, LLC*, 556 F.3d 247 (4th Cir. 2009) to determine whether a contract is a forward contract. Under the *National Gas* analysis, a contract is considered a forward contract where:

> (1) substantially all expected costs of performance are attributable to the underlying commodity; (2) the contract has a maturity date of more than two days after the contract was entered into; (3) the price, quantify, and time elements must be fixed at the time of contracting; and (4) the contract has a relationship to the financial markets. *Conti v. Perdue BioEnergy, LLC (In re Clean Burn Fuels, LLC)*, 540 B.R. 195, 204 (Bankr.

> M.D.N.C. 2015) (citing *Hutson v. E.I. du Pont de Nemours & Co. (In re Nat'l Gas Distribs., LLC*, 556 F.3d 247, 256-57 (4th. Cir. 2009)).

Arcapita Bank, 2021 Bankr. LEXIS 1098 at *104-105.

The court found that the Agreements failed to meet the *National Gas* requirements, and thus, found that the transactions did not satisfy the safe harbor for forward contracts.

The court found that the Agreements did not satisfy the fourth factor of the *National Gas* test because there was no "relationship" between the Agreements and the broader financial markets. When determining if such a relationship exists, courts examine the "primary purpose" of the agreement at issue. *See, e.g., Clear Peak Energy, Inc. v. Southern Cal. Edison Co. (In re Clear Peak Energy, Inc.)*, 488 B.R. 647, 659-660 (Bankr. D. Ariz. 2013). The fourth factor will be satisfied where the primary purpose of the agreement is "financial and risk-shifting in nature," such as seeking to hedge against fluctuations in the price of a commodity, "as opposed to the primary purpose of an ordinary commodity contract, which is to arrange for the purchase and sale of the commodity." *Id.* (quoting *BCP Liquidating LLC v. Bridgeline Gas Mktg. (In re Borden Chems. & Plastics Operating Ltd.)*, 336 B.R. 214, 220 (Bankr. D. Del. 2006)).

Here, the court found that the primary purpose of the Agreements was not risk-shifting in nature. In drafting the safe harbor provisions relating to forward contracts, "Congress intended to reach agreements whose purpose was to protect against the uncertainty of price fluctuations [,]" *In re Borden*, 336 B.R. at 221, as opposed to ordinary commodity contracts. The court found that the Agreements did not shift any risk of fluctuations in the commodity price from one party to the other, as is seen with commodity forwards. Rather, they operated more like ordinary commodity contracts.

The Agreements also failed the second factor of the *National Gas* test because they specified maturity dates that were less than two days after the contracting date. Courts have held the "maturity date" to be the date of delivery of the underlying commodity. *See Buchwald v. Williams Energy Mktg. & Trading Co. (In re Magnesium Corp. of Am.)*, 460 B.R. 360, 373 (Bankr. S.D.N.Y. 2011) (determining the maturity date "necessarily calls for an examination of the time at which the underlying commodity is to be delivered" and where a base contract gave rise to a series of individual future contracts, "it may be better to analyze the issue in terms of [each of the delivery dates] as multiple 'maturity date[s].'").

The court found that the maturity dates of these transactions were the same day as—and not more than two days later than—the dates on which the parties entered into those contracts because the Agreements called for "immediate delivery on a deferred payment basis" of certain commodities after the parties enter into a contract fixing the price of sale.

For these reasons, the court held that the Agreements were not forward contracts, ultimately meaning that the Transaction Proceeds were not afforded safe harbor protections,

and thus became property of the bankruptcy estate. The court reasoned further that the Defendants violated the automatic stay by willfully withholding the Transaction Proceeds.

E. Chapter 7

***In re Barksdale*, No. 20-8008, 2020 Bankr. LEXIS 2318 (B.A.P. 6th Cir. Aug. 28, 2020) (Effect of Discharge)**

Key Takeaway:

A Chapter 7 discharge only extinguishes the *in personam* (personal liability) mode of enforcing a claim, whiling leaving intact any *in rem* action against the debtor's property. Secured creditors are free to pursue collection actions against their collateral after a debtor has been granted a Chapter 7 bankruptcy discharge. Although 11 U.S.C.S. § 522 (f) permits a debtor to avoid judicial liens, consensual liens or liens imposed by delinquent real property taxes are not included. Additionally, the Ohio Rev. Code Ann. § 2329.661(C) exemption does not affect or invalidate consensual liens.

Summary:

The Debtor filed a Chapter 13 case, in which he scheduled real property and his vehicle. He listed two debts, one which he owed for real estate taxes to the county and the second being a car loan owed to the bank. The Debtor voluntarily converted the case to Chapter 7, received a Chapter 7 discharge, and the case closed. Three months later, the Debtor then filed his Motion to Reopen the Case for Determination of Dischargeability of Debt, contending that because the bank failed to object to his Statement of Intention of keeping his vehicle, the bank's lien against the vehicle was thus discharged and must be released. The Debtor also contended that the taxes owed to the county were discharged under § 507, which in turn discharged any *in rem* claim against the real property. Upon review, the United States Bankruptcy Court for the Northern District of Ohio issued an order for a supplemental brief in support of Debtor's motion explaining further the cause that justified reopening his case.

The Debtor filed the supplemental brief arguing that "res judicata and collateral estoppel prohibit the bank from collection actions against the vehicle because its lien was discharged." *Id.* at *4. Debtor also argued under § 522 (f) that he may avoid the bank's and county's liens because his exemptions in the vehicle and real property exceeded the value of their respective liens. The bankruptcy court denied Debtor's Motion, reasoning as follows:

> Secured creditors are generally free to pursue actions against their collateral after a bankruptcy case has been concluded despite the debtor's discharge of personal liability from most prepetition debts. Nor does a debtor's claim of exemption affect consensual liens or tax liens. Section 522(f) of the Bankruptcy Code permits a debtor to avoid judicial liens, which do not include consensual liens (such as the lien held by the Bank) …or liens imposed by delinquent real property taxes (such as the lien held by [the county]).

Id. at *5.

This appeal followed. The United States Bankruptcy Appellate Panel for the Sixth Circuit ("BAP") stated that a case may be reopened "to administer assets, to accord relief to the debtor, or for other cause." 11 U.S.C. § 350(b). However, a bankruptcy court does not need to reopen a case if doing so would be futile.

The court on appeal held that exemptions do not discharge tax or consensual liens. "A '[c]hapter 7 bankruptcy discharge does not, in and of itself, discharge a creditor's lien.'" *Id.* at *7. The Debtor also claimed exemptions under Ohio Rev. Code Ann. § 2329.66, but the court clarified that this statute does not "'impair a lien for the payment of taxes, debts, or other obligations owed to this state' for a debtor's residence." *Id.* Therefore, the lien against the real property survived despite the Debtor's claimed exemption. Additionally, the exemption statute does not affect or invalidate a consensual lien, such as the bank's lien against the vehicle. Thus, the Debtor's claim of exemptions and discharge do not affect the county's or the bank's liens, and those secured creditors may pursue collection attempts against their collateral. This court affirms the bankruptcy court's denial of Debtor's Motion to Reopen reasoning that reopening efforts would be futile because the court cannot offer any alternative relief to the Debtor.

Additionally, Debtor contended that he may avoid the County's lien for property taxes under § 522(f)(1), which permits debtors to avoid judicial liens that "impair a debtor's examination in their property." However, real property tax liens are statutory liens, not judicial liens. Therefore, § 522(f) does not allow the Debtor to avoid the County's statutory tax lien against Real Property, and cause did not exist to reopen the case under this argument.

***Nyamusevya v. CitiMort.*, Inc., No. 19-8027, 2021 Bankr. LEXIS 174 (B.A.P. 6th Cir. Jan. 20, 2021) (Effect of Abandonment and Discharge on Stay)**

Key Takeaway:

The Sixth Circuit BAP held that, after abandonment and a Chapter 7 discharge, the Debtor's property is no longer protected by the automatic stay.

Summary:

CitiMortgage, Inc. had started foreclosure proceedings against the Debtor. After several appeals by the Debtor, the appellate court issued a stay of the foreclosure sale conditioned upon the Debtor's timely posting of a supersedeas bond. The Debtor did not post the bond and instead filed a voluntary Chapter 13 petition before converting his case to a Chapter 7 liquidation proceeding.

CitiMortgage later asked the Trustee to abandon the Property, prompting the Trustee to file a notice of abandonment declaring the Property no longer offered a benefit to unsecured creditors and was of inconsequential value to the estate. *Id.* at *4. At this time the Debtor did not

object to the abandonment. CitiMortgage moved for relief from the automatic stay under 11 U.S.C. § 362(d) to resume the foreclosure. The United States Bankruptcy Court for the Southern District of Ohio determined that CitiMortgage's motion for relief from stay was moot, because the automatic stay no longer shielded the Debtor's property from the lender's foreclosure efforts.

On appeal the Debtor contended that the Trustee did not properly abandon the Property. The court's declaration of the motion for relief as moot follows from a straightforward application of 11 U.S.C. § 362(c). "The stay of an act against property of the estate under subsection (a) of this section continues until such property is no longer property of the estate." 11 U.S.C. § 362(c)(1). When the Trustee abandoned the property, it was removed from the estate. Additionally, the entry of the discharge under Debtor's Chapter 7 relief terminated the automatic stay as applied to the Debtor and to his property. Both the abandonment and discharge led to the Debtor's property resuming its pre-bankruptcy status, as the Debtor's own property, subject to CitiMortgage's lien.

The Sixth Circuit BAP affirmed the bankruptcy court's reasoning and holding. Section 554(a) of the Bankruptcy Code allows a trustee, after notice and a hearing, to abandon property that is of inconsequential value and benefit to the estate. The Trustee's abandonment power is discretionary, and the burden is on the party opposing the abandonment to prove a benefit to the estate and an abuse of discretion by the Trustee.

The Debtor contended that the bankruptcy court deprived him of due process because it did not hold a hearing prior to the abandonment. However, 11 U.S.C. § 102(1)(B) "authorizes an act without an actual hearing when there is proper notice and a hearing is not requested timely by a party in interest." *Id.* The Panel evaluated Debtor's claims under Rule 6007(a) and § 102(1) and held that because Debtor did not avail himself of a court process to prevent the abandonment action -- such as an objection to the filing or a request for a hearing – he cannot complain that he did not get the process he was due. Additionally, under these circumstances, the abandonment did not deprive the Debtor of any property, but rather revested his property back to him and the Debtor still maintained interest in that property.

The Panel affirmed the bankruptcy court's order declaring the Property no longer protected by the automatic stay due to the proper abandonment and Chapter 7 discharge.

***Homaiden v. Sallie Mae, Inc., et al.*, No. 20-1981 (2nd Cir. Ct. App. July 15, 2021) (Dischargeability of Private Student Loans)**

Key Takeaway:

While most student loans are non-dischargeable, under 11 U.S.C. § 523(a)(8), private student loans may be dischargeable.

Summary:

Here the creditors contended that § 523(a)(8)(A)(ii) prevented discharge of the obligations as "obligation[s] to repay funds received as an educational benefit, scholarship or stipend," which it contended would include all private student loans. The Court disagreed, concluding that it excepts from discharge a far narrower category of debt.

Here, the student got a discharge that was vague on whether it included the creditor's debt, and repaid the debt but later sued the creditor to establish that the debt had been discharged, so he could sue for violation of the discharge injunction. The Court concluded that if Congress intended to include all private student loans in a prohibition on dischargeability, it should have done so with language more specific than a reference to "funds received as an educational benefit," especially when other provisions in 523(a)(8) refer expressly to loans -- i.e. those made or backed by the government, as in 523(a)(8)(A)(i)).

F. Chapter 13

***Penfound v. Ruskin*, No. 19-2200 (6th Cir. Ct. App. August 10, 2021) (Post-Petition Retirement Contributions)**

Key Takeaway:

An interruption in 401(k) contributions as a result of an employment change may mean that later resumed contributions are not "regular" pre-bankruptcy contributions that may be excluded from the calculation of disposable income.

Summary:

Here the Debtor regularly contributed to his 401(k) while at Employer 1. He then went to Employer 2, who did not have a plan, so he was not making contributions. He then went to Employer 3, who had a plan, where he eventually resumed his contributions. In his and his wife's Chapter 13, they sought to exclude the current contributions from disposable income. The Bankruptcy Court declined to permit the exclusion based on this history -- that he made no contributions in the six months preceding the bankruptcy -- the District Court agreed and the Sixth Circuit did as well.

***Smith v. U.S. Bank National Association (In re Smith)*, No. 20-3150 (6th Cir. Ct. App. June 9, 2021) (Voluntary Dismissal in Chapter 13)**

Key Takeaway:

This case acknowledges a Chapter 13 Debtor's virtually absolute right to dismiss his case, even after bad faith serial filings.

Summary:

11 U.S.C. sec. 1307(b) provides that, if a Chapter 13 debtor moves to dismiss his case, "the court shall dismiss" it. This Debtor filed a Chapter 13 petition three separate times, always on the eve of a foreclosure sale, later seeking dismissal of the Chapter 13 each time. The Bankruptcy Court had dismissed all three times, on the basis that it had to do so notwithstanding the Debtor's bad faith but, after the last dismissal, invoked its equitable powers to vacate that last dismissal order, reinstate the most recent case, and impose a long term lifting of the stay. The Sixth Circuit reversed, holding the reinstatement contrary to law.

The Court held that 1307(b) is not discretionary, even where the Debtor filed in bad faith. The Court held that even section 105(a), granting bankruptcy courts broad equitable powers, did not permit the court to disregard the mandatory language of 1307(b). The decision does suggest other remedies for serial bad faith filing, such as sanctions and stay relief.

G. Chapter 11

***In re Hartshorne Holdings, LLC, et al.*, No. 20-40133-thf (Bankr. W.D. Ky. Aug. 14, 2020) (Enforceability of Terms of Contract Assumption and Assignment)**

Key Takeaway:

This is the first known decision to address whether a source restriction may be excised from a mineral supply contract in order to permit the contract's assumption and assignment, pursuant to bankruptcy law, to an assignee who would source the coal from a different location. The court held that the source term was material and must be given effect, thus not permitting the proposed assumption and assignment. This decision informs coal operators that a source provision in their mineral supply agreements will be enforced notwithstanding their reorganization and sale efforts.

Summary:

Louisville Gas and Electric Company and Kentucky Utilities Company (collectively "LG&E/KU") entered into a contract with Hartshorne Mining Group LLC ("Hartshorne") to purchase 4.75 million tons of coal from 2018 through 2023, with a contract value of in excess of approximately $190 million. The contract specified that the coal must be sourced only from two specifically identified mines in western Kentucky which were being developed by Hartshorne.

Hartshorne began mining from the Poplar Grove mine in 2019 but struggled to meet its requirements under the contract. On February 20, 2020, Hartshorne and certain of its affiliates (collectively, the "Debtors") filed for protection under Chapter 11 of the Code with the stated objective of liquidating their assets through a Section 363 sale process. The Debtors marketed their mines and other assets for sale but received no bids. Their lender — an Australian private equity firm — had lent approximately $50 million to the enterprise. With no bids, the Debtors and lender resorted to a lender credit bid of $14 million to acquire the LG&E/KU contract, a

smaller supply contract with another utility and certain other minor select assets, but not the mines themselves. The Debtors, with the lender's consent, began closing their mines and moved the court to approve an assignment of the supply contracts to the lender, with the lender stating that it would supply them through an international broker from various other industry sources as opposed to the mine sources specified by the contracts. LG&E/KU objected to the assignment on grounds including that the proposed sale could not depend on an alteration of the source and related terms in its contract.

The issue before the bankruptcy court was the tension between two bankruptcy concepts: (1) that a contract buyer/assignee must perform all of the terms of a contract of which it takes assignment, good and bad (i.e., no cherry-picking); and (2) a contract provision that merely serves as an anti-assignment provision is not enforceable in bankruptcy and may be given no effect by the court.

The bankruptcy court sustained LG&E/KU's objection and opined that its testimony regarding its expert and complex fuel procurement process established that the coal source term was material, not just an anti-assignment provision, and could not be altered to permit amendment." Moreover,

> [a]s stated above, contracts and unexpired leases must be assumed in their entirety, with all their benefits and all their burdens. *In re J. Peterman Co.*, 232 B.R. 366, 369 (Bankr. E.D. Ky. 1999). While Section 365(f)(1) does give the [c]ourt broad equitable power to excise "anti-assignment" provisions from those contracts and leases if their construction "restricts or conditions the assignment," *In re Mr. Grocer, Inc.*, 77 B.R. 349, 354 (Bankr. D.N.H. 1987), the [c]ourt will not opt to treat the source provision as such here. Although Debtors argue that the source provisions "are impermissible anti-assignment provisions which are disregarded under Section 365(f)," and "must be excised for the benefit of the estates," [R. 454 at 4], this [c]ourt disagrees, finding no precedent for ignoring the coal source terms over the Utilities' objections, or treating them as anything other than material terms for which the Utilities specifically bargained.

Id. at 21. At the end of the day, the bankruptcy court was "not comfortable being the first bankruptcy court on record to write off a coal source provision as an immaterial anti-assignment term, and permit assignment of coal supply contracts over the buyers' objections to unknown third-party brokers and vendors." *Id.* at 22.

The Debtors appealed, after which the parties settled pursuant to an agreement that the contract would not be assumed or assigned but would be rejected and terminated, and with the Debtors' eventual plan of liquidation being consistent with that treatment.

***In re NRA of Am.*, No. 21-30085, 2021 Bankr. LEXIS 1336 (Bankr. N.D. Tex. May 11, 2021) (Dismissal for Cause)**

Key Takeaway:

Pursuant to 11 U.S.C.S. § 1112(b), a court shall dismiss a case for cause unless the court determines that the appointment under 11 U.S.C.S. § 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate. "Cause" for purposes of dismissal can include the finding that the debtor's filing for Chapter 11 relief is not in good faith – such as filing to gain an unfair litigation advantage and to avoid a state regulatory scheme.

Summary:

The United States Bankruptcy Court for the Northern District of Texas granted the motion by the New York Attorney General ("NYAG") and others to dismiss the National Rifle Association of America's Chapter 11 bankruptcy filing for cause.

NYAG conducted a fifteen-month-long investigation of the NRA that revealed what it contended was widespread misuse of assets by the NRA's executive vice president and his inner circle. Nine-months prior to this decision, NYAG filed a lawsuit in New York seeking dissolution of the NRA based on allegations of misuse of authority, abuse of powers, and acts conducted in an illegal, oppressive, or fraudulent manner. The NRA and a newly formed LLC filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code in Texas seeking protection of the Code, purportedly to preserve itself from the "existential threat" litigation posed. The question for the Court was whether the "existential threat" the NRA faced is the type of threat the Bankruptcy Code is meant to protect against.

The movants sought three forms of relief: (1) dismissal of the bankruptcy cases; (2) appointment of a Chapter 11 trustee; or (3) the appointment of an examiner. Pursuant to § 1112(b), courts may dismiss a case for cause which, the Fifth Circuit Court of Appeals has held, includes a finding that the debtor's filing for relief is not in good faith. "Furthermore, courts have held that a Chapter 11 petition is not filed in good faith unless it serves a valid bankruptcy purpose." Id. at *22.

The Court first analyzed whether there is cause for dismissal, specifically, whether the NRA filed for bankruptcy in good faith. In its discussion, the Court noted that the NRA provided the Court with several reasons for filing this bankruptcy case: (1) Avoid dissolution; (2) Avoid receivership in a New York state court; and (3) Remove themselves from New York and relocate to Texas. The Court analyzed the evidence of the NRA's reasons for filing bankruptcy. During the deposition of the NRA's general counsel, Mr. Frazer, the only reasons he identified for filing bankruptcy were "to streamline litigation, consolidate the claims against the NRA, and reorganize in Texas." Id. at *34. However, in his testimony he agreed the bankruptcy filing allowed the NRA to seek protection from regulation in New York. Also, he had not been consulted about the filing. The Court analyzed the testimony of the NRA's executive vice president, Mr. LaPierre, where he

confirmed that even if the court dismissed the NRA's bankruptcy case, the NRA would still be able to pay its debts in full and meet its obligations. Id. at *39.

The Court held that the evidence did not support a finding that the purpose of the bankruptcy filing was to reorganize the NRA, nor to streamline litigation and control litigation costs, but rather, "but for the NYAG Enforcement Action, it would not have been necessary to file for bankruptcy." Id. at *41, and the primary purpose of doing so was to avoid potential dissolution.

Once the Court determined the primary purpose for filing the bankruptcy case, it addressed whether that was a valid bankruptcy purpose, i.e., a filing bankruptcy in good faith. The Court appeared to follow Third Circuit Court of Appeals' two inquiries concerning good faith: "(1) whether the petition serves a valid bankruptcy purpose and (2) whether the petition is filed merely to obtain a tactical litigation advantage." Id. at *46.

The Court found that the type of dissolution that NYAG was seeking is not the type of dissolution from which the Bankruptcy Code provides sanctuary:

> For this reason, the Court believes the NRA's purpose in filing bankruptcy is less like a traditional bankruptcy case in which a debtor is faced with financial difficulties or a judgment that it cannot satisfy and more like cases in which courts have found bankruptcy was filed to gain an unfair advantage in litigation or to avoid a regulatory scheme. . . Courts have consistently held that a bankruptcy case filed for the purpose of obtaining an unfair litigation advantage is not filed in good faith and should be dismissed.

Id. at *49. Additionally, the Court discussed some of the NRA's other stated reasons for filing bankruptcy and concluded that, even if the goal was simply to reincorporate in Texas, the purpose of the bankruptcy would still appear to be avoidance of New York regulators.

The NRA argued that "if avoiding dissolution is found to be an inappropriate bankruptcy purpose, this would allow a state to block a debtor's right to file for bankruptcy simply by filing an action seeking dissolution, and this would be tantamount to allowing a state to preempt federal law." Id. at *53. The Court responded that it was "evaluating the debtor's good faith or lack thereof in filing bankruptcy based on the totality of the circumstances of this specific case," rather than creating a per se rule stating a "pending dissolution action renders an entity ineligible for bankruptcy." Id. at *53.

The Court found, for the reasons stated above, there was cause to dismiss this case without prejudice as it had not been filed in good faith. The primary purpose for filing the Chapter 11 bankruptcy petition was to gain an unfair litigation advantage and to avoid a state regulatory scheme. Additionally, because the NRA had by this time improved its governance and compliance, and had enough money to both defend litigation and pay creditors in full, the

appointment of a trustee or examiner as an alternative was not in the best interests of creditors and the estate. Id. at *58.

***In re Paragon Offshore, PLC*, No. 16-10386 (June 28, 2021 letter ruling by Judge Sontchi) (UST Fees)**

Key Takeaway:

This is an important decision on an unsettled issue -- whether the Office of the United States Trustee may collect its statutory fees for distributions from post-confirmation litigation trusts. Judge Sontchi ruled that, where the United States Trustee had collected its fee on the transfer of Debtor assets into the trust, it could not collect again on distributions from that Trust.

Summary:

This is a hot issue generating multiple opinions. The Delaware Bankruptcy Court is one of the most influential in the country but the issue has not been determined at a circuit court level. Judge Sontchi's opinion has sharp words for the United States Trustee in this request -- calling its position "absurd" and "offensive."

***Alliance WOR Properties, LLC v. Illinois Methane, LLC (In re HNRC Dissolution Co.)*, 2021 U.S. App. LEXIS 20545 (6th Cir. Ct. App. July 12, 2021) (Creditor Notice Under 363 Sales)**

Key Takeaway:

Lack of notice to a creditor can jeopardize the status of a sale of assets as "free and clear of liens, claims and encumbrances" under 11 U.S.C. § 363.

Summary:

In 1998 a coal company conveyed its rights to methane gas in some of its reserves. A recorded deed memorialized the conveyance and delayed payment obligation to the methane buyer. The coal company later filed for bankruptcy protection and sold its coal interests "free and clear" to a buyer under 11 U.S.C. § 363. Years later, the methane buyer asserted a right to payment from the 363 sale buyer, who defended based on the methane buyer's claims having been extinguished in the earlier bankruptcy sale. However, while there were several publication notices of the sale, there was no actual notice given or attempted to be given to the methane buyer. The methane buyer first learned of the bankruptcy when the 363 sale buyer offered it as a defense. The Bankruptcy Court held that the publication notice was inadequate as to this creditor and, as a result, its claims had not been extinguished. The District Court and Sixth Circuit affirmed.

The issue was one of due process. The Bankruptcy Court determined that the methane buyer's interest was a "known" interest and, without notice, enforcement of it could not be enjoined. Publication alone might be sufficient for an unknown interest, but a "known interest" is one actually known or "reasonably ascertainable," and it requires more. Here the methane

buyer's interest was determined to be a vested property interest -- i.e. it was a covenant running with the land under state law. The case includes an extended discussion of the records review that the Courts concluded would have turned up this interest, so as to have permitted actual notice to have been given.

***GLM DFW, Inc. v. Windstream Holdings, Inc. (In re Windstream Holdings, Inc.)*, 838 Fed. App'x 634 (2nd Cir. Feb. 18, 2021) (Equitable Mootness on Appeal Post-Confirmation)**

Key Takeaway:

The Second Circuit Court of Appeals applied the equitable mootness doctrine to dismiss a creditor's appeal of an order authorizing payment to critical vendors. It supported an expansive application of the equitable mootness doctrine, suggesting it may be applied to block appeals from a broad range of unstayed pre-confirmation orders after the plan of reorganization has been confirmed.

Summary:

A creditor appealed a bankruptcy court's order approving the payment of prepetition debts to "critical vendors." The creditor did not seek a stay of the order pending appeal. On appeal, the district court affirmed the bankruptcy court's order. Before the Second Circuit decided the creditor's appeal from the district court's decision, the debtor's Chapter 11 plan of reorganization was confirmed. The Second Circuit thereafter found that the doctrine of equitable mootness applied to the appeal and declined to disturb the order approving payment to critical vendors.

The Second Circuit explained that "the primary purpose of equitable mootness is to give courts a tool 'to avoid disturbing a reorganization plan once implemented'" and "[a]s a result, where, as here, such a plan has already been substantially consummated, we presume that an appeal is equitably moot." *Id* at 636. The Second Circuit then identified five factors that a creditor must demonstrate to appeal an unstayed order after the plan of reorganization has been confirmed. The factors are:

(1) The court can still order some effective relief;
(2) Such relief will not affect the re-emergence of the debtor as a revitalized corporate entity;
(3) Such relief will not unravel intricate transactions so as to knock the props out from under the authorization for every transaction that has taken place and create an unmanageable, uncontrollable situation for the bankruptcy court;
(4) The parties who would be adversely affected by the modification have notice of the appeal and an opportunity to participate in the proceedings; and
(5) The appellant pursued with diligence all available remedies to obtain a stay of execution of the objectionable order if the failure to do so creates a situation rendering it inequitable to reverse the orders appealed from.

Id. (quoting *Frito-Lay, Inc v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944, 952-53 (2d Cir. 1993)).

The appellant-creditor argued that the doctrine of equitable mootness did not apply, insisting that the doctrine be limited in application to orders that directly concern the bankruptcy court's order confirming the debtor's plan of reorganization. The court disagreed, explaining that "equitable mootness can be applied in a range of contexts, including appeals involving all manner of bankruptcy court orders." *Id.* at 637 (quotation marks omitted). The court then turned to the *Chateaugay* factors (above) and focused on the importance of the "diligence" factor. "Most notably," the Second Circuit explained, "[the creditor] did not pursue with diligence all available remedies to obtain a stay of execution of the objectionable order." *Id.* (quotation marks omitted). The Second Circuit further explained that "[i]n the absence of any request for a stay, the question is not solely whether we *can* provide relief without unraveling the [p]lan, but also whether we *should* provide such relief in light of fairness concerns." *Id.* (quotation marks omitted).

Ultimately, the Second Circuit reasoned that "[g]ranting [the creditor] the relief it seeks could cause tens of millions of dollars in previously satisfied claims to spring back to life, thereby potentially requiring the bankruptcy court to reopen the plan of reorganization" and therefore dismissed the appeal as moot. *Id.*

***In re KG Winddown, LLC*, No. 20-11723 (S.D.N.Y. June 9, 2021) (Structured Dismissal in Chapter 11)**

Key Takeaway:

This case explores SCOTUS's 2017 *Jevic* ruling regarding structured dismissals and their limits, interpreting that case as permitting dismissals when they do not violate the absolute priority rule and they otherwise comply with the Bankruptcy Code.

Summary:

Multiple Debtors filed Chapter 11 cases in on July 28, 2020. The Debtors closed a sale of substantially all their assets on December 24, 2020. After payment of administrative claims, the Debtors were expected to have no remaining cash (with counsel accepting a fee discount for that calculation not to go negative). The Debtors moved the Court to approve a structured dismissal of the cases, including continued effectiveness of all prior orders in the cases, the Court's retention of jurisdiction, and dismissal on certification that administrative claims (including professional fees) and U.S. Trustee fees had been paid and certain monthly operating reports having been filed. The U. S. Trustee objected.

The court interpreted the ruling in *Czyzewski v. Jevic Holding Corp. (In re Jevic Holding Corp.)*, 137 S. Ct. 973 (2017), which described a structured dismissal of a Chapter 11 case as a dismissal which alters "a Chapter 11 dismissal's ordinary restorative consequences" (i.e. property revesting in the Debtors). That Court declined to express a view actually approving structured

dismissals, but did hold that a bankruptcy court cannot approve them where they provide for distributions that do not follow the Bankruptcy Code's priority scheme absent the consent of those affected. The court also concluded that the Code had the flexibility to protect rights acquired in reliance on the bankruptcy cases. In other words, *Jevic* did not close the door on structured dismissals but did limit them.

Here, the New York bankruptcy court approved the dismissal, where the Debtors had no remaining material assets, no operations, and no resources to fund a plan, on the basis that other alternatives would impose additional costs not in the best interests of creditors and the estates. Where the UST had principally objected that dismissal was premature -- because several steps were proposed to be taken before dismissal -- the Court noted that a process for dismissal was appropriate but required the Debtors to add creditors' ability to object during the process. The UST objected that a provision for the continued effectiveness of an exculpation provision was an unnecessary "comfort order," but the Court held that parties had relied on that provision in connection with the sale and could continue to do so, and comfort orders could be appropriate.

H. Small Business Chapter 11

In re Patel, No. 09-39791-C-11, 2020 Bankr. LEXIS 2904 (Bankr. E.D. Cal. Oct. 15, 2020) (Disposable Income)

Key Takeaway:

The new Subchapter V requires the debtor to pay all disposable income to creditors for a period set by the court of three-to-five years. *See* 11 U.S.C. Section 1191(c)(2). This case discussed revenue which should be included in disposable income.

Summary:

In a Subchapter V proceeding, a court may confirm a plan even if all creditor classes reject it and may do so without adhering to the "absolute priority rule," which, generally speaking, requires a Chapter 11 plan "to adhere to the order of priority entitlements against the debtor's assets between classes of unsecured claims and equity interests under applicable non-bankruptcy law" and ensures that creditors are paid in full before equity owners retain anything. Charles Jordan Tabb, The Law of Bankruptcy 1166-67 (2d ed. 2009). In place of the absolute priority rule, Debtors must commit all disposable income to the plan.

The Debtors filed for relief under Subchapter V to save their forty-five-unit motel from foreclosure. The Debtors alleged that they committed all of their "disposable income" as defined in 11 U.S.C. Section 1129(a)(15)(B) to pay the unsecured class for eighty-four months, representing that their only source of income would be from the motel's operations. However, the Debtor ultimately failed to make any payments to the unsecureds and at the end of the eighty-four months, an unsecured creditor invoked the plan's default provision to request conversion or dismissal.

In deciding whether conversion or dismissal was appropriate, the court took an in-depth look at the Debtors' revenue to determine whether the Debtors actually had "disposal income" – they alleged that they did not. The court discovered nearly $100,000.00 generated by sources other than motel operations (i.e. profits from investment accounts) that qualified as actual disposable income required to be disbursed to unsecured creditors. The court held that the Debtor's failure to disburse those funds was a default, clarifying and holding that "disposable income" means actual disposable income and that the definition includes revenue from *all sources*. The court also explained that a debtor owes a duty to account to the creditors concerning disposable income on a periodic basis rather than at the end of a plan term.

***In re Wright,* No. 20-01035, 2020 Bankr. LEXIS 1240 (Bankr. D.S.C. Apr. 27, 2020); *In re Blanchard*, No. 19-12440, 2020 Bankr. LEXIS 1909 (Bankr. E.D. La. Jul. 16, 2020) (Defunct Businesses Eligible for Subchapter V)**

Key Takeaway:

A business need not be actively operating to take advantage of Subchapter V.

Summary:

To qualify for relief under Subchapter V, a debtor must: (1) be a debtor under Chapter 11; (2) be a "small business debtor" under Section 101(51D) of the Code; and (3) must elect to have Subchapter V apply to its case. Section 101(51D) defines a "small business debtor" as "a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning single asset real estate) that has aggregate noncontingent liquidated secured and unsecured debt" in an amount not more than $7,500,000, no less than 50% of which arose from the commercial or business activities of the debtor. Some courts interpret these requirements more broadly than others and afford a debtor some leniency in meeting the otherwise rigid standard by evaluating the entire business as a whole.

In *Wright*, the Debtor filed for relief under Subchapter V and designated that he was a "small business debtor". The trustee filed a Motion to Strike asserting that the Debtor did not meet the definition of a "small business debtor" because the business entities the Debtor owned had ceased operations prior to the bankruptcy filing. Nevertheless, as of the petition date, 56% of the amount of debt was stipulated to be business debt. The court ruled that it is unnecessary for a debtor to be conducting a business when filing its petition to qualify for Subchapter V. The court explained that "[a]lthough the brief legislative history of the SBRA indicates it was intended to improve the ability of small businesses to reorganize and ultimately remain in business, nothing therein, or in the language of the definition of a small business debtor, limits application to debtors *currently engaged* in business or commercial activities." The court held that the Debtor was "engaged in commercial or business activities" by addressing residual business debt after the entities ceased operations.

Similarly, in *Blanchard*, the court held that personal guarantees of a defunct business's debts are enough to satisfy the qualifications needed to be a small business debtor.

***In re Cord David Johnson and Sunny Lea Johnson,* No. 19-42063-ELM, 2021 Bankr. LEXIS 471 (Bankr. N.D. Tex. Mar. 1, 2021) (Principal of Defunct Business Not Eligible for Subchapter V)**

Key Takeaway:

A defunct business may not be eligible for relief under Subchapter V of Chapter 11 – even where the debtor is employed as an officer with "heightened obligations" in his mother's company – because the "engaged in" inquiry is inherently contemporary in focus instead of retroactive.

Summary:

In *Johnson*, the Debtor owned several defunct businesses when he filed for bankruptcy relief under Chapter 7. These businesses were neither currently operating nor was there any plan for them to become operational in the future. On his petition date, the Debtor was employed as an officer—Drilling Manager—in his mother's company. The Debtor did not possess any ownership interest in his mother's company. The Debtor ultimately moved to convert his bankruptcy to a small business reorganization under Subchapter V. The U.S. Trustee and certain creditors objected to the conversion. At issue in the case was the meaning of the words "engaged in" and "commercial or business activities," neither of which are separately defined in the Code.

The Court ruled that the "'engaged in inquiry is inherently contemporary in focus instead of retrospective, requiring the assessment of the debtor's current state of affairs as of the filing of the bankruptcy petition." *Id.* at *15. Applying these principles to the facts before it, the court found that the Debtor's ownership of defunct businesses, which appeared to be permanently out of business, did not satisfy the "engaged in" requirement for Subchapter V qualification.

The Court then considered whether the Debtor's employment as "Drilling Manager" at his mother's company satisfied the "commercial or business activity" requirement for Subchapter V qualification and found that it did not. The court explained that "applying the ordinary meaning of 'commercial or business activities,' a person engaged in 'commercial or business activities' is a person engaged in the exchange or buying and selling of economic goods or services for profit." *Id.* at *21. Applying this definition to the facts before it, the Court held "[the Debtor] is nothing more than an employee of [his mother's business] with heightened obligations to the company on account of his role as an officer. As such, [the debtor] does not qualify as a small business debtor." *Id.*

***In re Offer Space, LLC*, No. 20-27480, 2021 Bankr. LEXIS 1077 (Bankr. D. Utah Apr. 22, 2021) (Defunct Business May Be Eligible for Subchapter V)**

Key Takeaway:

Courts will consider the totality of the circumstances when determining whether a debtor is "engaged in commercial activities" necessary to meet the eligibility requirements for Subchapter V. Such activities may include: having active bank accounts, having accounts receivable, analyzing and exploring counterclaims in a lawsuit, managing stock, winding down business and taking reasonable steps to pay creditors and realize value for assets. However, merely engaging in the bankruptcy process, without more, would be insufficient to satisfy the "engaged in commercial or business activities" requirement.

Summary:

In *Offer Space*, the Debtor, a limited liability company, prior to filing bankruptcy began suffering difficulties due to legal claims and chargebacks. As a result, the Debtor began informing its vendors that it would be unable to continue providing them services. As part of the winding down process, the Debtor sold its property software—the main operational asset of its business.

The Debtor ultimately filed for relief under Subchapter V. On the petition date, the Debtor's assets consisted of a bank account, accounts receivable, claims in a lawsuit against a third-party, and stock; (2) the Debtor had no employees, was no longer conducting business in the manner previously described, and had no intention to reorganize its business; and (3) the Debtor was using reasonable efforts to pay its creditors and realize value for its assets. The trustee objected to the Debtor's eligibility arguing that the Debtor was not "engaged in commercial or business activities."

The court overruled the trustee's objection finding that because the Debtor *is the business*, its winding down activities, such as having active bank accounts, having accounts receivable, analyzing and exploring counterclaims in a lawsuit, managing stock, winding down its business and taking reasonable steps to pay its creditors and realize value for its assets, was sufficient to satisfy the eligibility requirement of being "engaged in commercial or business activities" necessary for relief under Subchapter V.

***In re Ikalowych,* No. 20-17547, 2021 Bankr. LEXIS 997 (Bankr. D. Co. Apr. 15, 2021) (Qualification As Small Business Debtor)**

Key Takeaway:

A guarantor of commercial debt may qualify as small business debtor.

Summary:

An individual debtor may establish their eligibility as a small business debtor where the person is engaged in commercial or business activities, as of the petition date, whose debts were

less than $7.5 million, and more than half of which arose from debtor's commercial or business activities.

The Debtor was employed by an entity for several years, and served as the entity's manger. The Debtor stopped working for the entity when it was winding down its business and eventually ceased operations all together. While employed and managing the entity, the Debtor personally guaranteed a substantial amount of debt on behalf of the entity. The single issue before the court was whether the Debtor, as an individual, qualified as a small business debtor.

In resolving the issues for the Debtor, the court reasoned that: (1) the Debtor was a person under Section 1182(1)(A); (2) the Debtor satisfied the $7.5 million debt cap imposed by Section 1182(1)(A) because the "aggregate noncontingent liquidated secured and unsecured debt" as of the petition date was "not more than $7.5 million"; (3) the Debtor was a "person engaged in commercial and business activities" as of the petition date because the Debtor participated in activities to wind down the entity; and (4) most of the Debtor's debts arose from his "commercial or business activities" since the debtor put himself on the line for the entity by personally obligating himself to pay the outstanding debt.

***In re 305 Petroleum, Inc.*, No. 20-11593, 2020 Bankr. LEXIS 3008 (Bankr. N.D. Miss. Oct. 27, 2020) ($7.5 Million Debt Cap)**

Key Takeaway:

The debts of a debtor's affiliate – even an affiliate that is not eligible to file for Subchapter V itself – is properly aggregated into the total debt to be weighed against the $7.5 million debt cap.

Summary:

Four affiliated entities filed petitions for relief under Subchapter V. An objection was filed on the basis that, when the debt of a single asset real estate debtor was aggregated with the debts of the other three debtors, the combined debt exceeded the $7.5 million debt ceiling, rendering the debtors ineligible for small business debtor status.

The court held that the debt of the debtor's affiliate — even where the affiliate did not itself qualify for Subchapter V reorganization — is properly aggregated into the total debt to be weighed against the $7.5 million debt ceiling. In reaching its decision, the court explained that "Congress made clear that a small business debtor cannot be a member of a group of affiliates whose aggregate debt exceeds $7.5 million," and that the affiliate's "status as a single asset real estate debtor has no impact on its status as an affiliate of the jointly administered debtors" for the purpose of the debt cap.

***In re Slidebelts, Inc.*, No. 19-25064, 2020 Bankr. LEXIS 1777 (Bankr. E.D. Cal. Jul. 6, 2020); *In re Bonert*, No. 19-20836, 2020 Bankr. LEXIS 1783 (Bankr. C.D. Cal. Jun. 3, 2020) (Refiling and Amendment)**

Key Takeaway:

A court may decline to allow a regular Chapter 11 debtor to dismiss its reorganization and immediately refile under Subchapter V in a case where counsel for the creditors' committee had not yet been paid.

Summary:

In *Slidebelts*, the Debtor filed for relief under the regular Chapter 11 provisions. Soon after filing, the Debtor sought to dismiss its Chapter 11 case so that it could re-file under Subchapter V. The Official Committee of Unsecured Creditors opposed the motion, arguing that the Debtor's failure to propose a mechanism for payment of its professional fees amounted to an unlawful *de facto* structured settlement. The court denied the Debtor's motion to dismiss reasoning that "[a]ny prejudice to the debtor is outweighed by the need to protect professionals who have rendered services in reliance on the bankruptcy case." The court reasoned further that any prejudice to the Debtor was a result of its own making, and dismissal at the expense of the professionals was not permitted.

In contrast, the court held in *Bonert*, that the Debtors were permitted to amend their petition to reflect that they were "small business debtors" and to elect treatment under Subchapter V despite the appointment of a Committee. The court reasoned that the re-designation was not sought in bad faith and that no party would be unduly prejudiced. The court found it notable that because the Committee had only been in existence for a short period of time before the Debtors sought re-designation—the Committee was appointment on February 20, 2020 and the Debtor sought re-designation on March 3, 2020—the Committee would not be unduly prejudiced.

***In re ENKOGS1, LLC*, No. 21-00276, 2021 Bankr. LEXIS 1043 (Bankr. M.D. Fl. Apr. 20, 2021) (Hotel Eligibility)**

Key Takeaway:

When determining whether a hotel debtor is a "single-asset real estate" debtor and otherwise ineligible for Subchapter V, courts will consider the entire spectrum of a debtor's business operations. As a general rule, hotels are not single-asset real estate debtors, and thus are eligible for relief under Subchapter V.

Summary:

The Debtor, which owned and operated a seventy-nine-room hotel, filed for relief under Subchapter V. A creditor objected to the filing, contending that the Debtor's hotel was a single-asset real estate project rendering the Debtor ineligible for relief. The court determined that the

Debtor *was eligible* to file a Subchapter V case because it operated a substantial business other than merely managing the real estate. In particular, the Debtor did more than just rent rooms on a nightly basis because it provided room cleaning services, laundry services, internet/wi-fi services, phone services, bus and trailer parking, business services, served complimentary breakfast, and maintained a swimming pool and fitness center.

***In re Keffer*, No. 20-20334, 2021 Bankr. LEXIS 1020 (Bankr. S.D. W. Vir. Apr. 16, 2021); *In re Twin Pines, LLC,* No. 19-10295, 2020 Bankr. LEXIS 1217 (Bankr. D.N.M. Apr. 30, 2020); *In re Seven Stars on the Hudson Corp.*, 618 B.R. 333 (Bankr. S.D. Fla. 2020) (Conversion to Subchapter V)**

Key Takeaway:

Although the deadlines for converting to a Subchapter V have expired, conversion may nonetheless be permitted where the delay was caused by circumstances beyond a debtor's control.

Summary:

In *Keffer*, the Debtor originally sought relief under Chapter 13 and diligently progressed through that process. However, a claim from the IRS increased his total liabilities such that they exceeded the debt limits for Chapter 13 cases rendering him no longer eligible for Chapter 13 relief. The Debtor then sought to convert his case to Subchapter V. The trustee filed an objection, arguing that the deadlines for Subchapter V had already passed before the Debtor filed his motion to convert. The court, noting that there is a split of authority as to the issue, reasoned that even though the deadline for conversion had passed, if a debtor can demonstrate a need for extension of the deadlines, a debtor may still convert.

The court reasoned that the Debtor qualified for conversion because there was no indication that "he engaged in dilatory tactics, he has not been accused of acting in bad faith, and there is no contention that granting conversion would be a substantial abuse of the [Code]." Next, the court considered whether the Debtor was able to show that "delay necessitating the extension was caused by circumstances beyond [his] control." 11 U.S.C. Sections 1188(b), 1189(b). The court answered this question with a resounding yes, stating that he was not—and could not have been—aware of the amount of the IRS's claim until the IRS processed his return. The court permitted the Debtor to convert his case to Subchapter V, despite certain of its deadlines having already passed.

Similarly, in *Twin Pines* the Court held that it had discretion to extend the status conference and plan deadlines since they had expired long before the Debtor was able to elect Subchapter V. However, in *Seven Stars*, the Court held that violation of the applicable procedural requirements could prevent a debtor from converting its case.

***In re Ventura*, 615 B.R. 1 (Bankr. E.D.N.Y. 2020) (Combined Business and Residential Property)**

Key Takeaway:

A court can still find that property is being utilized for the purpose of operating a small business even where the debtor resides on the property as their principal residence. Also, a court has the authority to reset deadlines in favor of a debtor to ensure that the debtor is able to take advantage of the benefits afforded by the Small Business Relief Act.

Summary:

The individual Debtor filed a petition under Chapter 11 describing her debts as primarily consumer debts; she did not designate herself as a small business debtor. In reality, the debts stemmed from the ownership and operation of a bed and breakfast with mortgage debt of over $1.6 million. As the Debtor's Chapter 11 progressed, it became apparent that her plan was not confirmable because she was unable to bifurcate the mortgage claim to only pay the secured portion of the claim since the bed and breakfast was also her principal residence. For that reason, the Debtor amended her petition to designate herself as a small business debtor and sought to proceed under Subchapter V. The lender and the trustee objected.

The Court noted that the Debtor did not designate herself as a small business debtor on the date that she filed the petition, as it was filed fifteen months ***prior*** to the effective date of the SBRA. However, the court found that this fact did not preclude the Debtor from later amending her petition to take advantage of Subchapter V. The court reasoned that it had discretion to reset the timelines to allow the Debtor to avail herself of the newly enacted SBRA. The court held that the primary use of the property was the operation of a bed and breakfast, even though it was also the Debtor's principal residence, and as such, she was still eligible to file under Subchapter V.

I. Discharge and Dischargeability

***Ragone v. Stefanik & Christie, LLC (In re Ragone)*, No. 20-8013, 2021 Bankr. LEXIS 1298 (B.A.P. 6th Cir. May 13, 2021) (Discharge Injunction)**

Key Takeaway:

Courts may hold creditors in civil contempt for violating a discharge injunction if there is no objectively reasonable basis to doubt whether the order barred the creditor's conduct. There is a two-step inquiry to determine whether a creditor has violated a discharge order, however, "the debtor carries the burden of proving that the creditor committed a sanctionable violation of the discharge injunction by clear and convincing evidence." *Id.* at *12.

Summary:

11 U.S.C.S. § 524(a)(1), (2), and (3) of the Bankruptcy Code are commonly referred to as the discharge injunctions. 11 U.S.C.S. § 524(a)(1) and (2) provide that "a discharge in bankruptcy (1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged [] whether or not discharge of such debt is waived; (2) operates as an injunction against the commencement or continuation of an action…" *Ragone* at *11. The purpose of the discharge injunction is to provide debtors with a fresh start by ensuring that creditors will not pursue any further collection efforts against debtor personally, once debt has been discharged.

Stefanik & Christie, LLC and attorney John Christie are collectively "Creditor." An Ohio State Court awarded a judgment against Ragone. He filed a Chapter 7 petition for bankruptcy relief and the judgment creditor assigned the judgment to its lawyers, Stefanik & Christie, LLC. The Bankruptcy Court closed Ragone's case without a discharge. Four months later, the creditor filed an Order and Notice of Garnishment in a pending garnishment action. In the same month, the Debtor filed a motion to reopen his bankruptcy case, which the court granted, and was issued an order of discharge. Following his discharge, his wages continued to be garnished. He filed an "Emergency Motion to Stay Disbursements and Terminate the Wage Garnishment" in April 2016, clarifying that the judgment against him was discharged in his Chapter 7 case. The Creditor then filed a motion to reopen the bankruptcy case and revoke his discharge. Before the hearing on the discharge revocation request, the state court granted Appellee's Emergency Motion and dismissed the Garnishment Action.

One year later, the Debtor moved to reopen his bankruptcy case to enforce the discharge injunction against the Creditor, which the bankruptcy court granted. The Debtor asked the bankruptcy court to find the Creditor in contempt for violating the discharge injunction of § 524. He asserted that, once the Creditor learned of his Chapter 7 discharge, they failed to turn over his garnished funds and continued to garnish his income. *Id.* at *9.

The Creditor filed a motion for summary judgment claiming they had no knowledge of the bankruptcy filing or discharge, and once they learned of it, they agreed to terminate the garnishment. The bankruptcy court found this to be untrue, and denied their motion. The BAP for the Sixth Circuit agreed with the bankruptcy court's conclusion that the Creditor learned of the discharge in March 2016 and continued to litigate in state court until July 2016.

The bankruptcy court applied the U.S. Supreme Court's *Taggart* standard: "a court may hold a creditor in civil contempt for violating a discharge order if there is no fair ground of doubt as to whether the order barred the creditor's conduct." *Id.* at *12. The two-step inquiry consists of determining (1) whether the creditor's actions violated the discharge injunction and (2) "whether there was any objectively reasonable basis for believing that the action did not violate the discharge." *Id.* The bankruptcy court found that the Creditor had no objectively reasonable basis for refusing to terminate the garnishment action and, once they had no doubt the judgment

was discharged, they were under an obligation to return the garnished funds. The Creditor did neither of these things, and thus its actions were contemptuous. The BAP agreed.

Additionally, the Panel affirmed the bankruptcy court's decision to impose joint and several liability on the law firm Creditor and one of its members for the discharge injunction violation and the Debtor's entitlement to reasonable attorney's fees.

One B.A.P. judge concurred in part and dissented in part, stating that the Panel correctly affirmed the contempt finding and award against the law firm creditor, but erred in the ruling as to its member attorney because the evidence did not support a finding that he personally held or retained the garnishment funds, or contemptuously assisted the firm in obtaining those funds, before either had notice of the discharge. *Id.*

J. Jurisdiction

Ballinger v. Smith (In re Smith), No. 20-8015, 2021 Bankr. LEXIS 139 (B.A.P. 6th Cir. Jan. 21, 2021) (Appeal Deadlines and Excusable Neglect)

Key Takeaway:

A debtor who suffered a judgment that a debt was non-dischargeable failed to file a timely notice of appeal but did file a motion to extend the time to appeal under Rule 8002(d)(1), which allows the bankruptcy court to extend the time to file a notice of appeal when a party's motion is filed either "(A) within the time prescribed by this rule; or (B) within 21 days after that time, if the party shows excusable neglect." Fed. R. Bankr. P. 8002(d)(1). *Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. P'ship.*, 507 U.S. 308, 395, 113 S. Ct. 1489, 123 L. Ed. 2d 74 (1993) established a five-factor standard to determine whether a party's neglect in missing a deadline is excusable. Here, the Bankruptcy Court, in denying the motion, improperly focused on only the date on which the motion was filed, rather than the other *Pioneer* factors, so the BAP remanded for it to assess the other factors.

Summary:

The United States Bankruptcy Court for the Western District of Kentucky entered a judgment against Debtor finding the debt against him non-dischargeable. Debtor failed to file a timely notice of appeal within the 14-day period pursuant to Federal Rule of Bankruptcy Procedure 8002(a). However, Debtor filed a motion for extension of time to file a notice of appeal pursuant to Rule 8002(d)(1)(B), which allows a motion to be filed within 21 days after the deadline for filing a notice of appeal expires.

The bankruptcy court held a hearing and issued an order denying Debtor's motion. The court cited to the non-exclusive factors to be weighed in *Pioneer* and noted that "'the excuse given for the later filing must have the greatest import.'" *Id.* at *3. The court held that waiting an

additional three weeks before notifying the court of Debtor's request does not constitute as "excusable neglect" and therefore denied Debtor's motion. Debtor appealed.

The BAP cited to the Supreme Court's decision in *Pioneer* and listed out the factors to be weighed in determination of a party's excusable neglect:

> The danger of prejudice [to the opposing party], the length of the delay and its potential impact on judicial proceedings, the reason for the delay, including whether it was within the reasonable control of the movant, and whether the movant acted in good faith.

Pioneer, 507 U.S. at 395. The Panel vacated the order and remanded for further proceedings. The Panel held the bankruptcy court misapplied the law because it rested its entire decision on the number of days Debtor waited before filing the motion to extend time to appeal, without examining the remaining *Pioneer* factors. *Id.* at *5. All factors must be examined when determining whether a party's conduct constitutes "excusable neglect".

K. Attorneys

Bingham Greenebaum Doll, LLP v. Glenview Health Care Facility, Inc. (In re Glenview Health Care Facility, Inc.), 620 B.R. 582 (B.A.P. 6th Cir. 2020) (Attorney Employment)

Key Takeaway:

When the Bankruptcy Court declined to approve the employment of Committee counsel because the firm had previously represented a shareholder of the Debtor on estate planning matters, the Sixth Circuit BAP reversed because 11 U.S.C. § 1103 has no "disinterested person" requirement (although 327(a) has it for payment of professionals), and the Kentucky Rules of Professional Conduct also would not permit disqualification here.

Summary:

Glenview Health Care Facility, Inc. ("Debtor") filed a voluntary Chapter 11 bankruptcy petition and the Official Committee of Creditors Holding Unsecured Claims was formed. The Committee filed an application to employ Dentons Bingham Greenebaum, LLP ("DBG") which included a declaration disclosing any potential conflicts, detailing DBG's prior representation of a fifty-percent shareholder of the Debtor, in an estate planning matter. The Declaration also highlighted screening measures where counsel who represented the insider would not be representing the Committee on this matter. Debtor objected to DBG's employment asserting that DBG was more involved with Debtor and the shareholder, and asking the bankruptcy court to deny the Committee's application to employ DBG and disqualify them for the prior representation, which it did.

On appeal, DBG contended that the bankruptcy court abused its discretion. The BAP for the Sixth Circuit vacated the bankruptcy court's order and remanded the matter for further proceedings for the reasons as set forth below.

The bankruptcy court cited § 1103 stating "a professional seeking appointment under § 327 bears the initial burden of proof that they meet all qualifications of the statute in order to obtain the appointment." *Id.* at 587. DBG asserted that it met the requirements set forth in § 1103 because they did not represent an adverse party while employed by the Committee, and prior representation has since concluded. Additionally, other courts have recognized "prior representations, even if adverse to the interests of the committee…do not disqualify committee counsel." *Id.* Notwithstanding that, a court can deny a committee professional's compensation at this point "if, at any time during such professional person's employment under section 1103 of this title, such professional person is not a disinterested party, or represents or holds an interest adverse to the interest of the estate," *Id.* DBG was not seeking compensation; they were seeking approval as counsel. Comparing the language in § 1103 with § 327, the Panel held that 11 U.S.C. § 1103, unlike § 327(a), does not have a "disinterested person" requirement written into the statute -- a prior but concluded representation should not be disqualifying. Thus, the bankruptcy court erred by conflating § 1103 with § 327 and misapplied the law, reflecting an abuse of discretion.

The Panel held the bankruptcy court, in withholding approval of DBG's employment, was also entitled to rely on Kentucky Rule of Professional Conduct 1.9 but reached the wrong conclusion under those rules. The BAP noted Sixth Circuit's three-part test for determining whether grounds for disqualification exist, articulated in *Dana Corp. v. Blue Cross & Blue Shield Mut. of N. Ohio*, 900 F.2d 882 (6th Circuit. 1990):

> (1) A past attorney-client relationship existed between the party seeking disqualification and the attorney it seeks to disqualify; (2) the subject matter off those relationships was/is substantially related; and (3) the attorney acquired confidential information from the party seeking disqualification.

Dana Corp. at 889.

The Panel assessed the factors and held the bankruptcy court's disqualification of DBG was an abuse of discretion. With regard to the first factor: prior relationship, the shareholder was not the party who sought disqualification, rather it was the Debtor, thus there was no prior relationship between the party who sought disqualification and the attorney it sought to disqualify. The second factor: subject matter, also fell short of the required showing for disqualification because the bankruptcy court based its argument on inference rather than evidence. The third factor: confidential information, was based on a potential, not actual, conflict which is not substantive enough grounds for disqualification.

DBG also contended that the bankruptcy court erred by failing to consider an exception to disqualification outlined under Kentucky Rule of Professional Conduct 1.10. "The bankruptcy court cited the 'rule of imputed disqualification' which charges all lawyers with the conflicts of

their colleagues within a firm," *Bingham* at 593, and ruled the screening procedures DBG placed on their attorneys, as stated in the Declaration, would not resolve any potential conflict. DBG asserted that the bankruptcy court failed to consider the exception, permitting the screening of otherwise disqualified lawyers.

LUNCH PRESENTATION

UPDATE FROM THE KENTUCKY DEPARTMENT OF FINANCIAL INSTITUTIONS

CHARLES A. VICE
Commissioner
Department of Financial Institutions
Frankfort, Kentucky

1

University of Kentucky College of Law

2021 Conference on Legal Issues for Financial Institutions

Kentucky Department of Financial Institutions

October 15, 2021

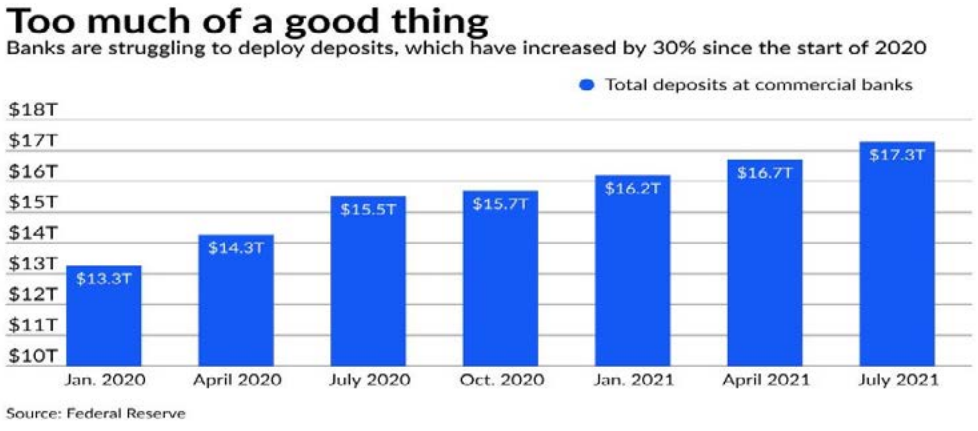
2

Discussion Topics

- Banking Trends
- Credit Union Trends
- Economic Changes
- Digital Assets

3

Increased Liquidity



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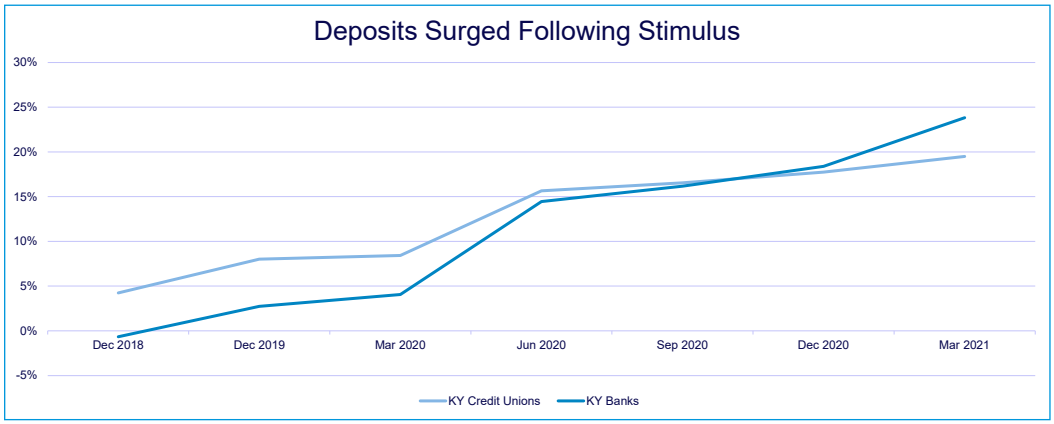
Deposit/Share Surge in Kentucky



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Kentucky Bank Performance

	12/31/2018	12/31/2019	12/31/2020	03/31/2021
# of Banks	120	114	109	108
# of Banks (< $100 million)	23	22	18	16
Total Assets (millions)	$51,867	$53,280	$61,359	$64,027
Total Loans (millions)	$37,160	$37,932	$41,324	$41,343

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Kentucky Bank Performance

NIM – Net Interest Margin
ROAA – Return on Average Assets
ROE – Return on Equity
CAP – Tier 1 Leverage Capital Ratio

03/31/2021	Employees	NIM	ROAA	ROE	CAP
National	714,364	2.91	1.41	13.31	9.36
Kentucky	11,295	3.48 #1	1.45 #3	13.44 #3	10.47 #1
Illinois	43,560	2.00	1.10	11.73	8.19
Indiana	12,508	3.22	1.56	14.39	9.82
Missouri	24,260	3.08	1.40	14.32	9.11
Ohio	10,112	3.32	1.34	10.97	10.02
Tennessee	23,250	3.04	1.34	12.18	9.16
Virginia	14,429	3.29	1.40	10.51	10.36
West Virginia	5,414	3.36	1.50	11.24	10.31

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Kentucky Credit Unions

	12/31/2018	12/31/2019	12/31/2020	03/31/2021
# of CU	22	22	22	20
# of CU (< $100 million)	14	14	14	12
Total Assets (millions)	$4,201	$4,534	$5,232	$5,505
Total Loans (millions)	$2,978	$3,175	$3,387	$3,370

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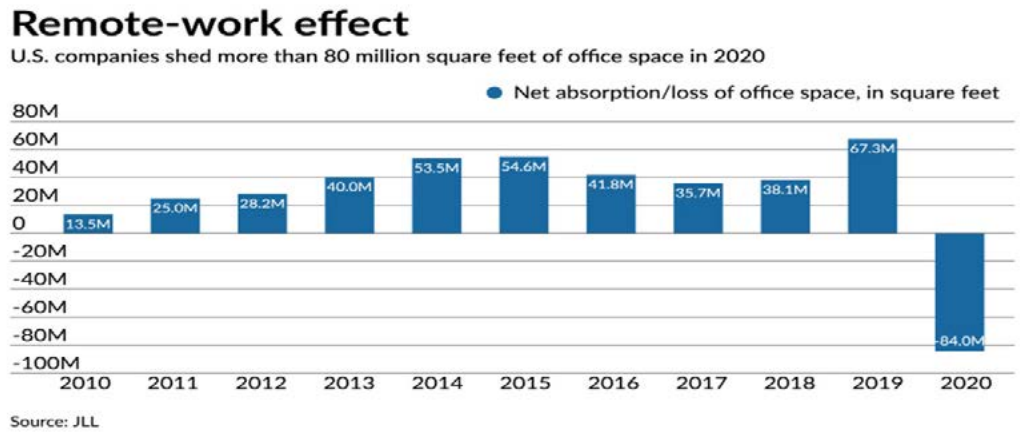
Kentucky Credit Union Performance

03/31/2021	Number of Credit Unions	Net Worth Ratio	Return on Average Assets	Net Interest Margin
National	1,901	9.86	1.03	2.48
Kentucky	20	10.87 #3	0.67 #7	2.61 #5
Illinois	161	9.55	1.44	2.67
Indiana	26	9.52	0.81	2.55
Missouri	94	9.18	0.93	2.45
Ohio	62	10.19	1.25	2.54
Tennessee	76	11.27	1.10	2.70
Virginia	24	9.67	0.68	2.69
West Virginia	3	13.93	0.62	2.94

9

Office Space Usage



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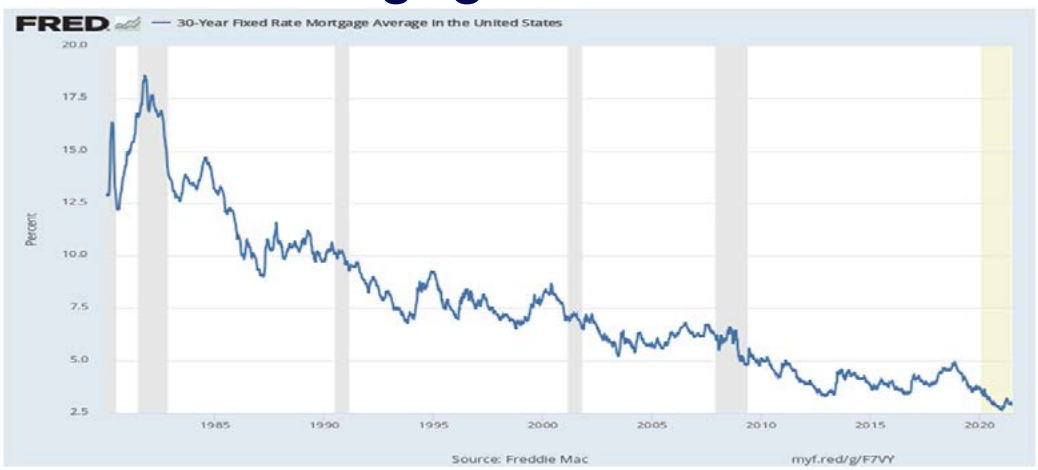
30- Year Mortgage Loan Rates



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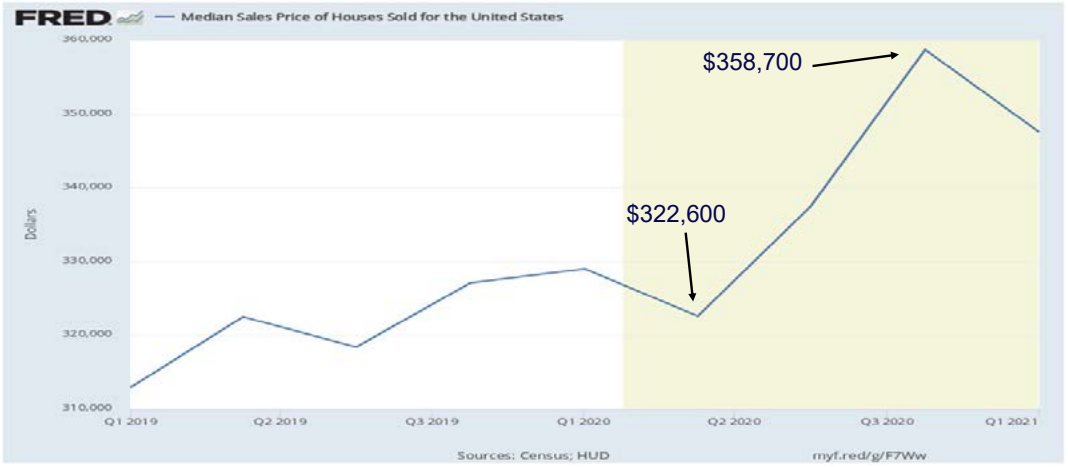
U.S. Median Home Price



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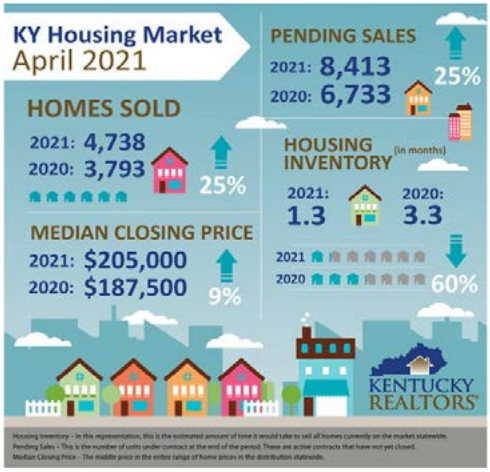
Housing Market



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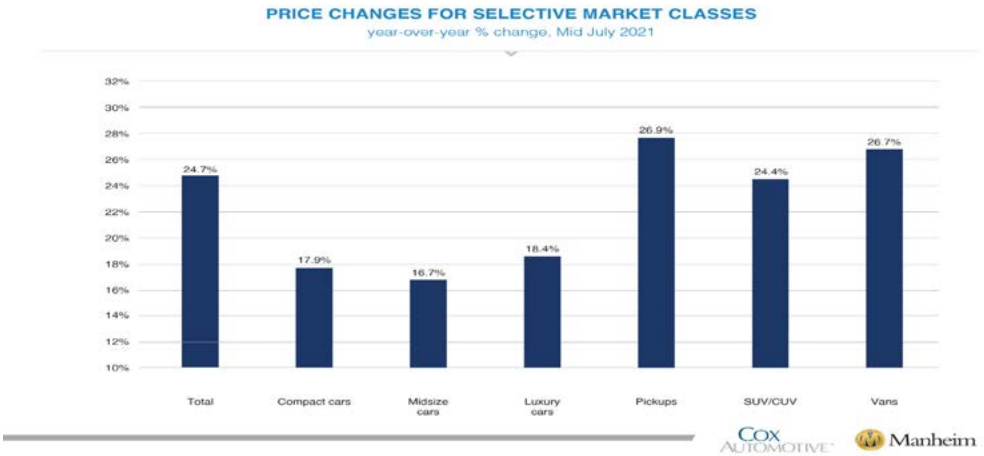
Used Car Values



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Digital Assets

The Hill 5/22/2021 – "Five Reasons Why Cryptocurrencies are Raising Alarm"

- Soaring and volatile prices
- New technology
- Growing pains for platforms
- Security concerns
- More money means more taxes

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Banking Digital Assets

05/10/2021 – *American Banker* article by Penny Crosman

- Banks are helping customers buy, sell and hold Bitcoin
- Access information via mobile banking apps
- Bitcoin rewards debit card
- Cardholders can purchase and redeem Bitcoin at 19 ATMs
- JPMorgan Chase will offer an actively managed Bitcoin fund
- Morgan Stanley has created a cryptocurrency trading desk
- Banks offering digital asset custody to institutional investors

16

Special Purpose Depository Institutions

- Wyoming 2019
- Nebraska – Legislature passed 05/21/2021
- Bills filed in Kentucky during the 2020 Legislative Session
  - SB 177
  - SB 178

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PPC Public Protection Cabinet TEAM KENTUCKY

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18

SECTION E

ETHICAL CONSIDERATIONS DURING AN ECONOMIC DOWNTURN

MARTIN B. TUCKER
Dinsmore & Shohl LLP
Lexington, Kentucky


Dinsmore
Ethical Considerations During an Economic Downturn

1


Dinsmore
Marty Tucker, Partner
Co-Chair,
Business Restructuring Group
Dinsmore & Shohl LLP
2

2

Outlook for 2022 and Beyond

- **The end of relief measures (e.g. PPP, EIDL)**
- **Waning of deferrals and forbearances**
- **Sunsetting of moratoriums (external and internal)**
- **Industries not negatively affected (or benefitting) by COVID-19**
- **Continuation of the pandemic**

3

Outlook for 2022 and Beyond, cont.

- **Mirror image of 2008+?**
  - **Residential foreclosures**
  - **Commercial foreclosures**
  - **Workouts and restructurings**
  - **Bankruptcies**
    - Chapter 7 liquidations
    - Subchapter V for small businesses

4

Impact on outside (and inside) counsel

- **Specialization in areas of lender representations**
  - **To some extent prior to 2008**
    - Bankruptcy specialists
    - All others
  - **2008-2012(ish)**
    - Still bankruptcy specialists but retooling
    - More "cradle to grave"
    - Experienced young lawyers

5 >

5

Impact on outside (and inside) counsel, cont.

- **Where have all the bank lawyers gone?**
  - **Since 2012(ish)**
    - Economy improved…work declined
    - Especially in the bankruptcy arena
      - Lack of broad experience "in the code"
    - Growth of KY bank in-house legal departments
      - In house lawyers somewhat "out of practice"
      - Outside lawyers limited in terms of numbers or broad experience

6 >

6

Overall concerns…

Who will help lead lending institutions through the inevitable economic downturn?

How will those people guide and assist?

What ethical concerns should those lawyers have in representing lending institutions?

7 >

7

Ethics Tips, Tricks and Issues

- **Identify ethical concerns and considerations?**
  - **Competence**
  - **Confidentiality**
  - **Conflicts of Interest**
  - **Identifying your client**
  - **Duty to (Former) Clients**
  - **Unauthorized practice of law**
  - **Considerations for Waivers of Conflicts of Interest**

8 >

8

Competence

- **As a lending institution lawyer, should I really be doing this?**
  - **Foreclosures (consumer / commercial)**
  - **Bankruptcies (Chapter 7; Chapter 13; Chapter 11; Chapter 12)**
  - **Lending**
  - **Dealing in certain specialized types of collateral**
  - **Complex real estate transactions**
  - **Mergers and acquisitions**
  - **Out of state borrowers/collateral**

9

Competence, cont.

- **Ky. SCR 3.130(1.1)**
  - **Rule 1.1. Competence: A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.**
  - **Are you sufficiently competent to handle the particular engagement?**

10

Competence, cont.

- **In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include**
  - **the relative complexity and specialized nature of the matter,**
  - **the lawyer's general experience,**
  - **the lawyer's training and experience in the field in question,**
  - **the preparation and study the lawyer is able to give the matter and**
  - **whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question.**

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Competence, cont.

- **In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances. (Ky. SCR Rule 1.1, Comment 1).**
- **Competent representation can also be provided through the association of a lawyer of established competence in the field in question. (Ky. SCR Rule 1.1, Comment 2)**
- **To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject. (Ky. SCR Rule 1.1, Comment 3).**

12

Conflicts of Interest

- **"It isn't a big deal as I am not really "adverse" to your bank client…"**
  - **In my experience, other lawyers (including lawyers representing lending institutions) don't see conflicts of interest**
  - **Their knowledge of banks and banking they assume the banks will not mind**
  - **Don't believe they will be taking action adverse to the bank**
  - **Clearing conflicts is a pain**

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Conflicts of Interest, cont.

- **SCR 3.130(1.7) Current Clients:**

– **(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:**
– **(1) the representation of one client will be directly adverse to another client; or**
– **(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.**
– **(b) Notwithstanding paragraph (a), a lawyer may represent a client if:**
– (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
– (2) the representation is not prohibited by law;
– (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
– **(4) each affected client gives informed consent, confirmed in writing. The consultation shall include an explanation of the implications of the common representation and the advantages and risks involved.**

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Conflicts of Interest, cont.

- **SCR 3.130(1.8) Specific Rules to Current Clients:**

– **(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:**
– **(1) the client gives informed consent;**
– **(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and**
– **(3) information relating to representation of a client is protected as required by Rule 1.6.**

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Conflicts of Interest, cont.

- **Subpoenas**
- **Foreclosures**
- **"Race to Judgment"**
- **Scarce resources**
- **Bankruptcies**

16

Identifying your client

- **What to do when your bank client is wearing multiple "hats"**
  - **When a bank is acting as lender and trustee of a trust**
  - **Two completely different interests and sets of duties**
  - **May have two different sets of legal representatives**

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Identifying your client, cont.

- ***Saba v. Fifth Third Bank of N.W. Ohio*, N.A.**
  - **2002-Ohio-4658, ¶ 1 (Ct. App.)**
  - **Where bank is lender and trustee, an Ohio court ruled that there can be a potential conflict where a bank is both trustee for a trust and a lender to a beneficiary.**
  - **However, this conflict will only exist where the trustee engages in self-dealing or breach of good faith on the part of the trustee.**

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Identifying your client, cont.

- It should be noted, however, that where a conflict surfaces, and such conflict is one where information is needed from one side of business (say the lender) and it is crucial that the other side of business (say the trustee) prevent disclosure to the first party, that is an instance – while hard to imagine from a practical standpoint, could create an unwaivable conflict.
- ***See Conrad Chevrolet, Inc. v. Rood***, 862 S.W.2d 312 (Ky. 3 1993).

19

Duty to (former) clients

- **Is a bank still your client if you haven't don't work for them for some time?**
  - Smaller lending institutions
  - Community banks
  - Specialized practice

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Duty to (former) clients, cont.

- Ky. SCR 3.130(1.9): Rule 1.9. Duties to former clients.

– **(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.**
– **(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client:**
  - (1) whose interests are materially adverse to that person; and
  - (2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9 (c) that is material to the matter; unless the former client gives informed consent, confirmed in writing.

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Duty to (former) clients, cont.

- Ky. SCR 3.130(1.9): Rule 1.9. Duties to former clients.

– **(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:**
  - (1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or
  - (2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

22

Duty to (former) clients, cont.

- When is a client transition from current to former under the Rules of Professional Conduct?
    - Does that bank view you as their lawyer? Other lawyers utilized for similar instances?
    - Even if they haven't engaged you in some time, could the bank reasonably think you still represent them and/or have an obligation to them?
    - Have records been returned from the last engagement?
    - Business conflict v. ethical conflict: Are there considerations outside the rules you should consider? Could this new representation prevent future representations for current clients?
    - Did you formally disengage?
    - If litigation was initiated, have the proper motions been filed with the proper tribunals with proper notice to the client of your withdrawal?

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Duty to (former) clients, cont.

- Ethics Opinion KBA E-148
    - Question: May a lawyer, who has been employed by a bank in numerous matters over a long period of years but is not paid a retainer by the bank, accept employment adverse to the bank in litigation unrelated to any matter in which he was formerly employed by the bank?
        - Answer: Yes.
    - But…"Conceivably, there are circumstances in which frequent prior employment, recurring over a period of years, might give rise to a justifiable expectation by a client that the lawyer will not accept employment adverse to him. No such circumstances exist in this case. Banks commonly employ different law firms for different purposes."

24

Unauthorized practice of law

- **What can you do when your bank client crosses state lines?**
  - **Are you licensed in that state?**
  - **Do you have law partners involved in the case licensed in that state?**
  - **Local admission rules say "any state"**
  - **Does admission solve any UPL concerns?**
  - **Crossing lines can be actual or virtual**

25

Unauthorized practice of law, cont.

- ***In re Desilets,* 291 F.3d 925 (6th Cir. 2002)**
  - **the Sixth Circuit permitted an attorney to practice bankruptcy law in a state in which the attorney was not admitted by the state bar, yet was admitted to the appropriate federal district court.**
- **Unauthorized practice of law in KY and other states**
  - **Understand the other jurisdictions UPL rules to understand potential exposure**
  - **Formal admission, pro hac vice, local counsel, attorneys in other offices**
- **Competence**

26

Considerations for waivers of conflicts of interest

- ***When you should (and shouldn't) waive conflicts of interest***
  - **Positional conflicts of interest**
  - **"Don't you want really good lawyers on the other side?"**
  - **Special counsel considerations**
  - **Business conflicts**
  - **Reputational conflicts**
  - **Karma**

27

Questions?

Marty Tucker, Partner
Co-Chair,
Business Restructuring Group
Dinsmore & Shohl LLP

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SECTION F

PPP and SBA Issues for Banks

ELLEN M. SHARP
Fifth Third Bank
Lexington, Kentucky

JOHN RYAN
Stock Yards Bank & Trust Co.
Louisville, Kentucky

Materials not available at time of printing.

We will provide materials to you as soon as they are available.

SECTION G

THE NDDA AND THE BANK SECRECY ACT

NANCY PRESNELL
Frost Brown Todd LLC
Louisville, Kentucky

The NDDA and the Bank Secrecy Act

Nancy Presnell | October 15, 2021

1

The Anti-Money Laundering Act of 2020 ~ AML/BSA Program Changes

- This is REALLY big news and represents the most significant change in 20 years, since the USA Patriot Act was passed in 2001.
- The National Defense Authorization Act (NDAA) for Fiscal Year 2021 includes the Anti-Money Laundering Act of 2020 (the "AML Act") and the Corporate Transparency Act (CTA). Included within the AML Act and the CTA are a significant number of provisions related to Anti-Money Laundering (AML) and countering the financing of terrorism (CFT), including reforms to the Bank Secrecy Act (BSA). The AML Act was approved over Presidential Veto January 1, 2021.

2

#1 ~ The CTA and the new "Beneficial Ownership" Registry

- A new requirement has been imposed upon businesses, through the CTA.
  - CTA found at H.R. 6395, 116th Cong. § 6403 (2020); *https://www.congress.gov/bill/116th-congress/house-bill/6395*
- FinCEN is tasked with creating a new BENEFICIAL OWNERSHIP registry compiled from reported disclosures made to it by all non-exempt domestic and foreign companies.
- Background ~ Since May of 2018, the banking industry has been required, as directed by the BSA, to collect beneficial ownership information from all commercial account holders.
- The CTA shifts this duty of assembling the data away from the nation's financial institutions and to the companies themselves.

3

Beneficial Ownership Registry ~ cont.

- The new reporting regime begins on the effective date of the CTA's implementing regulations, which regulations must (may) be finalized before January 1, 2022.
- "Reporting Companies" in existence on that date will be required to report beneficial ownership information within two years. Companies created after the effective date are required to report that information upon formation. Thereafter, Reporting Companies must submit an annual filing containing a list of the beneficial owners and an update of any change in ownership or control.
- With the consent of a Reporting Company, financial institutions will be permitted to access this information for Customer Due Diligence (CDD) purposes.

4

Establishment of National Exam and Supervision Priorities

Risk Based Programs: CTA requires that within 180 days of enactment, the Treasury is to issue and make public Treasury priorities for AML and CFT policy. On 6/30/21 Treasury published its priorities: corruption; cybercrime; fraud; foreign and domestic terrorist financing; transnational criminal organization activity; drug trafficking organization activity; human trafficking and smuggling; and proliferation financing.

- Regulations will now be issued by FinCEN regarding the priorities.
- Financial institutions will be required to incorporate the priorities into their existing BSA Compliance Programs. Per the Act, FIs will be evaluated on the incorporation of the priorities established above into their risk- based program to meet BSA compliance.

Why do we care? No action need be taken upon the publication of the Treasury AML and CFT priorities. All FIs (subject to 31 C.F.R. § 1010.200) should prepare to incorporate the priorities into risk-based monitoring procedures upon the effective date of FinCEN's regulations. Evaluate the financial institution's current AML and CFT Board (or Board Committee) reporting and how to incorporate the effectiveness of the risk-based BSA Program in regard to the priorities

5

Application to Dealers in Antiquities

The BSA's Financial Institution's definition is amended to add - "a person engaged in the trade of antiquities, including an advisor, consultant, or any other person who engages a s business in the solicitation or the sale of antiquities, subject to regulations prescribed by the Secretary."

See 31 U.S.C. 5312(a)(2)(Y) under Section 6110(a)(1)(B) of the AML Act.

- Treasury is to issue regulations not later than 360 days of the enactment of the Act, proposed rules regarding the inclusion of dealers in antiquities as a financial institution under the BSA.
- Regulations will be effective as of the date the final rules are issued.

Why do we care? Whether a customer is a dealer in antiquities is already part of most FI's CDD and EDD protocol under existing BSA Compliance Programs. On March 9, 2021, FinCEN Notice 2021-NTC2 issued specific Suspicious Activity Reporting requirements regarding those transactions related to a dealer in antiquities. When regulations are issued implementing BSA regulations of a financial institution for a dealer in antiquity, BSA Programs must be updated to reflect non-bank financial institution procedures and their applicability to dealers in antiquity, such as the monitoring of FinCEN registrations.

6

Strengthening FinCEN

Section 5312 of the BSA, Definitions and Applications, has been amended so that the definition of Financial Institution includes "a business engaged in the exchange of currency, funds, or value that substitutes for currency or funds."

- Also, Monetary Instrument definition has been revised to include value that substitutes for currency.
- "Currency" definition has expanded from the currency of any country to the "currency, funds or value that substitutes for currency."

Why do we care? Digital assets have fallen within the scope of the AML laws for years, but the changes to the Act codify this.
While most of our bank's clients presumptively are not currently dealing with cryptocurrency related-businesses, we're all aware of the expanding breadth of blockchain functionality within the economy. Keep this statutory change in mind … because the day is coming.

7

Financial Services De-Risking

- Address the impacts of financial institution de-risking that results in financial exclusion for non-profits providing international humanitarian relief, or those attempts to send remittances overseas.
- Requires Treasury to deliver a report on the causes and effects of de-risking, so that ultimately a strategy to reduce de-risking and adverse consequences related to de-risking.

Why do we care? Per the BSA Regulatory Examination Manual, charitable organizations are of high risk for money laundering and terrorist financing activities. Regulatory expectations are high regarding monitoring of accounts of a charitable organization. It is likely that how we monitor the charitable organization's accounts will evolve and may require more complex procedures?

8

Modernization of the AML

CTA requires Treasury and bank regulatory agencies (amongst other interested parties) to cooperate in submitting reports to Congress regarding the effectiveness of data derived from financial institution reporting under the BSA.

- Language is included regarding establishing a streamlined process to file noncomplex categories of suspicious activity reports, including those reports for structured transactions or continuous activity.
- There also will be CTR and SAR threshold review.

~ The Act requires the coordinated review(s) to be completed within one year of the CTA's enactment respecting the potential adjustments to the CTR and SAR thresholds. *Why do we care? Possible some good for financial institutions will result with modernization of the AML.*

Will we see the thresholds raised for required currency transaction reporting or suspicious activity reporting; thresholds that have been in place since implementation of the BSA.

9

"I'm going to make him an offer he can't refuse" a/k/a Crime Families and Check Cashing Businesses: What Could Possibly Go Wrong?

Capital One, N.A. - ASSESSMENT OF CIVIL MONEY PENALTY

January 15, 2021 - FinCEN and Capital One announced a settlement requiring the payment of $390 million in civil monetary penalties for willful and negligent violations of the anti-money laundering provisions of the Bank Secrecy Act (BSA).

Capital One admitted to failing to implement an effective anti-money laundering program in connection with a customer, the Check Cashing Group, which had between 90 to 150 check cashing locations in New York and New Jersey. The Assessment records a failure to file, during 2008 through 2014, both required suspicious activity reports (SARs) [31 U.S.C.§ 5318(g); 31 C.F.R. § 1020.320; 12 C.F.R. § 21.11] and currency transaction reports (CTRs) [31 U.S.C.§ 5313; 31 C.F.R. § 1010.311].

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The Assessment records, "*Capital One was aware of . . . warnings by regulators, criminal charges against some of the customers, and internal assessments that ranked most of the customers in the top 100 of the bank's highest risk customers for money laundering*." Accordingly, FinCEN perceived that an effective program for evaluating and filing SARs had not existed. Capital One also acknowledged negligently failing to file CTRs for "*approximately 50,000 reportable cash transactions representing over $16 billion in cash handled by its Check Cashing Group customers*." Further, because of the Check Cashing Group's associations with suspected criminal at several of its locations, this check cashing customer, which by the general nature of its business type was *per se* a listed inherently "*high-risk business unit*", required heightened scrutiny of its transactional operations.

The Assessment suggests that the assessed penalty is warranted because the violations "*resulted in the failure to accurately and timely report millions of dollars in suspicious transactions, including proceeds connected to organized crime, tax evasion, fraud and other financial crimes laundered through the Bank into the U.S. financial system*." The Assessment suggests that the penalty would have been much steeper but for Capital One's "extensive remediation and cooperation."

For all financial institutions, this Assessment signals that BSA compliance will be an increased regulatory priority and that serious penalties can be, and will be, assessed for perceived willful violations.

11

Questions?

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SECTION H

COMMERCIAL REAL ESTATE ISSUES FOR BANK COUNSEL

EMILY H. COWLES
Wyatt Tarrant & Combs LLP
Lexington, Kentucky

JOSEPH McBRIDE, CFA
Trepp LLC
New York, New York

COMMERCIAL REAL ESTATE
TRENDS IN A WORLD OF THE COVID-19 PANDEMIC

Emily H. Cowles
Wyatt, Tarrant & Combs, LLP

* * * * * *

Like the rest of our country and the world, the COVID-19 pandemic has greatly impacted commercial real estate (CRE) in Kentucky. In the early stages of the pandemic, direct impacts could be seen in the demand for space through quarantines, social distancing, shutdowns, supply chain disruptions, employment loss and devastating consumer confidence. Whether we are still in or coming out of the pandemic, words such as "recovery" and "correction" are commonly used in describing current trends or when forecasting the future of commercial real estate. Those of us that work under the big umbrella of the CRE market actually expect dips or for it to bottom-out, while knowing that it will correct and rise once again. Plainly, we are used to the ebbs and flows of the CRE market, but in comparison to the larger economy in this world of COVID-19, it appears thus far that the real estate market might have averted a complete disaster as we enter Q4 2021.

Low interest rates, excess capital and 1031 Exchange funds, and robust investors that are willing to take risk are driving real estate markets to pre-pandemic levels. By Q2 of 2020, most experts predicted the pandemic would trigger a reset or correction, but instead, many indicators show that a correction never arrived. That is not to say, however, that demand and positive growth is evenly spread across all segments. Multifamily, industrial, office, retail and hospitality are all moving at different speeds and each appear to face unique challenges.

Those pockets of the CRE market in Kentucky most negatively affected include tenant demand decreases in malls and office buildings, as e-commerce and working remotely increases. The online employment site Indeed has a section dedicated to remote jobs, and as of September 2021, it included more than 250 listings for work-from-home employment in the Lexington area. In February 2021, Indeed showed nearly 7% of job postings were remote compared to 2.9% in January 2020. Still, many local experts share the sentiment that working from home in Kentucky will not have as great of impact in Louisville or Lexington commercial spaces, as it will in the major cities such as New York, Los Angeles or Chicago.

According to Cushman & Wakefield,[1] although 5.3 million square feet of industrial space opened in Louisville last year and another 3.4 million square feet was under construction, the "low vacancy rate shows the need for the new construction as more supply is needed to keep up with the high demand in the market." By the end of Q1 2021, Cushman & Wakefield reported in the multifamily sector of Louisville Metro area 3,624 units completed over the last 12 months (which is 1,044 more than shown in Q3 2020), and 1,997 units currently under construction.

For Q2 2021, Cushman & Wakefield reports that multifamily occupancy rates in Lexington are sitting at 94.9%, which is down 100 bps from Q4 2020, and average rents are expected to climb 1.5% to a level of $878 by Q4 2021, and at a rate of 2.8% through 2023. Average rents for 1 bedroom apartments in Lexington are at $764.00 per month, and 2 bedroom apartments are at $922.00 per month, which presents an increase by 2.7% up from $842.00 compare to Q2 2020.

The industrial market in Louisville continues to grow as evidence by the 2.2. million square feet of leasing activity reported by Cushman & Wakefield by the end of Q2 2021. According to the Bureau of Labor Statistics, manufacturing jobs have increased from 82,100 to 82,500 during

[1] Cushman & Wakefield is a global real estate services firm with 400 offices, including Commercial Kentucky, Inc. founded in 1973, which covers office, industrial, multifamily, and retail and investments services.

the second quarter while trade and transportation jobs increased from 151,800 to 153,900. Amazon announced they would be adding nearly 2,000 jobs in the Louisville area. The industrial market in Louisville also reports 282,475 square feet of new construction, and with 6.4 million square feet under construction in the current Louisville market. Cushman & Wakefield reports that "bulk overall net absorption was positive 1.6 million square feet for the quarter as absorption continues to outpace construction completions. YTD overall net absorption is up to positive 3.4 msf, which is 2.6 msf more than what was recorded after the first two quarters of 2020."[2]

Office leasing activity in the Louisville Central Business District (CBD) remained slow during Q2 2021, and marked the 4th straight quarter CBD leasing activity was less than 10,000 square feet. Cushman & Wakefield reports the average asking rents decreased in the CBD market from $16.72 per square foot to $16.65 per square foot in the second quarter; whereas, in the suburban office market, the overall asking rent decreased from $20.20 per square foot to $19.84 per square foot. In Lexington, the Kentucky Commercial Real Estate Alliance reports an overall average asking office rent of $18.29 per square foot.

According to the Kentucky Department of Financial Institutions (DFI) 2020 annual report[3] released in July 2021, banks, credit unions and other lenders delivered economic relied through the federal Paycheck Protection Program (PPP), with approximately 50,655 PPP loans totaling nearly $5.3 billion approved in Kentucky. The banking and credit union industries reported asset growth in 2020, and liquidity, profitability, and capital ratios remained strong. For example, assets held by Kentucky banks increased 15% last year, fueled largely by economic stimulus funds in

[2] Net absorption is the sum of square feet that became physically occupied, minus the sum of square feet that became physically vacant during a specific period (usually a quarter or year).
[3] https://kfi.ky.gov/Documents/KDFI2020AnnualReportWeb.pdf

insured deposit accounts. Individual banks' assets ranged from $21.7 million to nearly $6.2 billion. Collectively, Kentucky banks had almost $61.4 billion in assets.

Collections and foreclosure activity in Kentucky has increased in 2021 since the eviction moratoriums rescinded. Specifically, the US Department of Housing and Urban Development (HUD) moratorium on all evictions of tenants living in properties secured with single-family mortgages insured by the Federal Housing Administration (FHA) expired on September 30, 2021 (as previously extended by HUD Mortgagee Letter 2021-19), as well as the Federal Housing Finance Agency (FHFA)'s moratorium on all evictions of tenants in single-family properties acquired by Fannie Mae or Freddie Mac through foreclosure and deed-in-lieu of foreclosure transactions expired September 30, 2021. The FHFA also announced that tenants of multifamily properties with mortgages backed by Fannie Mae and Freddie Mac that are subject to eviction for nonpayment of rent must be given 30 days' notice to vacate before the tenant can be required to leave the premises.

Interestingly, the Centers for Disease Control and Prevention (CDC) and Department of Health and Human Services (HHS) ordered a temporary ban on residential evictions through December 31, 2020, which moratorium was extended through March 31, 2021 by the CDC as requested by President Biden, and then again extended by further order through July 31, 2021. On August 4, 2021, after the prior moratorium expired the CDC issued a new order temporarily halting evictions in counties with heightened levels of community transmission.[4]

In Kentucky, the Kentucky Supreme Court issued Order 2020-08 postponing most eviction matters, and then issued Order 2020-28 extending expiration of the previous order to August 28, 2020. The Court later issued Order 2020-44 clarifying the eviction moratorium to be in accordance

[4] *See* Legal Update, COVID-19: CDC Issues New, Tailored Residential Eviction Moratorium, and COVID-19: Supreme Court Strikes Down CDC Residential Eviction Moratorium.

with Governor's orders and the federal CARES Act restriction, and then issued Order 2020-64 allowing all residential and commercial eviction actions to proceed subject to complying with the CARES Act for residential evictions.

What follows are the most current statistics and predictions for CRE in the Lexington market, but primarily in the Louisville market. By July 2021, Louisville was named one of the top cities for renters by WalletHub, and according to the Kentucky League of Cities, remains one of the fastest growing cities in Kentucky.

Market Summary – September, 2021

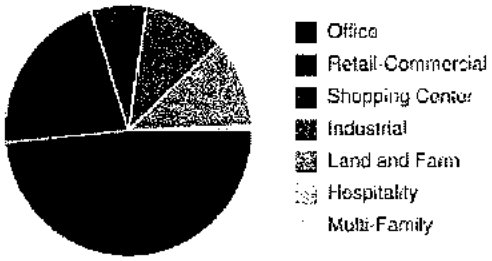
Lexington, KY

768,315 SF
Commercial Space For Sale

1.8 million SF
Commercial Space For Lease

697 Acres
Land & Farm For Sale

$155.9 million
Total Sale Price



Current Statistics for Lexington, KY

Property Type	Listings	Asking Lease Rate	Asking Sale Price	Below List	Days on Market	Total Available
Industrial	53	$6.95 PSF	$94.07 PSF	-	-	893,866 SF
Office	243	$18.29 PSF	$108.45 PSF	-	-	1.1 million SF
Retail-Commercial	108	$18.19 PSF	$175.73 PSF	12.3%	654	318,408 SF
Shopping Center	37	$17.22 PSF	$203.83 PSF	-	366	129,863 SF
Vacant Land	57	$2.44 PSF	$2.05 PSF	16.3%	869	30.8 million SF
Multi-Family	3	-	$141.17 PSF	-	95	101,080 SF

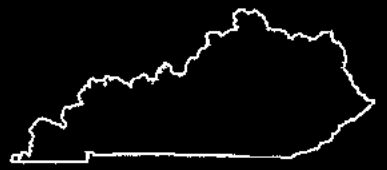
- **Frequency**: Statistics are compiled at the beginning of each month.
- **Reliability**: The quality of the data will vary based on many factors, including whether or not your CIE verifies the data on an ongoing basis. Statistics based on larger numbers of listings (as indicated by the "Listings" column) are generally more trustworthy.
- **Accuracy**: We make all attempts to normalize these stats, but make no guarantees about their accuracy. Outliers (extremely high or low values) are excluded from calculations.
- **Counts**: Listing and Transaction counts reflect the number of records with price and size information within valid ranges. The actual counts of all records in the CIE are larger.
- **Weighted Averages**: Price averages are weighed using the square footage available.
- **Direct**: Lease statistics are direct (exclude subleases).
- **Lease Types**: Because of discrepancies in how lease types (NNN, Gross, etc) are reported, we ignore differences in type – all types are folded together into the lease rate stats.
- **Below List**: Reflects the average percent difference between the original listed price and the final transaction price.
- **Net Absorption**: We calculate absorption using a 90 day period.
- **Locations**: We only allow filters for locations with at least 100 active listings.
- **Asking vs. Reported**: "Asking" prices are based on active listings for the chosen locale, while "Reported" prices are calculated using completed transactions as reported by CIE members.

Statistics courtesy of:
Kentucky Commercial Real Estate Alliance

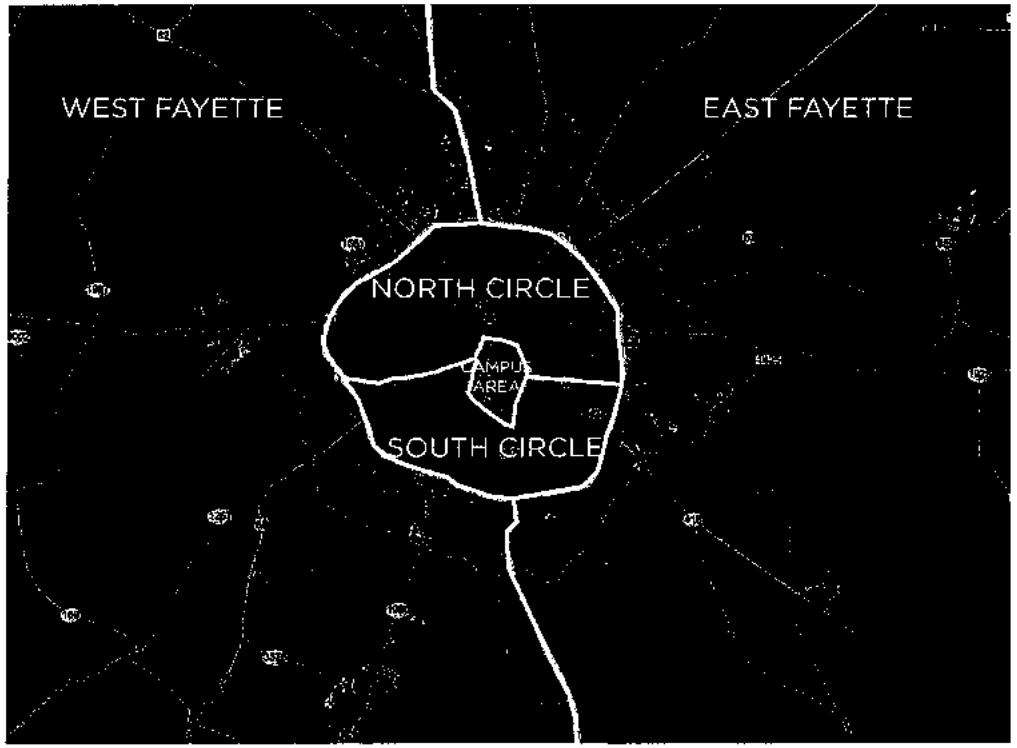
CUSHMAN & WAKEFIELD | COMMERCIAL KENTUCKY LOUISVILLE MULTIFAMILY RESEARCH

MARKET INSIGHT

LEXINGTON, KENTUCKY MULTIFAMILY REPORT | SECOND QUARTER 2021



The Cushman & Wakefield | Commercial Kentucky Multifamily Research Team provides in-depth coverage of the Lexington Metropolitan Statistical Area. In addition to analyzing multifamily rent and sale trends, these reports examine employment data, key economic announcements, and development pipeline news.



IN THIS EDITION

RESEARCH & SALES TEAM

CRAIG COLLINS
SENIOR DIRECTOR
ccollins@commercialkentucky.com

MIKE KEMETHER
EXECUTIVE VICE CHAIR, MULTIFAMILY ADVISORY GROUP
mike.kemether@cushwake.com

AUSTIN ENGLISH, MBA
ASSOCIATE
aenglish@commercialkentucky.com

CUSHMAN & WAKEFIELD
Commercial Kentucky

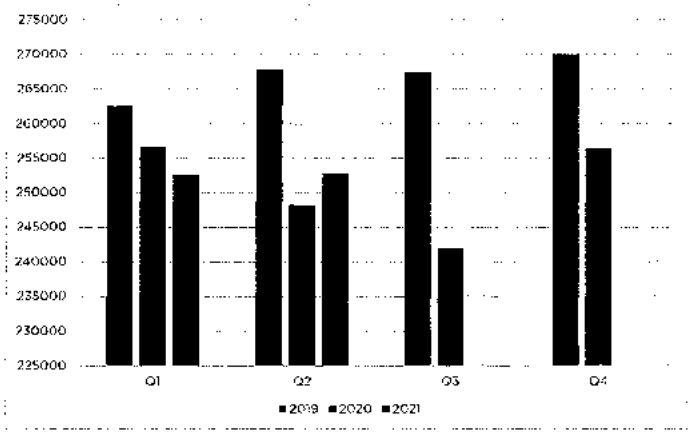
LEXINGTON METRO AREA

EMPLOYMENT & UNEMPLOYMENT TRENDS

As of the end of June 2021, unemployment rates in the Lexington area were 4.5%, which is down from 5.0% from December 2020. While the impact of COVID-19 is unmistakable, Lexington's unemployment rate is significantly lower than the national average, which was 5.9% for the same period.

LEXINGTON JOB GROWTH TRENDS

EMPLOYMENT IN THOUSANDS



Source: Bureau of Labor Statistics

JOB GROWTH & UNEMPLOYMENT RATE

0.26

% YOY

Average Q2 **employment** increased by 671 jobs.

70

BPS YOY

Average Q2 **unemployment** decreased to 4.5%.

LEXINGTON ACCOLADES

2021 Rankings for Lexington include:

#3 U.S. City for Best Work-Life Balance

#14 Most Livable Big Cities in America

#3 Safest City in America

#2 Top 14 Walkable Cities in the U.S.

ECONOMIC EXPANSION

The following are select announcements from fourth quarter 2020:

- ✔ E-commerce giant, **Amazon**, will expand their fullfilment processing center in Lexington. Construction has started on the 143,000 sf facility will open later this year. Amazon expects to hire up to 500 part-time, seasonal and full-time employees.
- ✔ Dixie to Go/PerfectTouch cup manufacturing company, **Georgia-Pacific**, to expand manufacturing capacity at Lexington facility. This will create about 50 jobs in the Lexington area.

	Q2 2020	Q4 2020	Q2 2021
MSA EMPLOYMENT (% Change)	1.2%	0.8%	0.26%
MSA UNEMPLOYMENT RATE (%)	4.2%	5.0%	4.5%

Source: Bureau of Labor Statistics

MULTIFAMILY TRENDS

Occupancy rates are currently sitting at 94.9%, which is down 100 bps from Q4 2020.

Between now and years end, no additional construction completions are expected in the Lexington metro area. Average rents are expected to climb 1.5% to a level of $878 by Q4 2021. Additionally, average rents are anticipated to rise at a rate of 2.8% through 2023, reaching average rates of $927 and $885 per unit, respectively for that same time period.

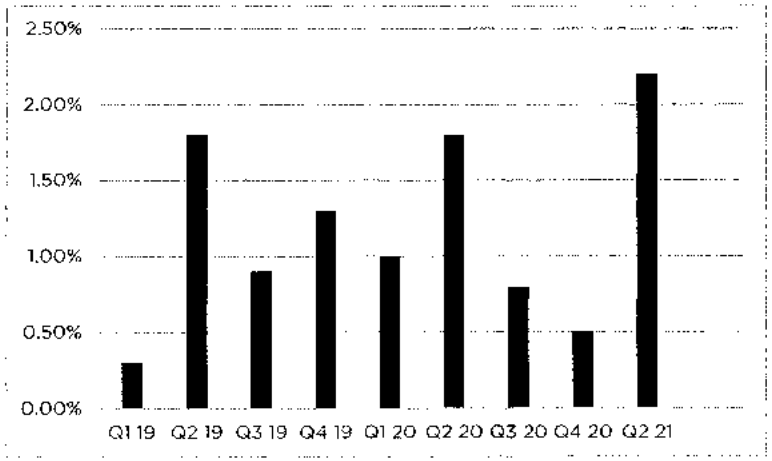
94.9%
Average Occupancy
decrease of 0.7% from 6/2020

3.2% and 3.04%
Respective Average Rental Rate
for 1 and 2 BR units from 6/2020

HISTORICAL METRO RENT GROWTH RATES

Average rents for 1 BR units are at $764/mo. with average rents for 2 BR units at $922/mo. Average rents have increased by 2.7%, up from $842 compared to Q2 2020.

LEXINGTON RENT GROWTH RATES



Source: PEIS

DEVELOPMENT / INVENTORY

929 units were completed in the last 12 months in the Lexington area. An additional 2,737 units are planned throughout the Metro Lexington area.

A recent Fayette County Housing Demand study forecasts household growth to yield an overall demand of 22,780 new housing units by 2025 - at least 6,275 of them multifamily.

DEMOGRAPHIC FUNDAMENTALS

The Lexington Metro population is projected to grow by 21% between 2015 and 2040.

POPULATION	2000: 408,469 2010: 472,099 2018: 512,516 2023: 545,588
PERCENT RENTER HOUSEHOLDS	2000: 37.5% 2010: 39.7% 2018: 41.1% 2023: 40.8%
MEDIAN HOUSEHOLD INCOME	2000: $40,642 2010: $47,432 2018: $55,150 2023: $65,262

MULTIFAMILY FORECAST

The following are Cushman & Wakefield's projections over the near term:

RENTS ↑ **VACANCY** ↑ **PIPELINE % GROWTH** ↓

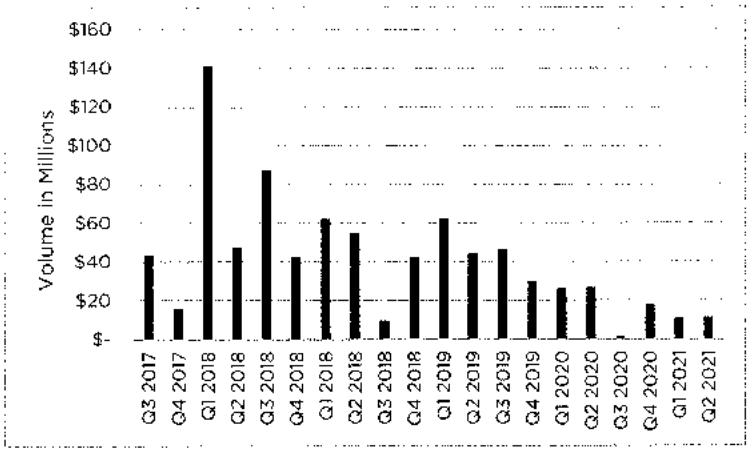
Forecast is 12-month outlook

INVESTMENT ACTIVITY

Multifamily investment activity as of Q2 2021 in the Lexington MSA is on the rise, already having doubled the amount of investment activity this time last year. The overall number of transactions is currently at 6, whereas year end transactions for 2020 totaled 10. The overall sales volume has significantly increased compared to this time last year.

No additional competitive apartment stock is expected to be introduced to the Lexington MSA this year. Between 2022 and 2023, developers are expected to deliver a total of 212 units.

HISTORICAL SALES VOLUME



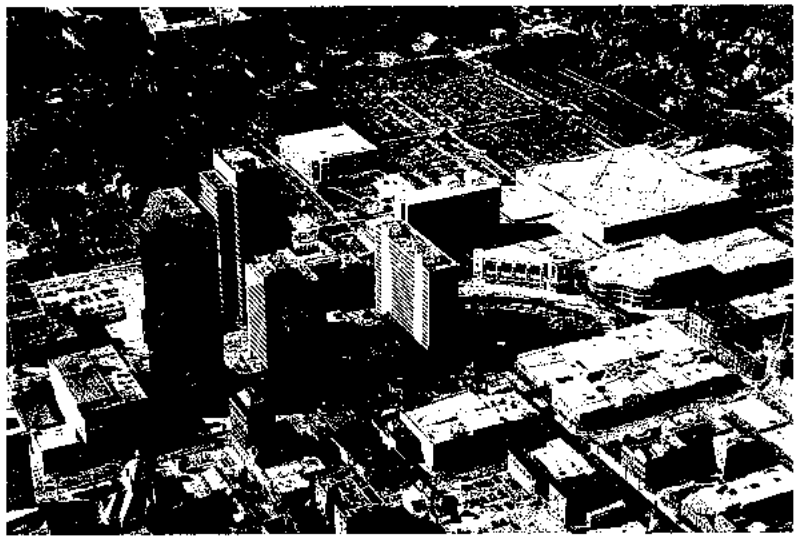
Source: Real Capital Analytics, Cushman & Wakefield | Commercial Kentucky Research

NOTABLE SALES

Class A – Veridian of Lexington (396 units) located in the West Fayette submarket was acquired by Brookside Properties for $106K per unit from Priderock Capital.

Class C – Ashland Apartment Group, LLC sold **Ashland Apartments** (84 units) located in the West Fayette Submarket to Vision & Beyond Capital Investments for $55.7K per unit.

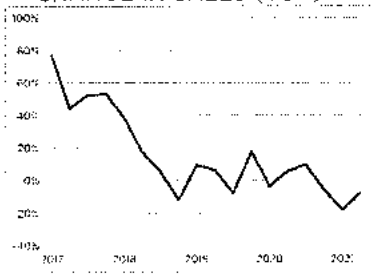
Class C – Cambridge Park Apartments LLC sold **Cambridge Park Apartments** (120 units) located in the West Fayette submarket to Vision & Beyond Capital Investments for $54.7K per unit.



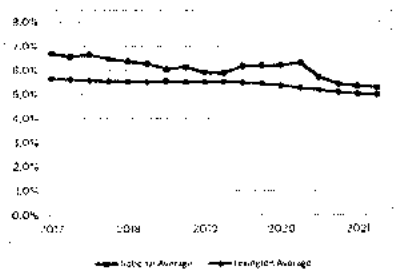
PRICING & CAP RATES

The market's mid-quartile spread is 5.0% to 5.3% while sales volume is on the rise.

CHANGE IN SALES (YOY)



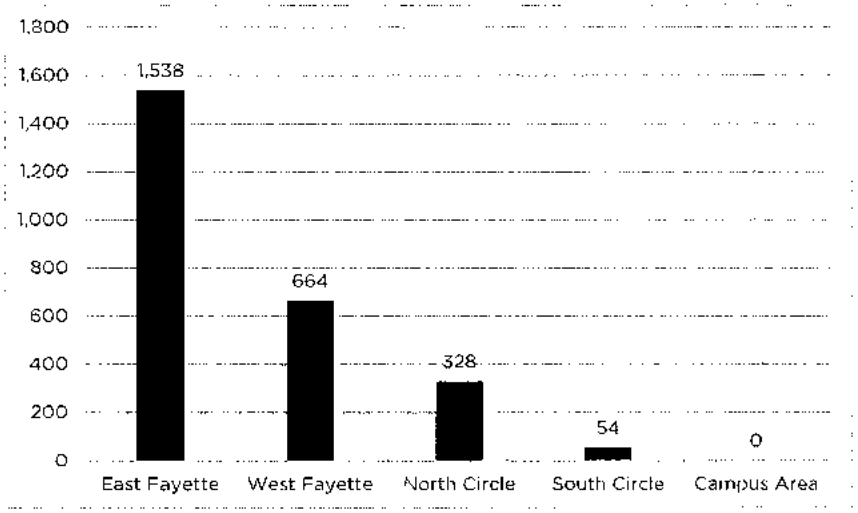
AVERAGE CAP RATE



Source: Real Capital Analytics, Cushman & Wakefield | Commercial Kentucky Research

SUBMARKET OVERVIEW

UNITS PLANNED BY SUBMARKET



Source: Cushman & Wakefield | Commercial Kentucky Research

SELECT MSA NEWS

- Indianapolis-based **Cityscape Residential** has closed a $135 million deal on three new multifamily developments in Indiana, Kentucky and Kansas.

- In Lexington, KY., **Cityscape** will debut **FIFTEEN51**, a residential village development on the University of Kentucky's Coldstream Research Campus. The development will provide 260 multifamily residential units and create a dynamic "live-work-play-learn" environment for the UK Community.

- **Lauth Communities**, a subsidiary of Carmel, Indiana-based Lauth Group, Inc. has acquired three multifamily properties located in Bowling Green and Lexington. The three properties, known as **The Drake** (Bowling Green), **The Stables at Waveland Farm and The Woods at 1850** (Lexington), will add 360 additional units to Lauth's portfolio. The Lexington properties will be rebranded as the Stables at Palomar and Stables at Woods, respectively. Together, they total 72 units.

FAYETTE COUNTY, KENTUCKY
Property Valuation Administrator
David O'Neill, PVA

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101 E. Vine St Lexington Ky 40507
(859)246-2722

Commercial Sales |January 01, 2021 - July 31, 2021|

Development Land

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
3/22/2021	1975 RUSSELL CAVE RD	$930,000			

Golf Course

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
3/12/2021	2300 SANDERSVILLE RD	$4,025,085	*		Country Club with Course
3/12/2021	2450 SANDERSVILLE RD	$4,025,085	*		

Healthcare

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
3/26/2021	3057 N CLEVELAND RD	$600,000	7749	$77	Office Condo
7/7/2021	1376 SILVER SPRINGS DR	$9,994,896	50805	$197	Office Condo

Hospitality/Recreation

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
3/4/2021	2341 BUENA VISTA RD	$1,750,000	5250	$333	Franchise Food
3/9/2021	502 W SECOND ST	$446,000	3658	$122	Retail
3/15/2021	2851 RICHMOND RD	$1,400,000	5621	$249	Franchise Food
3/26/2021	591 W SHORT ST	$355,000	940	$378	Retail
3/28/2021	266 E SECOND ST	$15,000	5220	$3	Bar/Lounge
3/30/2021	2340 BUENA VISTA RD	$1,200,000	2032	$591	Franchise Food
5/17/2021	3116 RICHMOND RD	$17,400,000	*		Retail
6/7/2021	1318 VERSAILLES RD	$750,000	2076	$361	Franchise Food
6/11/2021	286 SOUTHLAND DR	$1,250,000	4587	$273	Retail
7/29/2021	5365 ATHENS BOONESBORO RD	$1,778,000	3192	$557	Franchise Food

*-Multiple parcel sale, see property record card for details

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Industrial

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
1/8/2021	649 BIZZELL DR	$2,080,000	**		Warehouse
1/27/2021	847 ANGLIANA AVE	$1,500,000	28200	$53	Warehouse
1/29/2021	780 ENTERPRISE DR	$220,000	4260	$52	Warehouse
2/23/2021	767 E SEVENTH ST	$1,950,000	*		Warehouse
2/23/2021	767 E SEVENTH ST	$1,950,000	*		Mini Warehouse
3/5/2021	1801 EDISON DR	$2,600,000	**		Warehouse
3/5/2021	1801 EDISON DR	$2,600,000	**		Other
3/16/2021	976 DELAWARE AVE	$250,000	*		Manufacturing/Processing
3/30/2021	2321 MAGGARD DR	$1,300,000	11970	$109	Warehouse
4/23/2021	223 GOLD RUSH RD	$875,000	13445	$65	Office/Warehouse
4/23/2021	751 ENTERPRISE DR	$1,400,000	17800	$79	Manufacturing/Processing
4/28/2021	840 ANGLIANA AVE	$3,350,000	206496	$16	Warehouse
5/7/2021	540 E SECOND ST	$2,200,000	11880	$185	Warehouse
5/12/2021	333 HENRY ST	$720,000	*		Manufacturing/Processing
5/20/2021	698 KENNEDY RD	$660,000	**		Warehouse
5/20/2021	698 KENNEDY RD	$660,000	**		Auto Service Garage
5/20/2021	628 KENNEDY RD	$660,000	4468	$148	Retail/Warehouse
5/28/2021	938 MANCHESTER ST	$510,000	4000	$128	Office/Warehouse
6/18/2021	691 KENNEDY RD	$1,935,000	*		Auto Service Garage
6/18/2021	673 KENNEDY RD	$1,935,000	*		Manufacturing/Processing
6/18/2021	691 KENNEDY RD	$1,935,000	*		Warehouse
6/21/2021	938 NATIONAL AVE	$400,000	*		Warehouse
6/30/2021	2285 FRANKFORT CT	$690,000	10000	$69	Retail/Warehouse
7/1/2021	2086 BUCK LN	$2,700,000	47450	$57	Warehouse

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Land Only

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
4/29/2021	652 E MAIN ST	$700,000	2628	$266	Franchise Food

Office

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
1/8/2021	1720 SHARKEY WAY	$1,010,000	7700	$131	Office Building
1/19/2021	3320 CLAYS MILL RD STE 209	$325,000	*		Office Condo
1/19/2021	3320 CLAYS MILL RD STE 109	$325,000	*		Office Condo
1/21/2021	904 LIBERTY RD	$320,000	3248	$99	Office Building
1/29/2021	1031 WELLINGTON WAY UNIT 265	$140,000	1053	$133	Office Condo
1/29/2021	2357 HUGUENARD DR	$950,000	6840	$139	Office Building
1/29/2021	1640 NICHOLASVILLE RD STE 202	$130,000	1462	$89	Medical Office
2/4/2021	173 N LIMESTONE	$225,000	2580	$87	Office Building
2/4/2021	131 PROSPEROUS PL UNIT 19A&C	$205,000	1085	$189	Office Condo
2/10/2021	549 W THIRD ST	$360,000	**		Manufacturing/Processing
2/12/2021	3213 SUMMIT SQUARE PL STE 150	$125,000	1363	$92	Office Condo
2/22/2021	2505 LARKIN RD UNIT 104	$106,700	1060	$101	Office Condo
2/22/2021	2700 OLD ROSEBUD RD UNIT 250	$617,500	4097	$151	Office Condo
2/23/2021	3712 WILLOW RIDGE RD	$140,000	1344	$104	Office Condo
2/24/2021	1795 ALYSHEBA WAY UNIT 7102	$325,000	*		Office Condo
2/24/2021	1795 ALYSHEBA WAY UNIT 7202	$325,000	*		Office Condo
2/26/2021	429 N BROADWAY	$780,000	6167	$126	Office Building
3/9/2021	2121 NICHOLASVILLE RD UNIT 109	$75,000	3667	$20	Office Condo
3/18/2021	1641 NICHOLASVILLE RD	$525,000	3010	$174	Office Building
3/19/2021	1204 WINCHESTER RD STE 150	$285,000	*		Office Condo
3/19/2021	1204 WINCHESTER RD STE 100	$285,000	*		Office Condo
3/19/2021	771 CORPORATE DR	$13,200,000	131031	$101	Office Building

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Office

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
3/25/2021	2277 THUNDERSTICK DR	$2,550,000	40000	$64	Office Building
3/27/2021	3229 SUMMIT SQUARE PL STE 230	$268,000	1547	$173	Office Condo
3/31/2021	715 SHAKER DR STE 132	$160,000	2084	$77	Office Condo
4/9/2021	239 N BROADWAY	$820,000	7506	$109	Office Building
4/15/2021	1701 NICHOLASVILLE RD	$1,050,000	6080	$173	Medical Office
4/23/2021	1517 NICHOLASVILLE RD UNIT 402	$160,000	1952	$82	Office Condo
4/26/2021	153 PROSPEROUS PL UNIT 2B	$72,500	714	$102	Office Condo
4/27/2021	3131 CUSTER DR UNIT 2	$149,000	1152	$129	Office Condo
4/30/2021	535 WELLINGTON WAY STE 120	$540,000	2500	$216	Office Condo
4/30/2021	860 CORPORATE DR	$1,600,000	17446	$92	Office Building
5/6/2021	1604 HARRODSBURG RD	$385,000	2240	$172	Office Building
5/10/2021	3151 BEAUMONT CENTRE CIR STE 100	$1,000,000	*		Office Condo
5/10/2021	3151 BEAUMONT CENTRE CIR STE 110	$1,000,000	*		Office Condo
5/14/2021	330 ROMANY RD	$650,000	1984	$328	Medical Office
5/18/2021	278 SOUTHLAND DR	$1,800,000	*		Office Building
5/24/2021	644 N BROADWAY	$383,000	4297	$89	Office Building
5/27/2021	1401 NICHOLASVILLE RD	$555,000	2496	$222	Office Building
6/1/2021	1795 ALYSHEBA WAY UNIT 3202	$150,000	982	$153	Office Condo
6/2/2021	1031 WELLINGTON WAY UNIT 145	$271,400	*		Office Condo
6/10/2021	1795 ALYSHEBA WAY UNIT 1002	$96,000	982	$98	Office Condo
6/10/2021	265 REGENCY CIR	$205,000	2850	$72	Office Building
6/10/2021	265 REGENCY CIR	$255,000	2850	$89	Office Building
6/16/2021	1353 W MAIN ST	$720,000	9225	$78	Office Building
6/23/2021	637 SAYRE AVE	$232,400	2142	$108	Medical Office
6/24/2021	1031 WELLINGTON WAY UNIT 245	$271,400	*		Office Condo
6/28/2021	1795 ALYSHEBA WAY UNIT 5102	$152,500	1001	$152	Office Condo

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Office

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
7/2/2021	135-143 E MAXWELL ST	$13,653,000	37601	$363	Medical Office
7/6/2021	1056 WELLINGTON WAY	$2,995,000	22340	$134	Office Building
7/9/2021	1050 MONARCH ST STE 300	$1,090,000	*		Office Condo
7/9/2021	1050 MONARCH ST STE 301	$1,090,000	*		Office Condo
7/9/2021	1050 MONARCH ST STE 302	$1,090,000	*		Office Condo
7/15/2021	2216 YOUNG DR	$790,500	14752	$54	Office Building
7/16/2021	1030 MONARCH ST STE 320	$153,000	961	$159	Office Condo

Other

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
1/27/2021	866 S BROADWAY	$400,000	*		Other
3/26/2021	3743 RED RIVER DR	$1,900,000	**		Day Care
5/21/2021	1100 ARMSTRONG MILL RD	$1,100,000	20832	$53	Religious
5/28/2021	2033 GARDEN SPRINGS DR	$220,000	2156	$102	Day Care

Parking Garage Structure or Lots

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
1/27/2021	864 S BROADWAY	$400,000	*		
6/7/2021	1515 E NEW CIRCLE RD	$250,000			
7/13/2021	865 E HIGH ST	$3,625,000	*		

Retail

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
1/26/2021	7959 OLD RICHMOND RD	$154,000	700	$220	Retail
1/29/2021	280 BIG RUN RD	$500,000	6000	$83	Auto Service Garage
2/5/2021	790 E NEW CIRCLE RD	$330,000	1332	$248	Convenient Food Market with G

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Retail

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
2/12/2021	155 E REYNOLDS RD	$2,100,000	14400	$146	Neighborhood Shopping Center
2/26/2021	824 WINCHESTER RD	$290,000	5200	$56	Retail
3/3/2021	857 SPARTA CT	$250,000	2698	$93	Retail
3/5/2021	2167 N BROADWAY	$1,424,000			Retail
3/11/2021	233 SOUTHLAND DR	$580,000	5525	$105	Retail
3/31/2021	399 MEIJER WAY	$3,444,444	3150	$1,093	Car Wash - Automatic
3/31/2021	1821 ALYSHEBA WAY	$3,444,444	3600	$957	Car Wash - Automatic
3/31/2021	2637 RICHMOND RD	$1,111,112	5044	$220	Car Wash - Automatic
4/12/2021	220 RUCCIO WAY	$4,150,000	18394	$226	Strip Shopping Center
4/12/2021	472 SOUTHLAND DR	$204,000	1248	$163	Retail
4/15/2021	121 JAMES CT	$4,750,000	*		Mini Warehouse
4/15/2021	137 JAMES CT	$4,750,000	*		Mini Warehouse
4/21/2021	183 MOORE DR	$800,000	13360	$60	Retail
4/26/2021	427-429 E FIFTH ST	$85,000	2745	$31	Retail
4/27/2021	641 RED MILE RD	$750,000	1800	$417	Convenient Food Market with G
5/17/2021	3120 RICHMOND RD	$17,400,000	*		Community Shopping Center
5/17/2021	3180 RICHMOND RD	$17,400,000	*		Community Shopping Center
5/18/2021	268 SOUTHLAND DR	$1,800,000	*		Community Shopping Center
5/25/2021	145 BURT RD	$1,650,000	13360	$124	Neighborhood Shopping Center
5/26/2021	316-318 S ASHLAND AVE	$700,000	*		Retail
5/26/2021	314 S ASHLAND AVE	$700,000	*		Retail
5/27/2021	523 E THIRD ST	$225,000	7307	$31	Retail
6/1/2021	1405 N BROADWAY	$525,000	4230	$124	Auto Service Garage
6/9/2021	802-804 EUCLID AVE	$585,000	**		Office Building
6/25/2021	200 LEXINGTON GREEN CIR	$5,175,000	29053	$178	Retail
7/9/2021	1157 COMMERCIAL DR	$220,000	2000	$110	Retail

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Retail

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
7/9/2021	1157 COMMERCIAL DR	$185,000	2000	$93	Retail
7/13/2021	867 E HIGH ST	$3,625,000	*		Retail
7/14/2021	859 E HIGH ST	$1,250,000	6784	$184	Retail
7/16/2021	365-371 SOUTHLAND DR	$380,000	5400	$70	Retail
7/16/2021	1118 WINCHESTER RD	$600,000	1980	$303	Auto Dealer - Full Service
7/21/2021	1157 COMMERCIAL DR	$272,000	2000	$136	Retail
7/23/2021	527 ANGLIANA AVE	$2,310,000	**		Mini Warehouse
7/23/2021	1524 PARKERS MILL RD	$335,000	4200	$80	Health Spa

Telecom with Tower

Sale Date	Address	Price	Square Feet	$/SqFt	Structure
5/21/2021	1102 ARMSTRONG MILL RD	$1,100,000	*		

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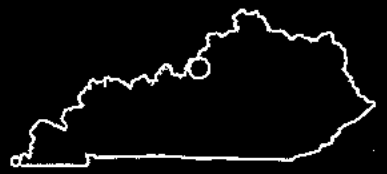
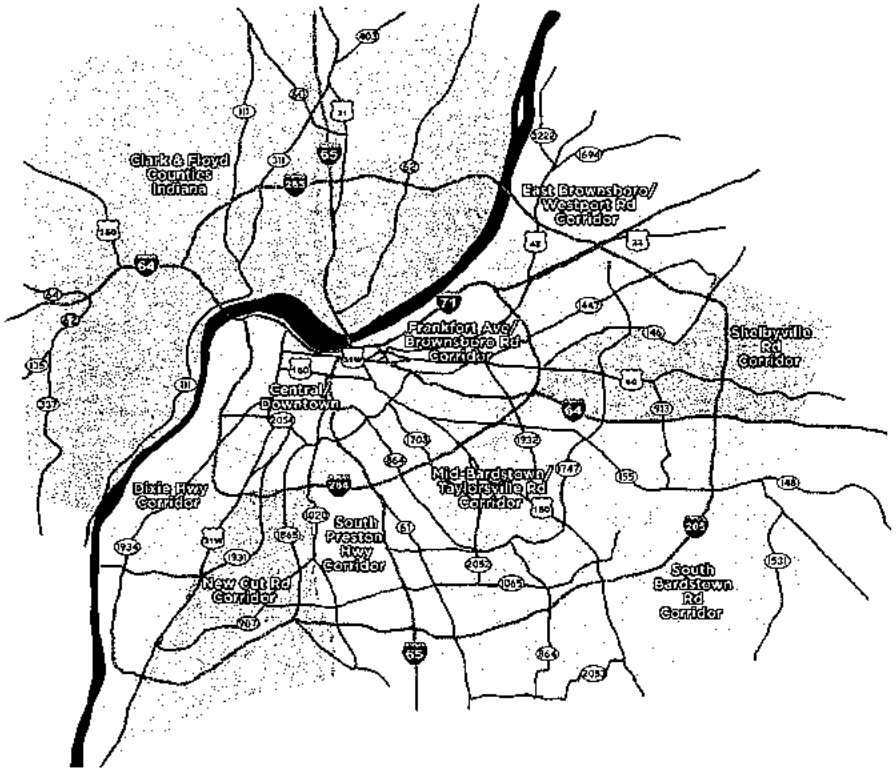
CUSHMAN & WAKEFIELD | COMMERCIAL KENTUCKY LOUISVILLE MULTIFAMILY RESEARCH

MARKET INSIGHT



LOUISVILLE, KENTUCKY MULTIFAMILY REPORT | FIRST QUARTER 2021

The Cushman & Wakefield | Commercial Kentucky Multifamily Research Team, along with Integra Realty Research, provides in-depth coverage of the Louisville Metropolitan Statistical Area. In addition to analyzing multifamily rent and sale trends, these reports examine employment data, key economic announcements, and development pipeline news.



IN THIS EDITION

RESEARCH & SALES TEAM

CRAIG COLLINS
SENIOR DIRECTOR - ccollins@commercialkentucky.com

MIKE KEMETHER
EXECUTIVE VICE CHAIR, MULTIFAMILY ADVISORY GROUP
mike.kemether@cushwake.com

CUSHMAN & WAKEFIELD
Commercial Kentucky

irr.

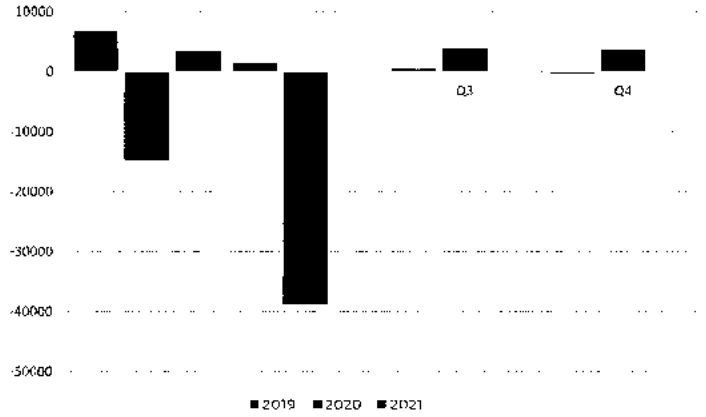
LOUISVILLE METRO AREA

EMPLOYMENT & UNEMPLOYMENT TRENDS

As of the end of March 2021, unemployment rates in the Louisville area decreased from 5.4% at the end of the third quarter to 4.6%, trending closer to the 4.1% rate seen pre-pandemic. Louisville's unemployment rate continues to be well below the national average, which was 6.1% for the same period. **Louisville ranked in the Top 10 of SmartAsset's "Best Cities for New College Graduates".**

LOUISVILLE JOB GROWTH TRENDS

EMPLOYMENT IN THOUSANDS



Source: Cushman & Wakefield | Commercial Kentucky

JOB GROWTH & UNEMPLOYMENT RATE

-3.7

% YOY

Average Q1 **employment** decreased by 23,950 jobs.

50

BPS YOY

Average Q1 **unemployment** increased to 4.6%.

ECONOMIC EXPANSION

The following are select announcements from first quarter 2021:

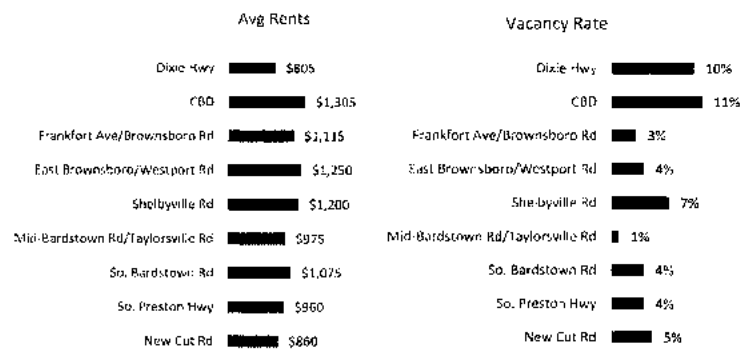
- ✔ **Amazon** announced they are continuing to expand their footprint in Louisville with two new facilities that will create hundreds of full-time jobs. The two new facilities have anticipated completion dates of 2021 and 2022 respectively.
- ✔ **Eberspacher North America**, a subsidiary of the German automotive comany Eberspacher, announced plans to invest $34 million in Jefferson County. As part of the plans, they would build a new manufacturing facility that would help create 214 jobs.
- ✔ International copper company, **Wieland North America**, selected Louisville to be the headquarters for its North American operations. The company will invest $8.8 million into the project and will produce 75 high paying jobs. In additon to the company leaders, the new location will be the home of the financial, legal, sales and marketing, human resources, and supply chain teams.
- ✔ **Affinity**, a uniform, professional workwear and safety garment manufacturer and distributor, announced they are moving their U.S. headquarters to River Ridge located in Southern Indiana. This relocation will be a $3.9 million investment and would created 160 new jobs.

	Q1 2020	Q3 2020	Q1 2021
EMPLOYMENT (% Change)	2.3%	-5.4%	1.2%
UNEMPLOYMENT RATE (%)	4.1%	5.4%	4.6%

Source: Bureau of Labor Statistics

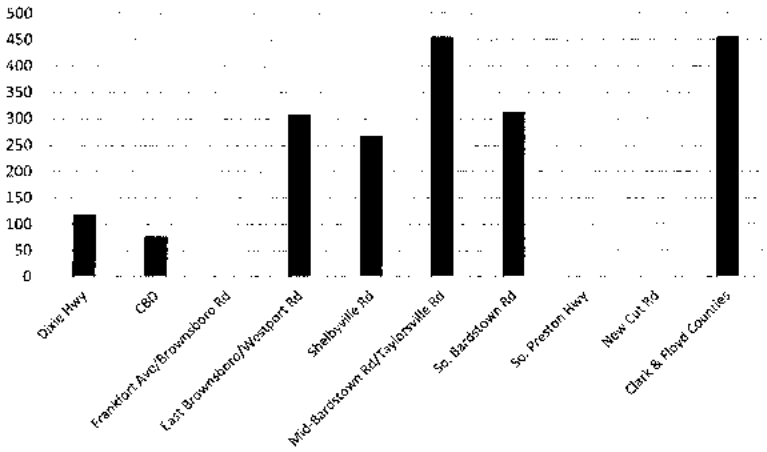
SUBMARKET OVERVIEW

RENTS & VACANCY BY SUBMARKET



Source: Integra Realty Research
Note: Data is based on respondent participation which varies by submarket

UNDER CONSTRUCTION BY SUBMARKET



Source: Cushman & Wakefield | Commercial Kentucky Research
Note: Submarkets are defined by Integra Realty Research

DEVELOPMENT / INVENTORY

In the last 12 months, 3,624 units were complete (which is 1,044 more than shown in our Q3 2020 report), and 1,997 units are currently under construction in the Louisville Metro area.

Additionally, over 11,200 units are planned throughout the Metro area, with two submarkets planning over 2,600 units each. Those submarkets are Area 2 (with 2,752 units planned) and Area 7 (with 2,610 units planned).

DEMOGRAPHIC FUNDAMENTALS

From 2019 to 2024, the metro is projected to add 17,200 households, of which approximately 5,600 will be renters.

POPULATION	2000:	1,121,242
	2010:	1,235,712
	2016:	1,308,447
	2021:	1,343,483
PERCENT RENTER HOUSEHOLDS	2000:	28.8%
	2010:	32.1%
	2016:	33.0%
	2021:	32.7%
MEDIAN HOUSEHOLD INCOME	2000:	$40,928
	2010:	$47,555
	2016:	$57,685
	2021:	$67,273

MULTIFAMILY FORECAST

The following are Cushman & Wakefield's projections over the near term:

RENTS **VACANCY** **PIPELINE % GROWTH**

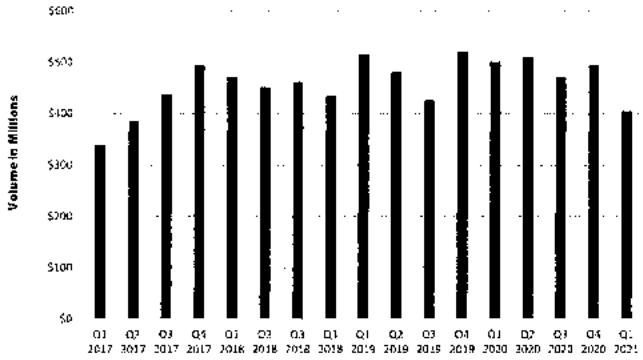
Forecast is 12-month outlook

INVESTMENT ACTIVITY

Multifamily investment activity for Q1 2021 in the Louisville MSA is starting to increase after a lull resulting from the COVID-19 virus and subsequent economic downtown. With occupancy rates high and only minor rent decreases, the market is beginning to return to early 2020 activity levels.

Regional and national apartment funds have been the largest active players for acquiring multifamily in the Louisville marketplace. Private capital also continues to play a major role in the B & C market.

HISTORICAL SALES VOLUME



Source: Real Capital Analytics, Cushman & Wakefield | Commercial Kentucky Research

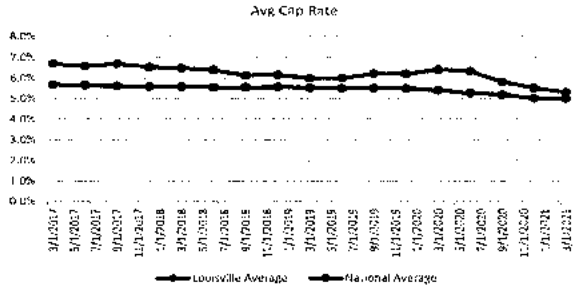
NOTABLE SALES

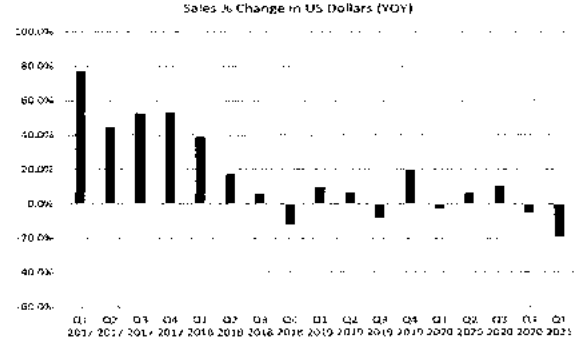
Class B – Beitel Group sold **Park at Hurstbourne** (690 units) to YMP Real Estate for $102k per unit. The property is located in the South Bardstown Road corridor.

Class B – Waypoint Residential sold **Apex on Preston Apartments** (312 units) to The Brookview Companies for $173k per unit. The asset is located in the South Preston Highway corridor.

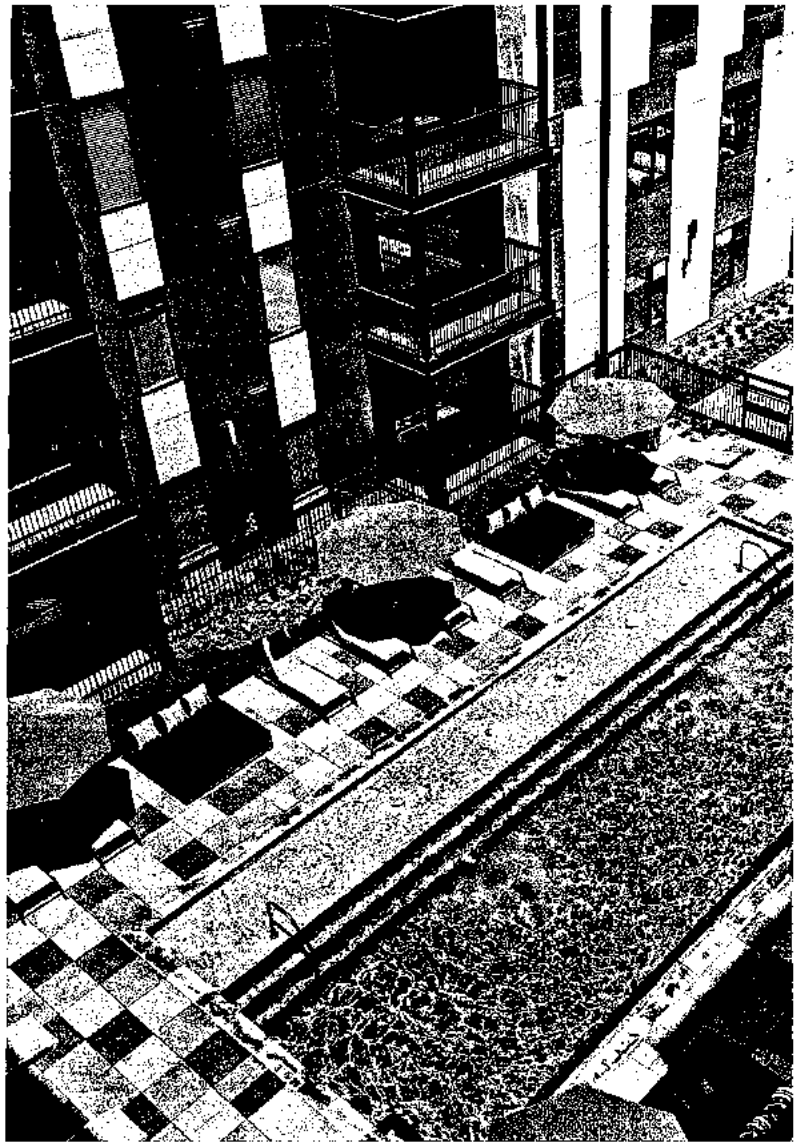
Class B – Tanglewood Apartments II, LLC sold **Tanglewood** (280 units) to 29th Street Capital for $78k per unit. The property is located in the South Preston Highway corridor.

CAP RATES & TRANSACTION VOLUME





Source: Real Capital Analytics, Cushman & Wakefield | Commercial Kentucky Research



SELECT MULTIFAMILY LOUISVILLE MARKET NEWS

- LDG Development continues its development binge by breaking ground on a new 312 unit apartment complex located on Taylorsville Road near the Bluegrass Industrial Park. This complex will consist of 13 separate buildings on 28 acres of land. Once completed, LDG will have more than 2,800 units in the state of Kentucky.

- Nashville developer, Vintage South Development, unveiled plans to convert an old industrial space into a new mixed-use development located near Old Louisville. As part of the project, the company would build a 400-unit apartment complex that is over 550,000 square feet. The development would also include an 87-unit hotel, 23,000 square feet of restaurant and retail space, and other commercial uses.

- Local company KJS LLC has filed plans to rezone 18 acres of land on Bardstown Road to develop a new 348-unit apartment complex. The complex will be comprised of 15 three-story buildings and will total over 450,000 square feet.

- GKG Investments LLC filed plans to construct a new 144-unit complex on nine acres. The property is located in South Louisville near Quail Chase Golf Course. Comprised of six three-story buildings, the complex would exceed 230,000 square feet.

- New York based company, The Brookview Companies, expanded their footprint in the Louisville market by acquiring the 312-unit **Apex on Preston**. They acquired the property for $54 million and brings their total investment in Louisville to $92 million after purchasing The Echelon at Middletown in 2019. The Apex on Preston was previously owned by Waypoint Residential.

- Local company, Jefferson Development Group, received approval from the Louisville Metro Council to move forward on a 343-unit project located in Downtown Louisville. The site, located across from Louisville Slugger Field, has been in the works since August 2019. In addition to the 343-units, the ground floor will consist of 11,000 square feet of commercial space.

MARKETBEAT

LOUISVILLE

Retail Q2 2021

	YoY Chg	12-Mo. Forecast
$63,000 Median HH Income	▼	▼
0.1% Population Growth	▬	▲
4.2% Unemployment Rate	▼	▼

Source: BLS (Economic Indicators are representative of specific county or MSA.)

U.S.ECONOMIC INDICATORS
Q2 2021

	YoY Chg	12-Mo. Forecast
13.2% GDP Growth	▲	▲
16.6% Consumer Spending Growth	▲	▲
31.0% Retail Sales Growth	▲	▲

Source: BEA, Census Bureau

MARKET OVERVIEW

The strength of the U.S. economy continues to improve as businesses continue to open more broadly from pandemic related cutbacks and closures. Retail sales rose by 0.6% in June, buoyed in large part by increased sales at restaurants, bars and soft-goods clothing and accessory retailers. Going forward, the National Retail Federation increased its projections for U.S. retail spending in 2021 to between $4.4 - $4.5 trillion, up from an earlier estimated range of $4.3 - $4.4 trillion.

Locally, the health of the market can be seen in the additional of several new-to-market restaurant concepts. At the Paddock Shoppes in northeast Louisville, Lexington, KY based Bluegrass Hospitality Group opened a new Malone's Steakhouse after converting a space previously occupied by Office Depot. The 18,000 sf, two-story restaurant features a retractable roof on the second floor and multiple private dining rooms and event spaces. This is the first Malone's location outside of Lexington, KY.

In the fast-growing Veterans Parkway corridor in Jeffersonville, IN, Austin, TX based Torchy's Tacos opened their first local location. Similarly, Auburn, AL based Chicken Salad Chick opened a new store on Veterans Parkway, with a second leased location coming in the Middletown trade area of East Louisville. Finally, The Capital Grille has announced plans to open their first Louisville location on the heavily trafficked Shelbyville Road in the eastern suburbs.

Back at the Paddock Shoppes, Williams-Sonoma, Inc. is making several big moves at the walkable, outdoor lifestyle center. The flagship Williams-Sonoma brand has opened a new store, backfilling an 8,000 sf inline space previously occupied by J. Crew. Finally, plans are in motion at the center for a new West Elm furniture location, which will be the brand's first Louisville location. While the West Elm location is new, the Williams-Sonoma and Pottery Barn stores will come at the expense of two existing mall locations in town.

Class B retail continues to languish with stubbornly high vacancy and stagnant rents. Discount retailers like Big Lots, Dollar Tree, and Ollie's have been the most active in backfilling vacant spaces in the market between 10,000 - 20,000 sf. Medical users are also taking up some of the slack – for instance, local developer The McMahon Group recently converted a vacant 135,000 sf former K-Mart box into a new testing laboratory for Norton Healthcare, a local hospital system and healthcare provider.

Downtown Louisville, which was heavily impacted in 2020 by Covid related office closures and several weeks of social unrest, is slowly starting to come back to life. Louisville Bats baseball games and Louisville FC (men's) and Racing Louisville (women's) soccer matches are now open at full capacity, and concerts and events along the riverfront are open to the public with minimal restrictions. These crowds have been a welcome site to hard-hit restaurants and hotels in the area, and we expect business will improve in the area as workers return to their offices and the economy continues to re-open.

A CUSHMAN & WAKEFIELD RESEARCH PUBLICATION

Cushman & Wakefield (NYSE: CWK) is a leading global real estate services firm that delivers exceptional value for real estate occupiers and owners. Cushman & Wakefield is among the largest real estate services firms with approximately 51,000 employees in 400 offices and 70 countries. In 2018, the firm had revenue of $8.2 billion across core services of property, facilities and project management, leasing, capital markets, valuation and other services.

BRENT DOLEN, CCIM
Director
+1 502 589 5150
bdolen@commercialkentucky.com

KRISTINE MCFARLAND
Research Analyst
+1 502 589 5150
kmcfarland@commercialkentucky.com

MARKETBEAT

LOUISVILLE

Industrial Q2 2021

	YoY Chg	12-Mo. Forecast
3.3% Vacancy Rate	▼	▲
3.6M YTD Net Absorption, SF	▲	▲
$4.24 Asking Rent, PSF	▲	▲

Overall, Net Asking Rent

ECONOMIC INDICATORS
Q2 2021

	YoY Chg	12-Mo. Forecast
646.8K Louisville Employment	▲	▲
4.2% Louisville Unemployment Rate	▼	▼
5.9% U.S. Unemployment Rate	▼	▼

Source: BLS

ECONOMIC OVERVIEW

The Louisville unemployment rate decreased 90 basis-points (bps) during the second quarter from 5.1% to 4.2%. According to the Bureau of Labor Statistics, manufacturing jobs have increased from 82,100 to 82,500 during the second quarter while trade and transportation jobs have increased from 151,800 to 153,900 during the second quarter. Additionally, Amazon announced they would be adding nearly 2,000 new jobs in the Louisville area while other companies such as PACCAR and Universal Woods have also planned new projects in the market that could create hundreds of new jobs.

MARKET OVERVIEW

Louisville continues to be a hot market for activity as evidenced by the 2.2 million square feet (msf) of leasing activity recorded during the second quarter. This strong quarter brought the year-to-date (YTD) total to 4.9 msf, which is 2.5 msf more than this time last year. The South and Southern Indiana submarkets have recorded the most activity after six months with 2.2 msf and 1.2 msf respectively.

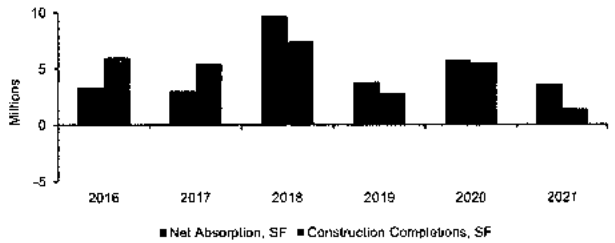
Overall net absorption for the quarter was positive 1.6 msf, marking the 24th consecutive quarter of positive net absorption. The YTD total for overall net absorption has risen to positive 3.6 msf, up 2.5 msf compared to Q2 2020. The Southern Indiana and South submarkets had the most positive absorption during the second quarter with positive 703,819 sf and 653,342 sf respectively. The South submarket has had the most overall absorption with 1.8 msf through the first half of the year.

The Louisville market had 282,475 sf of new construction delivered during the second quarter of 2021, bringing the YTD total to 1.5 msf of new product delivered. Additionally, there is currently 6.4 msf under construction in the Louisville market.

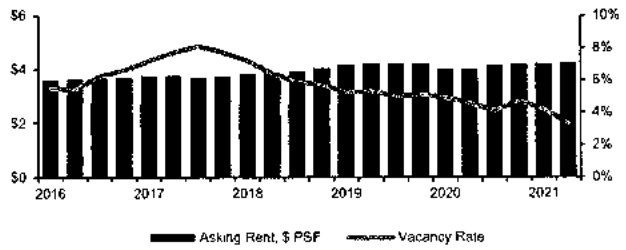
The vacancy rate decreased 90 bps during the second quarter from 4.2% to 3.3%. The current vacancy rate of 3.3% is the lowest rate ever recorded in the Louisville market. The South and the East submarkets have the lowest vacancy rates at the end of the second quarter with 0.9% and 1.8% respectively.

Overall average asking rent increased during the quarter from $4.22 per square foot (psf) to $4.24 psf and are up 5.5% from the $4.02 psf seen during Q2 2020. Warehouse/distribution average asking rents have increased from $4.01 psf to $4.18 psf from this time last year, a 4.2% increase. Meanwhile, manufacturing rents increased from $3.23 psf to $3.53 psf in this same time frame while office services has decreased from $8.49 psf to $7.85 psf.

SPACE DEMAND / DELIVERIES



OVERALL VACANCY & ASKING RENT



MARKETBEAT
LOUISVILLE
Industrial Q2 2021

BULK OVERVIEW

Bulk leasing activity for the second quarter was 1.7 msf, which brought the YTD total to 3.8 msf of leasing activity. The Southern Indiana submarket recorded the most leasing activity with 760,117 sf mainly due to CTDI leasing the entirety of a 702,800 sf building located in River Ridge. The South and Southern Indiana submarkets have had the most activity after two quarters with YTD totals of 1.9 msf and 910,117 sf respectively. Additionally, investment sales activity has continued to pick up steam in the bulk market with six bulk buildings being sold during the second quarter. The biggest sale that occurred was Hines Global buying 900 Patrol Road, a 1.0 msf building in Southern Indiana occupied by Amazon, from Prologis for $99 million.

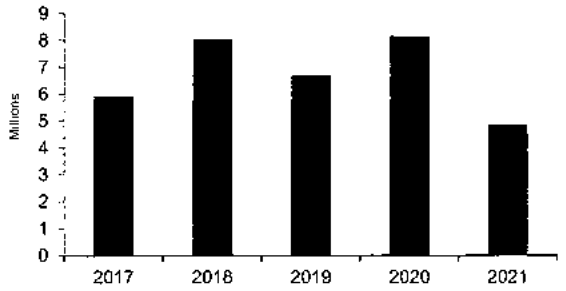
Bulk overall net absorption was positive 1.6 msf for the second quarter as absorption continues to outpace construction completions. YTD overall net absorption is up to positive 3.4 msf, which is 2.6 msf more than what was recorded after the first two quarters of 2020.

Only one new bulk building was completed during the second quarter which was a 259,800 sf spec building in Southern Indiana. This building was completed by Gray Construction and subsequently sold to Pinchal. YTD there has been 1.3 msf of new bulk product completed. Construction continues to ramp up to meet the high demand in the market with 6.4 msf currently under construction. Bullitt County and the South submarkets have the most square footage currently under construction with 3.3 msf and 2.0 msf respectively.

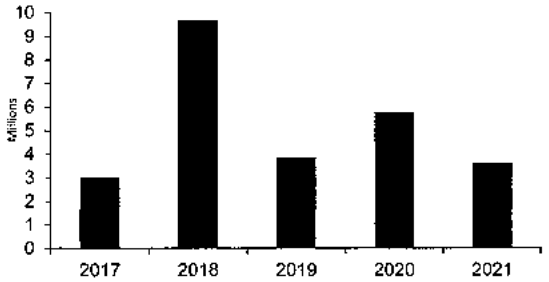
The bulk vacancy rate decreased 200 bps from 6.6% to 4.6% during the first quarter. The Southern Indiana submarket had the biggest decrease in vacancy rate during the second quarter dropping 370 bps from 12.7% to 9.0%. Additionally, the South submarket ended the second quarter with a bulk vacancy rate of 0.0%.

Average asking rent decreased from $4.21 psf to $4.15 psf during the second quarter, but is up 3.5% from the $4.01 psf at this time last year. This decrease in asking rent from this quarter can mainly be attributed to the lack of available space in the South submarket, typically the submarket with one of the highest asking rates, as well as the higher priced infill properties getting leased.

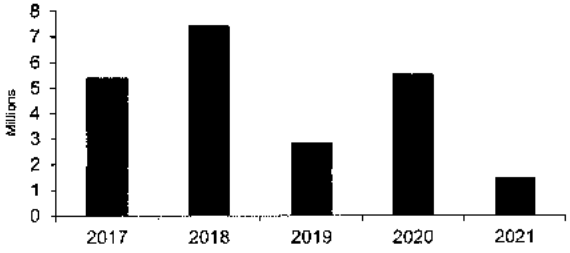
Leasing Activity – Overall (square feet)



Absorption – Overall (square feet)



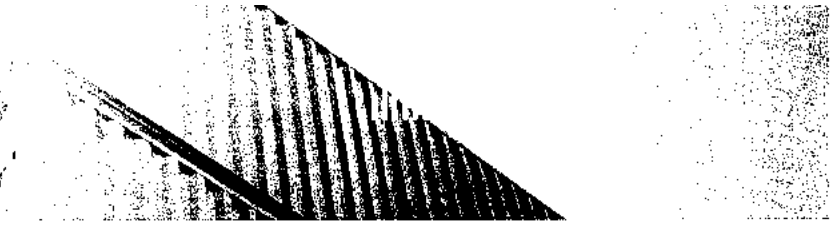
Construction Completions – Overall (square feet)



OUTLOOK

- Construction activity will continue to pick up as the demand for space in the Louisville market remains high.
- The Louisville market is on pace to have one if its best years ever with regards to net absorption. The YTD total of 3.6 msf nearly equaled the 10-year average of 3.9 msf of net absorption.
- Recently, newly constructed spec buildings have been getting leased rapidly with some only being on the market for as little as four months after completion. As the amount available space remains low, this trend is likely to continue.

MARKETBEAT
LOUISVILLE
Industrial Q2 2021



MARKET STATISTICS

SUBMARKET	TOTAL BLDGS	INVENTORY (SF)	YTD USER SALES ACTIVITY (SF)	OVERALL VACANCY RATE	YTD OVERALL NET ABSORPTION (SF)	UNDER CNSTR (SF)	YTD CONSTR COMPLETIONS (SF)	*OVERALL WEIGHTED AVG. NET RENT (MF)	*OVERALL WEIGHTED AVG. NET RENT (OS)	*OVERALL WEIGHTED AVG. NET RENT (W/D)
Central	**425**	**20,737,536**	**149,187**	**3.9%**	**33,249**	**0**	**0**	**$2.84**	**$8.03**	**$2.90**
Downtown	219	9,598,870	134,427	6.9%	17,738	0	0	$2.80	$6.79	$1.73
I-64	60	1,860,523	0	1.7%	-6,400	0	0	N/A	$9.40	N/A
I-65	146	9,278,143	14,760	1.2%	21,911	0	0	$5.03	N/A	$3.54
East	**412**	**27,010,558**	**0**	**1.8%**	**216,191**	**215,920**	**22,675**	**$5.89**	**$8.37**	**$5.65**
Jeffersontown	288	13,272,440	0	2.7%	238,140	117,120	22,675	$5.35	$7.90	N/A
Middletown / Eastpoint	82	3,695,621	0	2.1%	-31,192	98,800	0	$6.50	$10.65	N/A
Westport Road	42	10,042,497	0	0.6%	9,243	0	0	N/A	$7.02	$5.65
South	**525**	**57,939,241**	**0**	**0.9%**	**1,771,744**	**2,024,113**	**1,084,157**	**$3.75**	**$5.72**	**$4.99**
Airport	187	31,380,872	0	1.1%	361,152	1,472,103	0	$3.73	N/A	$4.98
Bishop Lane	212	9,030,777	0	2.2%	17,916	375,220	0	$3.77	$5.77	$5.00
Fern Valley	126	17,527,592	0	0.0%	1,392,676	176,790	1,084,157	N/A	$4.25	N/A
West / Southwest	**182**	**22,245,213**	**61,800**	**2.2%**	**-38,446**	**260,000**	**0**	**$5.50**	**$4.23**	**$3.96**
Iroquois	7	248,024	0	0.0%	0	0	0	N/A	N/A	N/A
Riverport	113	17,945,646	0	2.8%	-76,546	260,000	0	$5.50	$4.23	$3.96
Westend	62	4,051,543	61,800	0.0%	37,100	0	0	N/A	N/A	N/A
Bullitt County	**65**	**18,496,555**	**0**	**9.2%**	**702,260**	**3,306,754**	**0**	**N/A**	**N/A**	**$4.10**
Southern Indiana	**262**	**27,110,729**	**0**	**8.4%**	**942,153**	**618,635**	**359,800**	**$3.85**	**N/A**	**$4.32**
Floyd County	93	5,362,313	0	4.2%	43,150	0	100,000	$5.10	N/A	$4.81
Clark County	169	21,784,416	0	6.9%	899,003	618,635	259,800	$3.65	N/A	$4.28
LOUISVILLE TOTALS	**1,871**	**173,539,832**	**210,987**	**3.3%**	**3,626,151**	**6,425,422**	**1,466,632**	**$3.53**	**$7.85**	**$4.18**

*Rental rates reflect asking $psf/year

MF = Manufacturing OS = Office Service/Flex W/D = Warehouse/Distribution

MARKET STATISTICS -- BULK

SUBMARKET	TOTAL BLDGS	INVENTORY (SF)	YTD INVESTMENT SALES ACTIVITY (SF)	OVERALL VACANCY RATE	YTD OVERALL NET ABSORPTION (SF)	UNDER CNSTR (SF)	YTD CONSTR COMPLETIONS (SF)	YTD OVERALL LEASING ACTIVITY	*OVERALL WEIGHTED AVG. NET RENT Q2 2020	*OVERALL WEIGHTED AVG. NET RENT Q2 2021
Central	3	777,595	0	8.0%	0	0	0	0	$3.85	$3.85
East	25	5,271,261	0	0.4%	122,831	215,920	0	122,831	$5.81	$5.95
South	63	22,622,200	350,000	0.0%	1,775,782	1,970,273	1,084,157	1,880,592	$4.27	N/A
West / Southwest	46	11,813,024	783,139	4.0%	-49,951	260,000	0	199,576	$3.50	$3.96
Bullitt County	33	16,213,137	1,776,089	9.2%	702,260	3,306,754	0	702,260	$3.97	$4.10
Southern Indiana	32	13,941,257	1,274,800	9.0%	885,117	618,635	259,800	910,117	$3.81	$4.26
LOUISVILLE TOTALS	**202**	**70,638,474**	**4,184,028**	**4.6%**	**3,436,039**	**6,371,582**	**1,343,957**	**3,815,376**	**$4.01**	**$4.15**

*Bulk is defined by 100,000 sf +, Class A, 28'+ clear, and ESFR.

MARKETBEAT
LOUISVILLE
Industrial Q2 2021

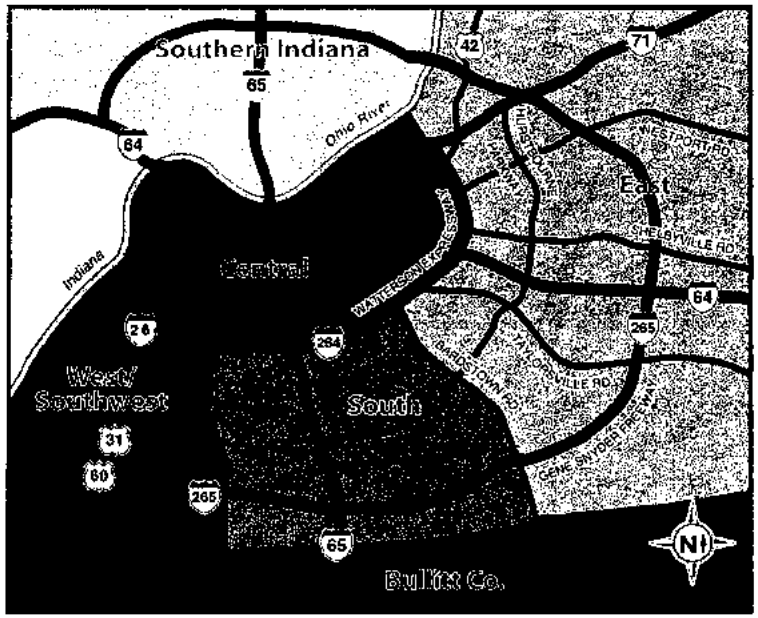
Key Lease Transactions – Q2 2021

Property	SF	TENANT	TRANSACTION TYPE	SUBMARKET
400 River Ridge Parkway	702,800	CTDI	New Lease	Southern Indiana
2103 South Park Road	324,416	The Hut Group	New Lease	South
6611 Shepherdsville Road	183,844	GE	New Lease	South
7001 Greenbelt Highway	128,808	Eberspacher	New Lease	West / Southwest

Key Sales Transactions – Q2 2021

PROPERTY	SF	SELLER/BUYER	PRICE / $PSF	SUBMARKET
900 Patrol Road	1,015,000	Prologis / Hines Global	$99M / $97.54	Southern Indiana
7001 Universal Coach Drive	380,389	Becknell / Raith Capital Partners	$20M / $53.13	West / Southwest
4500 Fern Valley Road	350,000	Fern Valley Distribution LLC / Exeter	$30M / $84.57	South

INDUSTRIAL SUBMARKETS



JOHNNY TOBE
Research Analyst
Tel: +1 502 589 5150
jtobe@commercialkentucky.com

KRISTINE MCFARLAND
Research Analyst
Tel: +1 502 589 5150
kmcfarland@commercialkentucky.com

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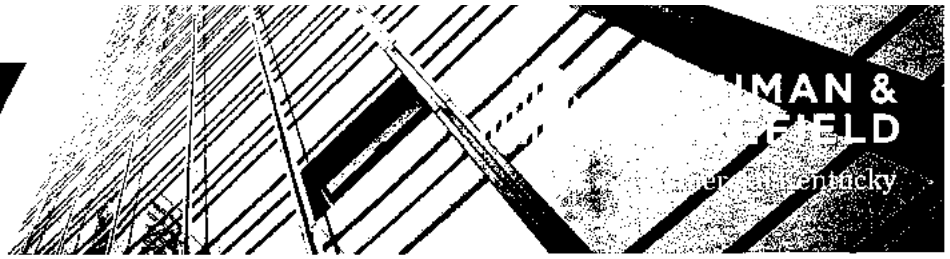
MARKETBEAT

LOUISVILLE

Office Q2 2021



	YoY Chg	12-Mo. Forecast
15.5% Vacancy Rate	▲	▼
-242K YTD Net Absorption, SF	▼	▲
$18.18 Asking Rent, PSF	▲	▬

(Overall, All Property Classes)

ECONOMIC INDICATORS
Q2 2021

	YoY Chg	12-Mo. Forecast
646.8K Louisville Employment	▲	▲
4.2% Louisville Unemployment Rate	▼	▼
5.9% U.S. Unemployment Rate	▼	▼

Source: BLS

ECONOMIC OVERVIEW

The U.S. unemployment rate has dropped slightly from 6.0% during the first quarter to 5.9% in the second quarter according to the Bureau of Labor Statistics. Additionally, job growth increased by 850,000 people during June 2021. Revised first quarter GDP growth, according to the Bureau of Economic Analysis, reflected an increase of 6.4% with experts predicting an increase of up to 9.0% GDP growth during the second quarter of 2021.

The unemployment rate in Louisville decreased from 5.1% to 4.2% during the second quarter of 2021, 60-basis points (bps) higher than the pre-pandemic unemployment rate. The employment level in Louisville increased by 6,800 jobs from the first quarter to the second quarter and is up almost 100,000 from this point last year.

CBD

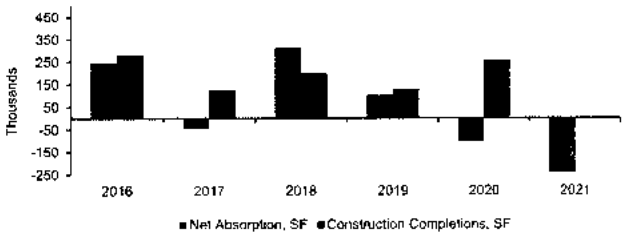
Leasing activity in the Central Business District (CBD) remained slow during the second quarter of 2021 with only 6,937 square feet (sf) of leasing activity recorded during the quarter, which brings the year-to-date (YTD) total up to 9,737 sf. This marks the fourth straight quarter CBD leasing activity has been less than 10,000 sf. Despite the lack of leasing activity, there were two significant redevelopment sales in the CBD during the second quarter. Two different out-of-market investors/developers, Newstream Cos. and 29th Street Capital, purchased the Kentucky Home Life Building and Artspace Building respectively. Both companies plan to convert the buildings into mixed-use space or apartments.

Overall net absorption for the second quarter was positive 1,486 sf which brings the YTD total to negative 89,139 sf. Class A overall net absorption was positive 9,917 sf while Class B was negative 8,431 sf.

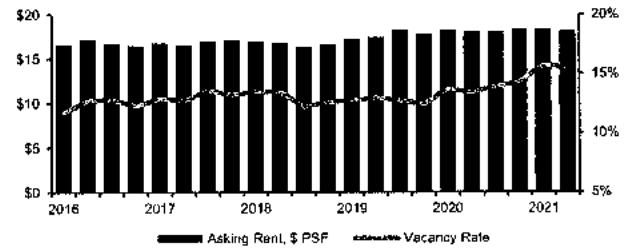
The vacancy rate in the CBD decreased 60 bps from 19.7% to 19.1% during the second quarter. Compared to the second quarter of 2020, the overall vacancy rate in the CBD has increased 120 bps. The Class A vacancy rate decreased from 23.5% to 23.1% while the Class B vacancy rate decreased 80 bps from 17.0% to 16.2%.

CBD overall average asking rents decreased from $16.72 per square foot (psf) to $16.65 psf during the second quarter. Class A CBD overall average asking rents remained level at $18.51 psf during the quarter while Class B CBD overall average asking rents decreased from $14.83 psf to $14.59 psf.

SPACE DEMAND / DELIVERIES



OVERALL VACANCY & ASKING RENT



MARKETBEAT

LOUISVILLE

Office Q2 2021

Suburban

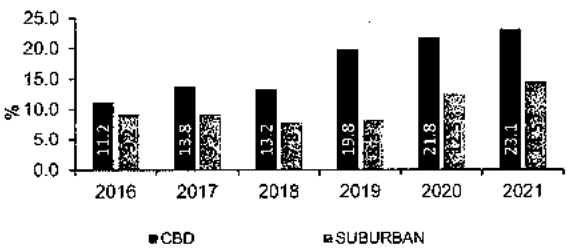
The suburban leasing activity finished the second quarter at 78,400 sf, which brings the YTD total to 157,958 sf. Suburban Class A leasing activity was 65,483 sf while Class B was 12,317 sf. The YTD totals for Class A and Class B are 124,652 sf and 32,706 sf respectively. The Hurstbourne/Eastpoint submarket recorded 66,859 sf of leasing activity during the second quarter which accounted for 85% of all suburban leasing activity during the quarter.

Overall net absorption for the suburban office market ended the second quarter at negative 47,352 sf marking the fourth consecutive quarter of negative absorption. The YTD total for overall net absorption in the Suburban market fell to negative 153,307 sf. Overall net absorption for the Class A suburban market was negative 31,371 sf while the Class B suburban market experienced 10,027 sf of negative absorption during the second quarter. The Northeast and South Central submarkets were the only submarkets to experience positive net absorption during the second quarter with positive 611 sf and positive 14,361 sf respectively.

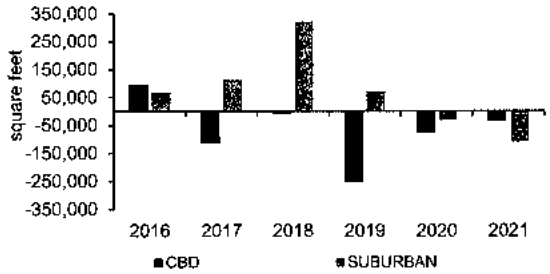
The overall suburban vacancy rate increased 20 bps from 12.6% to 12.8%, matching the highest suburban vacancy rate recorded since the third quarter of 2013. Compared to this time last year, the suburban vacancy rate has increased 280 bps. The Class A vacancy rate stayed flat at 14.5% while the Class B vacancy rate increased from 10.6% to 10.8%.

Overall average asking rents in the suburbs decreased from $20.20 psf to $19.84 psf. Class A suburban average asking rents decreased from $22.44 psf to $21.85 psf while Class B suburban average asking rents increased from $16.76 psf to $16.92 psf. The Northeast and Hurstbourne/Eastpoint submarkets continue to have the highest average asking rents with $22.95 psf and $21.69 psf respectively.

Class A Overall Vacancy Rates – CBD & Suburban



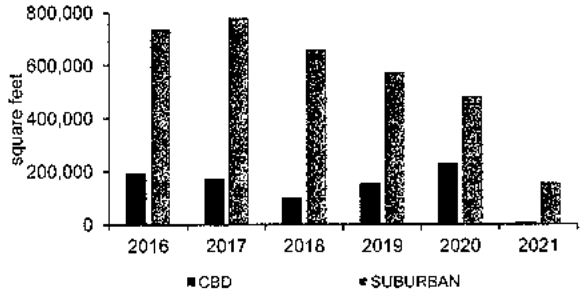
Class A YTD Overall Net Absorption – CBD & Suburban



Outlook

- Leasing activity in the CBD will continue to remain slow unless landlords begin to offer more concessions to potential tenants and/or lower the asking rental rates.
- Although overall net absorption has not been as negative as previous quarters, more negative absorption may occur during the second half of the year as tenants with leases expiring at the end of 2021 will be making decisions on their future office needs as the year progresses.
- As COVID restrictions have been lifted, full capacity events such as Louisville Bats baseball games and Louisville City and Racing Louisville soccer matches are helping restore some of energy and vitality to the CBD which should continue as more major employers begin to bring people back into the office.

YTD Leasing Activity – CBD & Suburban



MARKETBEAT

LOUISVILLE

Office Q2 2021

MARKET STATISTICS

SUBMARKET	INVENTORY (SF)	SUBLET VACANT (SF)	DIRECT VACANT (SF)	OVERALL VACANCY RATE	CURRENT QTR OVERALL NET ABSORPTION (SF)	YTD OVERALL NET ABSORPTION (SF)	YTD LEASING ACTIVITY (SF)**	UNDER CNSTR (SF)	OVERALL AVG ASKING RENT (ALL CLASSES)*	OVERALL AVG ASKING RENT (CLASS A)*
CBD	8,928,580	108,196	1,599,225	19.1%	1,486	-89,139	9,737	0	$16.65	$18.51
SUBURBAN	11,807,988	91,789	1,419,899	12.8%	-47,352	-153,307	157,958	48,000	$19.84	$21.85
Old Louisville	399,940	0	50,356	12.6%	0	5,868	5,868	0	$18.00	N/A
Hurstbourne / Eastpoint	5,026,318	57,701	673,578	14.5%	-35,687	-109,956	94,050	48,000	$21.69	$22.19
Plainview / Middletown	1,457,721	0	268,336	18.4%	-22,816	-37,497	2,523	0	$17.68	$21.00
Southeast	1,182,652	10,849	61,701	6.1%	-3,140	22,744	27,760	0	$18.02	$19.43
Northeast	896,861	20,297	103,181	13.8%	611	-5,452	4,825	0	$22.95	$23.07
St. Matthews	1,402,562	2,942	166,027	12.0%	-681	-42,180	22,932	0	$16.35	$18.67
South Central	1,441,934	0	96,720	6.7%	14,361	13,166	0	0	$16.20	N/A
LOUISVILLE TOTALS	20,736,568	199,985	3,019,124	15.5%	-45,866	-242,446	167,695	48,000	$18.18	$20.23

**Rental rates reflect full service asking*

***Does not include renewals*

	INVENTORY (SF)	SUBLET VACANT (SF)	DIRECT VACANT (SF)	OVERALL VACANCY RATE	CURRENT NET ABSORPTION (SF)	YTD OVERALL NET ABSORPTION (SF)	YTD LEASING ACTIVITY (SF)*	UNDER CNSTR (SF)	DIRECT AVERAGE ASKING RENT*	OVERALL AVERAGE ASKING RENT*
Class A	9,980,470	119,067	1,657,822	17.8%	-21,454	-149,265	130,031	0	$20.37	$20.23
Class B	10,103,301	80,918	1,286,059	13.5%	-18,458	-85,977	37,064	48,000	$15.68	$15.58
Class C	652,797	0	75,243	11.5%	-5,954	-7,204	600	0	$11.88	$11.88

KEY LEASE TRANSACTIONS Q2 2021

PROPERTY	SUBMARKET	TENANT	SF	TYPE
1680 Lyndon Farm Court	Hurstbourne/Eastpoint	GSA	38,958	Direct
9900 Corporate Campus Drive	Hurstbourne/Eastpoint	Aetna	16,239	Renewal
303 North Hurstbourne Parkway	Hurstbourne/Eastpoint	PSST	4,719	Sublease

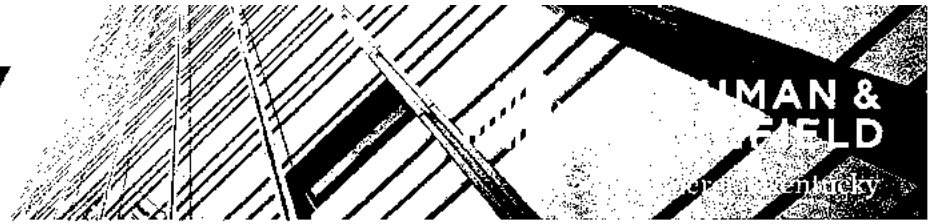
KEY SALE TRANSACTIONS Q2 2021

PROPERTY	SUBMARKET	SELLER / BUYER	SF	PRICE / $PSF
239 South Fifth Street	CBD	Madison Properties / Newstream Cos.	205,000	$15M / $73.17
325 West Broadway	CBD	FFTA Properties / 29th Street Capital	55,437	$1.4M / $24.80

MARKETBEAT

LOUISVILLE

Office Q2 2021



OFFICE SUBMARKETS

Central Business District (CBD): Extends from River Rd. to York St. and from Hancock St. to Ninth St.

Old Louisville: Includes the downtown area immediately surrounding the CBD, as well as Old Louisville.

Hurstbourne/Eastpoint: Largest suburban market includes areas east of I-264, north of Shelbyville Rd. and south of Westport Rd.

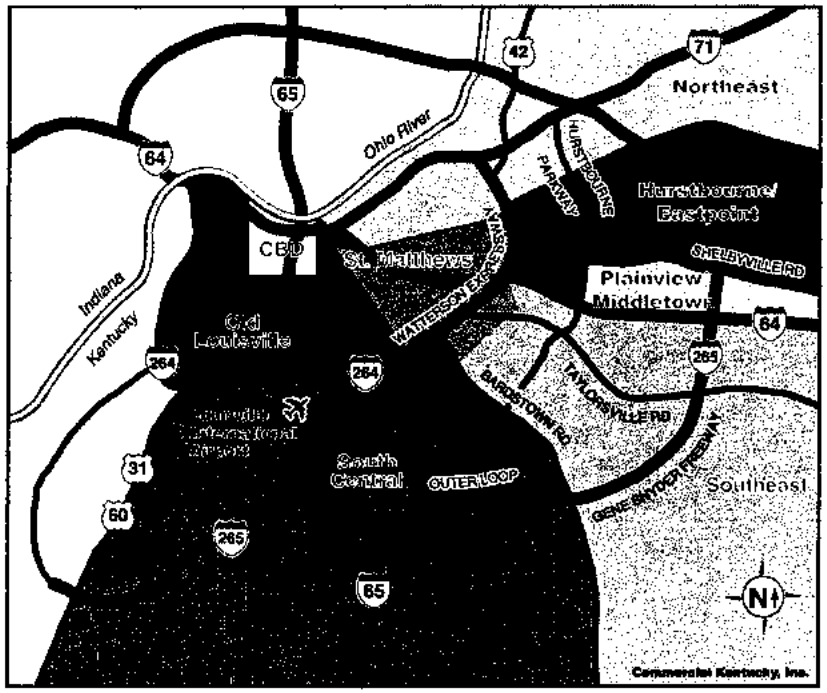
Plainview/Middletown: Contains the areas south of Shelbyville Rd., north of I-64 and east of Hurstbourne Pkwy.

Southeast: Includes the area along S. Hurstbourne Parkway, extending south from I-64 to Bardstown Rd.

Northeast: Embodies an area south of the Ohio River, north of Westport Rd. and east of I-264.

St. Matthews: Largely within I-264 and east of Bardstown Rd.

South Central: Encompasses an area southwest of Bardstown Rd. to Shively, which includes Louisville International Airport.



JOHNNY TOBE
Research Analyst
Tel: +1 502 589 5150
jtobe@commercialkentucky.com

KRISTINE MCFARLAND
Research Analyst
Tel: +1 502 589 5150
kmcfarland@commercialkentucky.com

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MARKETBEAT

LOUISVILLE

Industrial Q1 2021

	YoY Chg	12-Mo. Forecast
4.2% Vacancy Rate	▼	▬
2.1M YTD Net Absorption, SF	▲	▲
$4.22 Asking Rent, PSF *Overall, Net Asking Rent*	▲	▲

ECONOMIC INDICATORS
Q1 2021

	YoY Chg	12-Mo. Forecast
643.0K Louisville Employment	▼	▲
5.1% Louisville Unemployment Rate	▲	▼
6.0% U.S. Unemployment Rate	▲	▼

Source: BLS

ECONOMIC OVERVIEW

The Louisville unemployment rate decreased 100 basis-points (bps) during the first quarter from 6.1% to 5.1%. According to the Bureau of Labor Statistics, manufacturing jobs have increased from 78,200 to 82,100 during the first quarter while trade and transportation jobs have increased from 150,500 to 151,800 during the first quarter. Additionally, Amazon continues to grow its footprint in the Louisville market opening two new facilities during the first quarter which help create hundreds of new jobs.

MARKET OVERVIEW

Overall leasing activity started 2021 following the blistering pace set at the end of 2020 with 2.7 million square feet (msf) recorded during the first quarter. The South submarket had the most leasing activity with 1.4 msf and Bullitt County had the second most with 702,260 square feet (sf) leased.

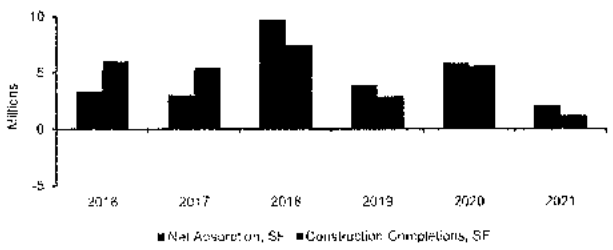
Overall net absorption for the quarter was positive 2.1 msf, marking the 23rd consecutive quarter of positive net absorption. The South and Bullitt County submarkets had the most positive absorption during the first quarter with positive 1.1 msf and 702,260 sf respectively. The West/Southwest submarket was the only submarket to record negative absorption during the quarter with negative 141,732 sf.

The Louisville market had 1.2 msf of new construction delivered during the first quarter of 2021. There is currently 4.2 msf of product under construction as developers try to keep up with the demand in the area.

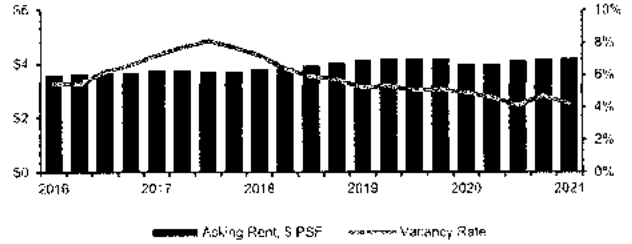
The vacancy rate decreased 50 bps during the first quarter from 4.7% to 4.2%. The South and the East submarkets have the lowest vacancy rates at the end of the first quarter at 2.2% for each.

Overall average asking rent increased during the quarter from $4.20 per square foot (psf) to $4.22 psf. Warehouse/distribution average asking rents increased from $4.17 psf to $4.20 psf while manufacturing and office service average asking rents decreased to $3.28 psf and $7.85 psf respectively.

SPACE DEMAND / DELIVERIES



OVERALL VACANCY & ASKING RENT



MARKETBEAT
LOUISVILLE
Industrial Q1 2021

BULK OVERVIEW

Bulk leasing activity for the first quarter was 2.1 msf. The South submarket accounted for 57% of bulk leasing activity with 1.2 msf recorded and the Bullitt County submarket accounted for 33% with 702,260 sf leased. The biggest lease during the quarter was Amazon taking 931,907 sf at a newly constructed building in the South submarket.

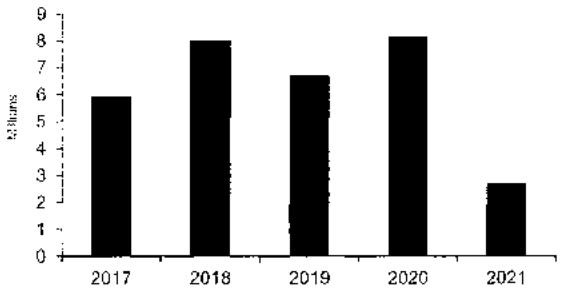
Bulk overall net absorption was positive 1.8 msf for the first quarter as absorption continues to outpace construction completions. The South and Bullitt County submarkets had the most bulk overall net absorption with positive 1.1 msf and positive 702,260 sf respectively.

Two new bulk buildings were completed during the first quarter with both coming in the South submarket. The two new buildings combined to add 1.1 msf of new inventory to the bulk market, and both buildings were leased at the time of completion. At the end of the first quarter, there was 4.2 msf of bulk product currently under construction. Bullitt County and the South submarket have the most currently under construction with 1.6 msf and 1.5 msf respectively. Additionally, the Southern Indiana submarket currently has 856,000 sf of new product under construction.

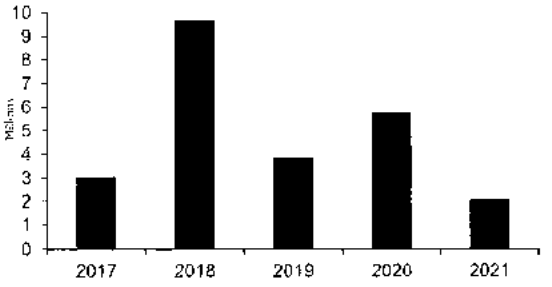
The bulk vacancy rate decreased 110 bps from 7.7% to 6.6% during the first quarter. The Bullitt County and Southern Indiana submarkets had the biggest decrease in vacancy rate during the first quarter. Bullitt County decreased from 13.5% to 9.2% while Southern Indiana decreased from 13.6% to 12.7%. The West/Southwest submarket was the only one to have an increase in vacancy rate, increasing from 3.6% to 4.8%.

Average asking rent increased from $4.18 psf to $4.21 psf during the first quarter. Compared to the first quarter 2020, bulk average asking rent has increased from $4.03 psf to $4.21 psf, a 4.5% increase.

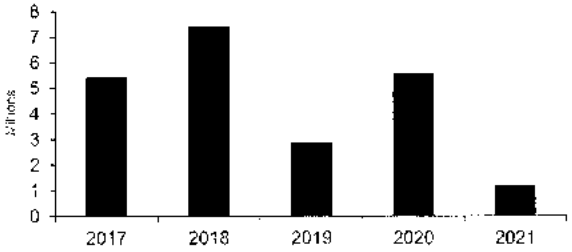
Leasing Activity – Overall (square feet)



Absorption – Overall (square feet)



Construction Completions – Overall (square feet)



OUTLOOK

- As construction activity continues to increase, quality land sites will continue to become difficult to find in the traditional submarkets.
- Demand in the Louisville market remains strong which will keep vacancy rates low until new construction projects are completed.

MARKETBEAT
LOUISVILLE
Industrial Q1 2021

MARKET STATISTICS

SUBMARKET	TOTAL BLDGS	INVENTORY (SF)	YTD USER SALES ACTIVITY (SF)	OVERALL VACANCY RATE	YTD OVERALL NET ABSORPTION (SF)	UNDER CNSTR (SF)	YTD CONSTR COMPLETIONS (SF)	*OVERALL WEIGHTED AVG. NET RENT (MF)	*OVERALL WEIGHTED AVG. NET RENT (OS)	*OVERALL WEIGHTED AVG. NET RENT (W/D)
Central	**427**	**20,856,243**	**43,287**	**4.0%**	**32,498**	**0**	**0**	**$2.84**	**$7.26**	**$2.90**
Downtown	220	9,666,620	28,527	7.0%	17,738	0	0	$2.80	$6.79	$1.73
I-64	60	1,860,523	0	1.3%	0	0	0	N/A	$8.01	N/A
I-65	147	9,329,100	14,760	1.3%	14,760	0	0	$3.98	N/A	$3.54
East	**411**	**26,987,883**	**0**	**2.2%**	**119,383**	**216,207**	**0**	**$6.95**	**$8.26**	**$5.18**
Jeffersontown	287	13,249,765	0	3.3%	144,840	117,120	0	$6.55	$7.28	$4.95
Middletown / Eastpoint	82	3,695,621	0	2.0%	-7,100	99,087	0	N/A	$11.13	$7.75
Westport Road	42	10,042,497	0	0.9%	-18,357	0	0	N/A	$6.95	$5.35
South	**526**	**57,999,200**	**0**	**2.2%**	**1,118,402**	**1,495,565**	**1,084,157**	**$3.79**	**$6.39**	**$4.95**
Airport	187	31,378,872	0	2.2%	32,186	1,262,783	0	$2.93	$7.42	$4.99
Bishop Lane	212	9,030,777	0	2.8%	-18,716	232,782	0	$4.13	$6.36	$4.73
Fern Valley	127	17,589,551	0	1.8%	1,104,932	0	1,084,157	N/A	$6.02	$4.95
West / Southwest	**182**	**22,245,213**	**37,100**	**2.7%**	**-141,732**	**0**	**0**	**N/A**	**$9.23**	**$3.83**
Iroquois	7	248,024	0	0.0%	0	0	0	N/A	N/A	N/A
Riverport	113	17,945,646	0	3.1%	-141,732	0	0	N/A	$9.23	$3.83
Westend	62	4,051,543	37,100	0.9%	0	0	0	N/A	N/A	N/A
Bullitt County	**65**	**18,496,555**	**0**	**9.2%**	**702,260**	**1,621,320**	**0**	**N/A**	**N/A**	**$4.05**
Southern Indiana	**261**	**26,926,361**	**0**	**8.5%**	**251,667**	**856,000**	**100,000**	**$3.76**	**N/A**	**$4.10**
Floyd County	93	5,362,313	0	3.9%	100,000	0	100,000	$3.95	N/A	$4.00
Clark County	168	21,564,048	0	9.7%	151,667	856,000	0	$3.74	N/A	$4.10
LOUISVILLE TOTALS	**1,872**	**173,511,455**	**80,387**	**4.2%**	**2,082,478**	**4,189,092**	**1,184,157**	**$3.28**	**$7.85**	**$4.20**

*Rental rates reflect asking Shell rates

MF = Manufacturing OS = Office Service/Flex W/D = Warehouse Distribution

MARKET STATISTICS – BULK

SUBMARKET	TOTAL BLDGS	INVENTORY (SF)	YTD INVESTMENT SALES ACTIVITY (SF)	OVERALL VACANCY RATE	YTD OVERALL NET ABSORPTION (SF)	UNDER CNSTR (SF)	YTD CONSTR COMPLETIONS (SF)	YTD OVERALL LEASING ACTIVITY	*OVERALL WEIGHTED AVG. NET RENT Q1 2020	*OVERALL WEIGHTED AVG. NET RENT Q1 2021
Central	3	777,595	0	6.0%	0	0	0	0	N/A	$3.85
East	25	5,271,261	0	2.7%	0	216,207	0	0	$5.84	$5.10
South	63	22,622,200	0	3.0%	1,102,332	1,482,765	1,084,157	1,207,332	$4.34	$4.95
West / Southwest	46	11,813,024	0	4.8%	-141,732	0	0	70,768	$3.69	$3.83
Bullitt County	33	16,213,137	1,776,089	9.2%	702,260	1,621,320	0	702,260	$3.97	$4.05
Southern Indiana	32	13,818,489	0	12.7%	125,000	856,000	0	150,000	$3.81	$4.12
LOUISVILLE TOTALS	**202**	**70,515,706**	**1,776,089**	**6.6%**	**1,787,860**	**4,176,292**	**1,084,157**	**2,130,360**	**$4.03**	**$4.21**

*Rental rates reflected by YTD OVERALL NET ABSORPTION and UNDER CNSTR

MARKETBEAT
LOUISVILLE
Industrial Q1 2021

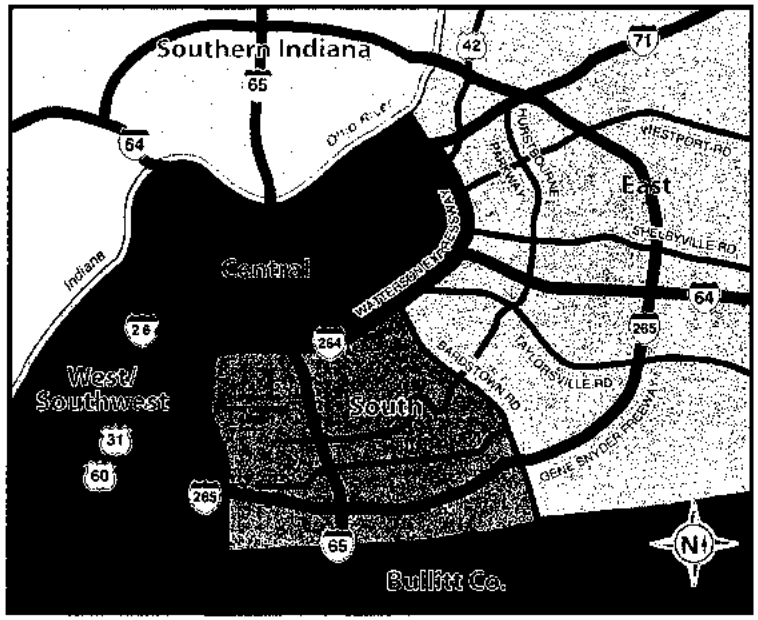
Key Lease Transactions – Q1 2021

Property	SF	TENANT	TRANSACTION TYPE	SUBMARKET
5540 Minor Lane	931,907	Amazon	New Lease	South
3208 East Blue Lick Road	302,500	Amazon	New Lease	Bullitt County
700 Omega Parkway	256,500	Material Handling Systems	New Lease	Bullitt County
800 Patro Road	196,000	Bose	Renewal	Southern Indiana

Key Sales Transactions – Q1 2021

PROPERTY	SF	SELLER/BUYER	PRICE / $PSF	SUBMARKET
170 Clermont Road	1,040,158	Core5 / JLL Income Property Trust	$95M / $91.33	Bullitt County
548 Cedar Grove	500,918	UBS Realty Advisors / Stoltz Management	$34M / $67.45	Bullitt County
167 International Boulevard	235,013	VanTrust / LBA Realty	$20M / 84.57	Bullitt County

INDUSTRIAL SUBMARKETS



Johnny Tobe
Research Analyst
Tel: +1 502 589 5150
jtobe@commercialkentucky.com

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MARKETBEAT

LOUISVILLE

Office Q1 2021

	YoY Chg	12-Mo. Forecast
15.7% Vacancy Rate	▲	▼
-186K YTD Net Absorption, SF	▼	▲
$18.35 Asking Rent, PSF	▲	▬

(Overall, All Property Classes)

ECONOMIC INDICATORS
Q1 2021

	YoY Chg	12-Mo. Forecast
643.0K Louisville Employment	▼	▲
5.1% Louisville Unemployment Rate	▲	▼
6.0% U.S. Unemployment Rate	▲	▼

Source: BLS

ECONOMIC OVERVIEW

The U.S. unemployment rate has fallen from 6.7% during the fourth quarter to 6.0% in the first quarter according to the Bureau of Labor Statistics. Additionally, the employment level increased by 609,000 people during March 2021. In just a little over a year since the beginning of the COVID-19 pandemic, the labor market continues to remain on track to a full recovery. The final fourth quarter GDP according to the Bureau of Economic Analysis was an increase of 4.3% with experts predicting an increase of anywhere from 3.0% to 5.0% increase during the first quarter of 2021.

The unemployment rate in Louisville decreased from 6.1% to 5.1% during the first quarter of 2021.

CBD

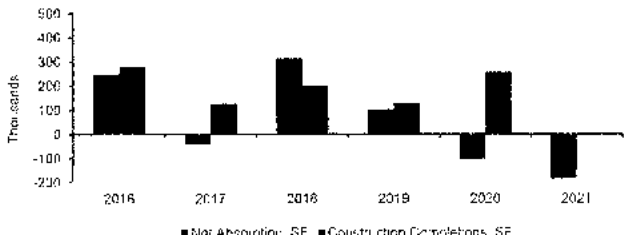
After a slow 2020, leasing activity in the Central Business District (CBD) remained slow during the first quarter of 2021. A total of 2,800 square feet (sf) of leasing activity was recorded during the first quarter. This marks the third straight quarter CBD leasing activity has been under 10,000 sf.

Overall net absorption for the first quarter was negative 90,625 sf. Class A overall net absorption was negative 47,356 sf while Class B was negative 43,269 sf.

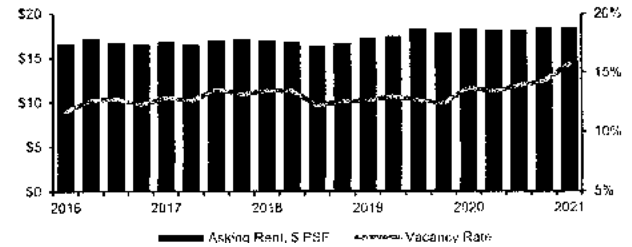
The vacancy rate in the CBD increased 120 basis-points (bps) from the fourth quarter from 18.5% to 19.7%. This is the highest vacancy rate recorded in the CBD since the third quarter of 2006 when the vacancy rate was 20.1%. The Class A vacancy rate increased from 21.8% to 23.5% while the Class B vacancy rate increased 90 bps from 16.1% to 17.0%. In addition, the sublease vacancy rate continues to rise in the CBD. The sublease vacancy rate ended the first quarter at 1.2%, a 90 bps increase from the 0.3% observed at the end of the first quarter 2020.

CBD overall average asking rents decreased from $16.73 per square foot (psf) to $16.72 psf during the first quarter. Class A CBD overall average asking rents increased from $18.49 psf to $18.51 psf during the quarter while Class B CBD overall average asking rents decreased from $14.92 psf to $14.83 psf.

SPACE DEMAND / DELIVERIES



OVERALL VACANCY & ASKING RENT



MARKETBEAT

LOUISVILLE

Office Q1 2021

Suburban

The suburban leasing activity finished the first quarter at 79,558 sf, which accounted for 96.6% of all leasing activity. Suburban Class A leasing activity was 59,169 sf while Class B was 20,389 sf. The Southeast and Hurstbourne/Eastpoint submarkets recorded the most leasing activity during the first quarter with 27,760 sf and 27,191 sf respectively.

Overall net absorption for the suburban office market ended the first quarter at negative 95,456 sf marking the third consecutive quarter of negative absorption. Overall net absorption for the Class A suburban market was negative 70,282 sf while the Class B suburban market experienced 23,924 sf of negative absorption during the first quarter. The Southeast and Old Louisville submarkets were the only submarkets to experience positive net absorption during the first quarter with positive 25,884 sf and positive 5,868 sf respectively.

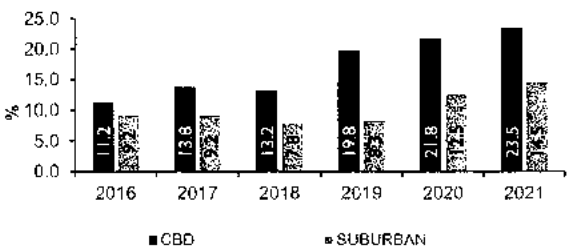
The overall suburban vacancy rate increased 140 bps from 11.2% to 12.6%, the highest suburban vacancy rate recorded since the second quarter of 2016. The Class A vacancy rate increased from 12.5% to 14.5% while the Class B vacancy rate increased from 9.5% to 10.6%. The suburban sublease vacancy rate increased from 0.7% to 0.9% during the first quarter. Compared to the first quarter of 2020, the sublease vacancy rate has jumped from 0.4% to 0.9%.

Overall average asking rents in the suburbs decreased from $20.46 psf to $20.20 psf. Class A suburban average asking rents decreased from $23.10 psf to $22.44 psf while Class B suburban average asking rents decreased from $16.86 psf to $16.76 psf. The Northeast and Hurstbourne/Eastpoint submarkets continue to have the highest average asking rents with $23.25 psf and $22.35 psf respectively.

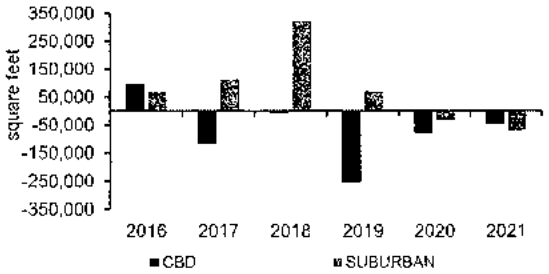
Outlook

- Leasing activity in the CBD will continue to remain slow unless landlords begin to offer more concessions to potential tenants or lower the asking rates for rent.
- Sublease space has become more prevalent over the last year and will continue to increase as tenants reassess their office needs.
- Short term renewals continue to be a popular tactic for tenants as they continue with a wait and see approach before addressing their office needs long term.

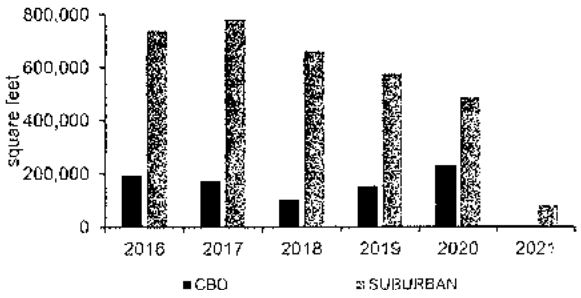
Class A Overall Vacancy Rates – CBD & Suburban



Class A YTD Overall Net Absorption – CBD & Suburban



YTD Leasing Activity – CBD & Suburban



MARKETBEAT

LOUISVILLE

Office Q1 2021

MARKET STATISTICS

SUBMARKET	INVENTORY (SF)	SUBLET VACANT (SF)	DIRECT VACANT (SF)	OVERALL VACANCY RATE	CURRENT QTR OVERALL NET ABSORPTION (SF)	YTD OVERALL NET ABSORPTION (SF)	YTD LEASING ACTIVITY (SF)**	UNDER CNSTR (SF)	OVERALL AVG ASKING RENT (ALL CLASSES)*	OVERALL AVG ASKING RENT (CLASS A)*
CBD	8,888,425	108,196	1,643,752	19.7%	-90,625	-90,625	2,800	0	$16.72	$18.51
SUBURBAN	11,807,988	106,537	1,385,170	12.6%	-95,456	-95,456	79,558	48,000	$20.20	$22.44
Old Louisville	399,940	0	50,356	12.6%	5,868	5,868	5,868	0	$18.00	N/A
Hurstbourne / Eastpoint	6,026,318	71,222	649,117	14.3%	-63,770	-63,770	27,191	48,000	$22.35	$22.91
Plainview / Middletown	1,457,721	0	245,520	16.8%	-14,681	-14,681	0	0	$17.45	$21.00
Southeast	1,182,652	10,849	58,561	5.9%	25,884	25,884	27,760	0	$18.11	$19.43
Northeast	896,861	20,297	103,792	13.8%	-6,063	-6,063	2,465	0	$23.25	$23.25
St. Matthews	1,402,582	4,169	166,743	12.2%	-41,499	-41,499	16,274	0	$16.62	$18.97
South Central	1,441,934	0	111,081	7.7%	-1,195	-1,195	0	0	$16.20	N/A
LOUISVILLE TOTALS	**20,696,413**	**214,733**	**3,028,922**	**15.7%**	**-186,081**	**-186,081**	**82,358**	**48,000**	**$18.35**	**$20.51**

**Rental rates reflect full service asking*

***Does not include renewals*

	INVENTORY (SF)	SUBLET VACANT (SF)	DIRECT VACANT (SF)	OVERALL VACANCY RATE	CURRENT NET ABSORPTION (SF)	YTD OVERALL NET ABSORPTION (SF)	YTD LEASING ACTIVITY (SF)*	UNDER CNSTR (SF)	DIRECT AVERAGE ASKING RENT*	OVERALL AVERAGE ASKING RENT*
Class A	9,980,470	133,815	1,654,948	17.9%	-117,638	-117,638	59,169	0	$20.70	$20.51
Class B	10,063,146	80,918	1,304,685	13.8%	-67,193	-67,193	23,189	48,000	$15.71	$15.61
Class C	652,797	0	69,289	10.6%	-1,250	-1,250	0	0	$11.86	$11.86

KEY LEASE TRANSACTIONS Q1 2021

PROPERTY	SUBMARKET	TENANT	SF	TYPE
2700 Blankenbaker Parkway	Southeast	J Knipper	27,760	Direct
6440 Dutchmans Parkway	St. Matthews	Undisclosed	6,460	Direct
914 East Broadway	Old Louisville	Undisclosed	5,868	Direct
9520 Ormsby Station Road	Hurstbourne/Eastpoint	Thrive365	5,568	Sublease

MARKETBEAT

LOUISVILLE

Office Q1 2021

OFFICE SUBMARKETS

Central Business District (CBD): Extends from River Rd. to York St. and from Hancock St. to Ninth St.

Old Louisville: Includes the downtown area immediately surrounding the CBD, as well as Old Louisville.

Hurstbourne/Eastpoint: Largest suburban market includes areas east of I-264, north of Shelbyville Rd. and south of Westport Rd.

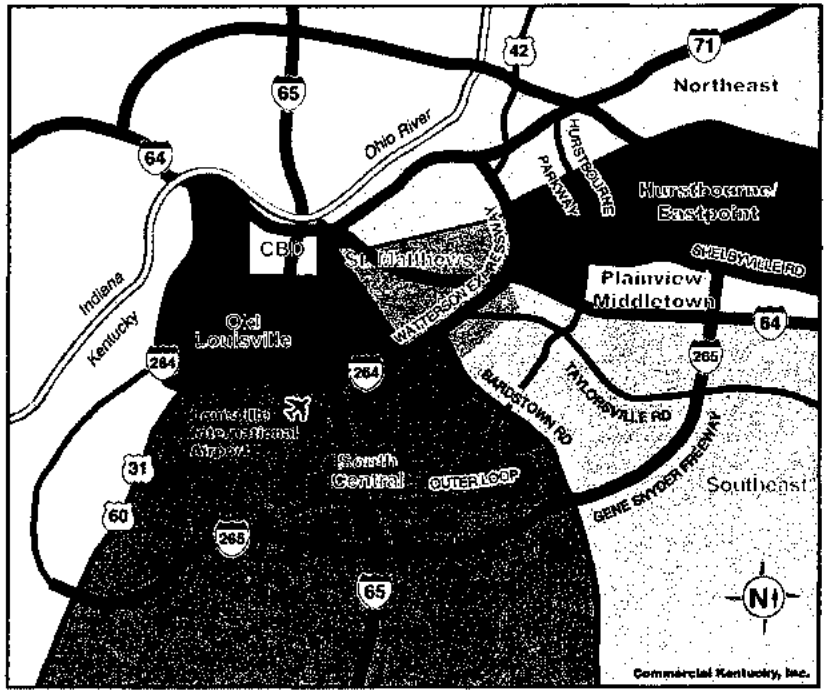
Plainview/Middletown: Contains the areas south of Shelbyville Rd., north of I-64 and east of Hurstbourne Pkwy.

Southeast: Includes the area along S. Hurstbourne Parkway, extending south from I-64 to Bardstown Rd.

Northeast: Embodies an area south of the Ohio River, north of Westport Rd. and east of I-264.

St. Matthews: Largely within I-264 and east of Bardstown Rd.

South Central: Encompasses an area southwest of Bardstown Rd. to Shively, which includes Louisville International Airport.



JOHNNY TOBE
Research Analyst
Tel: +1 502 589 5150
jtobe@commercialkentucky.com

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commercialkentucky.com

MARKETBEAT

LOUISVILLE

Industrial Q2 2020

	YoY Chg	12-Mo. Forecast
4.6% Vacancy Rate	▼	▲
1.1M YTD Net Absorption, SF	▼	▬
$4.02 Asking Rent, PSF	▼	▬

Overall, Net Asking Rent

ECONOMIC INDICATORS Q2 2020

	YoY Chg	12-Mo. Forecast
560.6K Louisville Employment	▼	▲
15.9% Louisville Unemployment Rate	▲	▼
13.0% U.S. Unemployment Rate	▲	▼

Source: BLS

ECONOMIC OVERVIEW

The COVID-19 pandemic struck the U.S. in March 2020, late in the quarter but with enough time to have a significant impact on first quarter market fundamentals. In the second quarter of 2020, the U.S. economy felt its effects more fully, as government-mandated shutdowns along with shelter-in-place ordinances pushed the country deeper into recession. The situation remains very fluid. Access the most recent information specific to COVID here.

MARKET OVERVIEW

Despite a lower number of leases signed than usual, leasing activity in the Louisville Industrial market remained strong in the second quarter with over 1.2 million square feet (msf) of activity. This brings the year-to-date (YTD) total to 2.4 msf of leasing activity. Warehouse/distribution buildings accounted for 90% of total leasing activity during the second quarter with over 1.0 msf leased. The South and Southern Indiana submarkets experienced the most activity during the quarter with 498,081 square feet (sf) and 331,666 sf respectively.

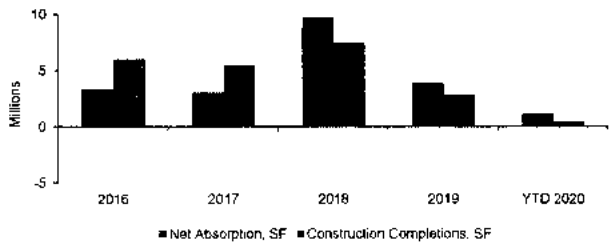
Overall net absorption for the second quarter was positive 901,374 sf and brings the YTD total to positive 1.1 msf. Most of the YTD positive absorption can be attributed to the South, West/Southwest, and Southern Indiana submarkets. The East submarket had negative absorption of 190,240 sf making it the only submarket with negative absorption during the second quarter.

The Louisville market remains hot for new construction with over 6.4 msf currently under construction. The South, Southern Indiana, and Bullitt County submarkets each have over 1.7 msf of new product under construction. Warehouse/distribution makes up 98% of the product currently under construction with 6.3 msf.

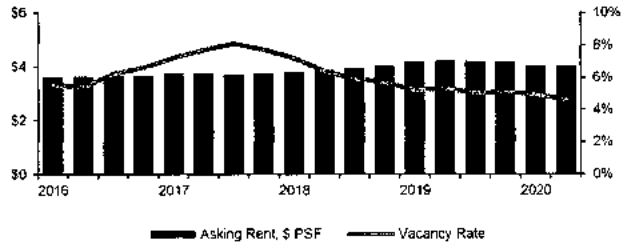
The vacancy rate decreased 30 basis-points (bps) during the second quarter down from 4.9% to 4.6%. The low vacancy rate shows the need for the new construction as more supply is needed to keep up with the high demand in the market. With a 230 bps decrease, the West/Southwest submarket had the greatest change from quarter to quarter dropping down to 0.7% from 3.0%.

Overall average asking rent decreased one cent from $4.03 per square foot (psf) down to $4.02 psf. Warehouse/distribution average asking rents decreased from $4.04 psf to $4.01 psf while manufacturing average asking rents decreased $3.24 psf to $3.23 psf. However, office service average asking rents increased from $8.34 psf to $8.49 psf.

SPACE DEMAND / DELIVERIES



OVERALL VACANCY & ASKING RENT



MARKETBEAT
LOUISVILLE
Industrial Q2 2020

BULK OVERVIEW

Bulk leasing activity for the second quarter was 951,666 sf which brings the mid-year total to over 1.8 msf. Leasing activity in the bulk market accounts for 76% of the overall mid year leasing activity. The South submarket has had the most activity at this point of the year with 901,311 sf.

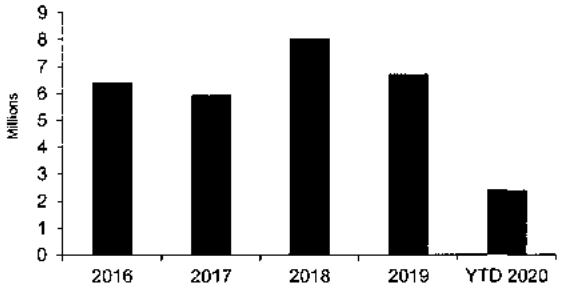
Bulk overall net absorption was positive 792,975 sf for the second quarter, and increased the YTD total to positive 855,535 sf. The South submarket continues to be the submarket with the most positive absorption at 769,845 sf for the first six months.

New construction in the bulk market continues to ramp up with 6.3 msf of product currently under construction. Some notable projects that started during the second quarter include Van Trust's 702,800 sf building in Southern Indiana, Molto's 324,416 sf in the South submarket, and Hunt Midwest's 322,831 sf in the East submarket. Additionally, two new bulk buildings were completed in the South submarket in April. Exeter completed a 252,000 sf building and Airtech completed a 167,000 sf building that is fully leased and occupied.

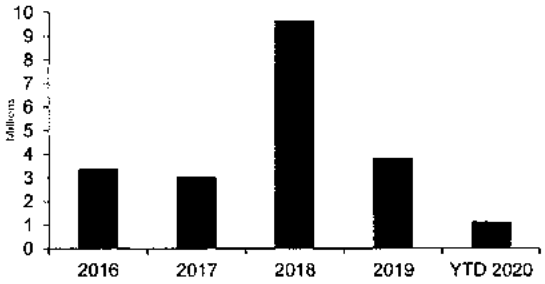
The bulk vacancy rate decreased 60 bps from 7.5% to 6.9% during the second quarter. The biggest decreases in vacancy occurred in the Southern Indiana submarket which decreased 200 bps from 7.6% to 5.6% and the West/Southwest submarket which decreased 110 bps from 2.0% to 0.9%.

Average asking rent decreased from $4.03 psf to $4.01 psf during the second quarter. The Bullitt County and Southern Indiana submarkets had no change in rent, while the other submarkets experienced decreases in average asking rent.

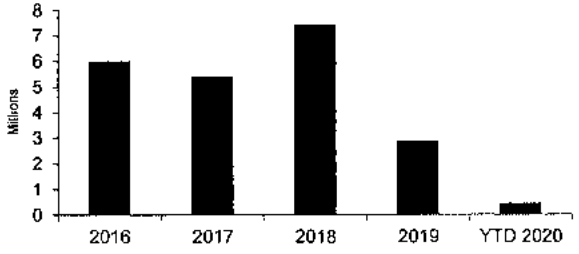
Leasing Activity – Overall (square feet)



Absorption – Overall (square feet)



Construction Completions – Overall (square feet)



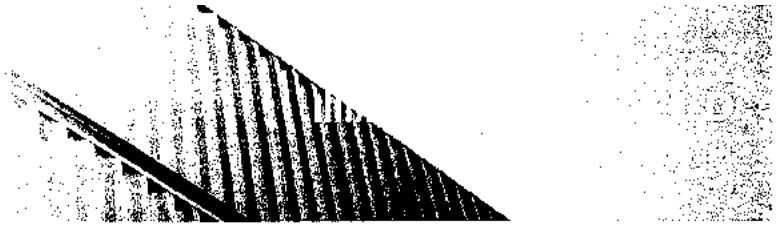
OUTLOOK

- Speculative deliveries of over 5.1 msf is expected to come to market by the end of the year.
- Vacancy rates will begin to increase as several new buildings are projected to be completed during the third quarter.
- Overall net absorption in the near term may lag behind the results of previous quarters.

MARKETBEAT

LOUISVILLE

Industrial Q2 2020



MARKET STATISTICS

SUBMARKET	TOTAL BLDGS	INVENTORY (SF)	YTD USER SALES ACTIVITY (SF)	OVERALL VACANCY RATE	YTD OVERALL NET ABSORPTION (SF)	UNDER CNSTR (SF)	YTD CONSTR COMPLETIONS (SF)	*OVERALL WEIGHTED AVG. NET RENT (MF)	*OVERALL WEIGHTED AVG. NET RENT (OS)	*OVERALL WEIGHTED AVG. NET RENT (W/D)
Central	**427**	**20,866,243**	**242,896**	**4.4%**	**40,034**	**0**	**0**	**$2.84**	**$7.23**	**$2.87**
Downtown	220	9,666,620	110,000	7.2%	86,780	0	0	$2.79	$5.84	$1.73
I-64	60	1,860,523	117,636	1.1%	0	0	0	N/A	$12.42	N/A
I-65	147	9,329,100	15,260	2.0%	-46,746	0	0	$3.13	$8.03	$3.85
East	**409**	**26,645,169**	**55,332**	**2.4%**	**-126,185**	**322,831**	**40,000**	**$6.99**	**$9.09**	**$5.67**
Jeffersontown	286	12,926,645	55,332	4.1%	-155,874	322,831	40,000	$8.00	$8.05	$5.52
Middletown / Eastpoint	81	3,682,921	0	1.9%	100	0	0	$6.45	$11.05	N/A
Westport Road	42	10,035,603	0	0.4%	29,589	0	0	N/A	$7.66	$5.95
South	**522**	**66,370,443**	**313,624**	**3.6%**	**514,902**	**1,704,707**	**419,000**	**$3.72**	**$7.41**	**$4.01**
Airport	186	31,051,866	313,524	3.9%	323,180	324,416	419,000	$3.54	N/A	$4.21
Bishop Lane	212	9,097,027	0	4.4%	-88,258	12,800	0	$3.96	$7.54	$3.83
Fern Valley	124	16,221,550	0	2.5%	279,980	1,367,491	0	N/A	$5.25	$3.82
West / Southwest	**181**	**21,930,713**	**503,639**	**0.7%**	**713,698**	**714,500**	**0**	**$1.03**	**$9.23**	**$3.50**
Iroquois	7	248,024	118,000	0.0%	118,000	0	0	N/A	N/A	N/A
Riverport	112	17,631,146	0	0.5%	209,959	714,500	0	N/A	$9.23	$3.50
Westend	62	4,051,543	385,639	0.9%	385,639	0	0	$1.03	N/A	N/A
Bullitt County	**63**	**16,291,297**	**0**	**17.4%**	**-495,233**	**1,948,758**	**0**	**N/A**	**N/A**	**$3.97**
Southern Indiana	**257**	**25,207,271**	**10,550**	**4.7%**	**479,280**	**1,719,090**	**0**	**$3.79**	**N/A**	**$3.83**
Floyd County	92	5,262,313	0	4.4%	-16,785	100,000	0	$3.95	N/A	$4.75
Clark County	165	19,944,958	10,550	4.8%	496,125	1,619,090	0	$3.77	N/A	$3.74
LOUISVILLE TOTALS	**1,859**	**167,301,136**	**1,125,941**	**4.6%**	**1,126,366**	**6,409,886**	**459,000**	**$3.23**	**$8.49**	**$4.01**

*Rental rates reflect asking $psf/year

MF = Manufacturing OS = Office Service/Flex W/D = Warehouse/Distribution

MARKET STATISTICS – BULK

SUBMARKET	TOTAL BLDGS	INVENTORY (SF)	YTD INVESTMENT SALES ACTIVITY (SF)	OVERALL VACANCY RATE	YTD OVERALL NET ABSORPTION (SF)	UNDER CNSTR (SF)	YTD CONSTR COMPLETIONS (SF)	YTD OVERALL LEASING ACTIVITY	*OVERALL WEIGHTED AVG. NET RENT Q2 2019	*OVERALL WEIGHTED AVG. NET RENT Q2 2020
Central	3	777,595	0	6.0%	-46,746	0	0	0	N/A	$3.85
East	24	4,948,430	0	1.3%	33,589	322,831	0	33,589	$5.95	$5.81
South	59	20,929,703	0	4.3%	769,845	1,691,907	419,000	901,311	$4.39	$4.27
West / Southwest	45	11,498,524	0	0.9%	195,200	714,500	0	307,800	$3.56	$3.50
Bullitt County	31	14,007,879	0	18.7%	-495,233	1,948,758	0	115,767	$3.96	$3.97
Southern Indiana	29	12,199,399	0	5.6%	397,880	1,619,090	0	457,800	$3.86	$3.81
LOUISVILLE TOTALS	**191**	**64,361,530**	**0**	**5.9%**	**856,535**	**6,297,086**	**419,000**	**1,816,267**	**$3.99**	**$4.01**

*Bulk is defined by 100,000 sf + Class A, 20+ floor ave. ESFR

MARKETBEAT
LOUISVILLE
Industrial Q2 2020

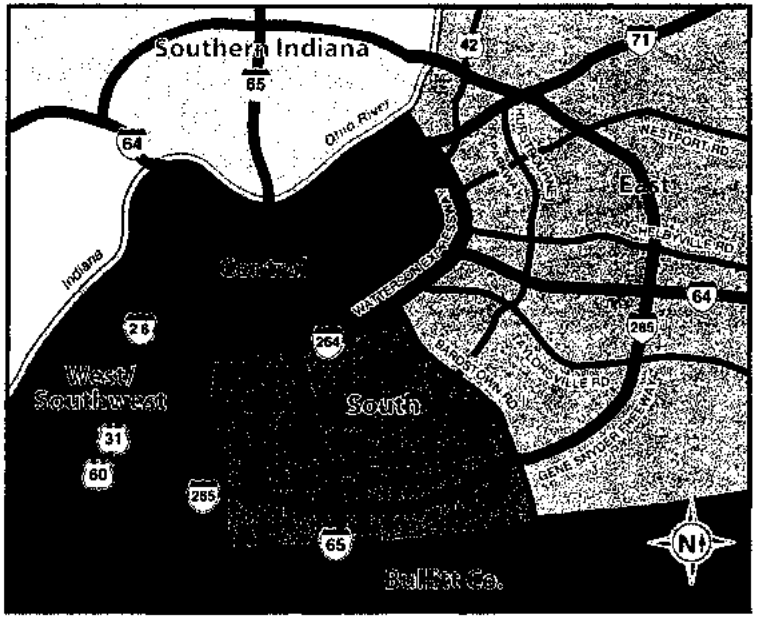
Key Lease Transactions – Q2 2020

Property	SF	TENANT	TRANSACTION TYPE	SUBMARKET
201 River Ridge Parkway	245,000	Kenco	New Lease	Southern Indiana
4500 Fern Valley Road	226,825	Houston Johnson	New Lease	South
800 Patrol Road	196,000	Bose Corporation	Renewal	Southern Indiana
1001 Glengarry Drive	125,202	Container & Packaging	New Lease	South

Key Sales Transactions – Q2 2020

PROPERTY	SF	SELLER/BUYER	PRICE / $PSF	SUBMARKET
2820 West Broadway	385,639	Sypris Technologies / Goodwill	$1.7M / $4.4	West / Southwest
3701 West Magnolia Avenue	141,025	Mesa Foods / STORE Capital	$6.3M / $59	West / Southwest

INDUSTRIAL SUBMARKETS



Johnny Tobe
Research Analyst
Tel: +1 502 589 5150
jtobe@commercialkentucky.com

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MARKETBEAT

LOUISVILLE

Office Q2 2020

	YoY Chg	12-Mo. Forecast
13.4% Vacancy Rate	▲	▼
-22.2K YTD Net Absorption, SF	▼	▲
$18.15 Asking Rent, PSF	▲	▬

(Overall, All Property Classes)

ECONOMIC INDICATORS
Q2 2020

	YoY Chg	12-Mo. Forecast
560.6K Louisville Employment	▼	▲
15.9% Louisville Unemployment Rate	▲	▼
13.0% U.S. Unemployment Rate	▲	▼

Source: BLS

ECONOMIC OVERVIEW

The COVID-19 pandemic struck the U.S. in March 2020, late in the quarter but with enough time to have a significant impact on first quarter market fundamentals. In the second quarter of 2020, the U.S. economy felt its effects more fully, as government-mandated shutdowns along with shelter-in-place ordinances pushed the country deeper into recession. The situation remains very fluid. Access the most recent information specific to COVID here.

CBD

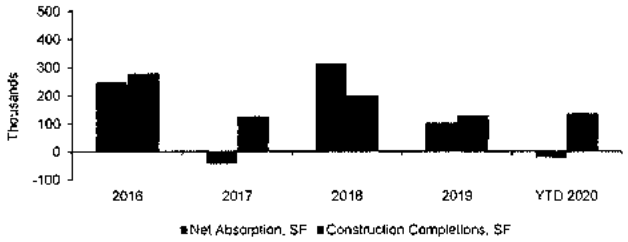
After a strong start to the first quarter, leasing activity in the CBD unsurprisingly slowed down during the second quarter. The second quarter had 29,090 square feet (sf) of leasing activity. Over 94% of the leasing activity occurred in the Class B market, which ended at a total of 27,474 sf. This brings the year-to-date (YTD) total to 219,444 sf. Despite the slow quarter, leasing activity through the first six months of 2020 is almost 174,000 sf greater than the first six months of 2019.

Overall net absorption for the second quarter was positive 25,674 sf bringing the YTD total to positive 14,060 sf. A much more welcome sight than the negative 47,010 sf of overall net absorption recorded after the first two quarters of 2019. All 25,674 sf of positive net absorption occurred in Class B space.

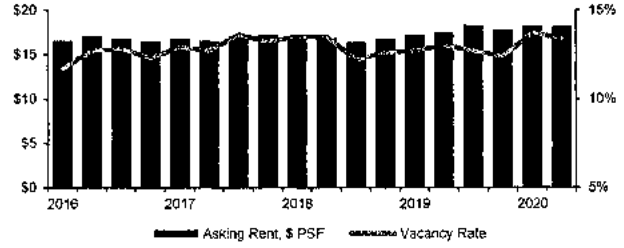
The vacancy rate in the CBD decreased 30 basis-points (bps) from 18.2% to 17.9% at the end of the second quarter. The Class A vacancy rate remained constant at 19.5%, while the Class B vacancy rate decreased 50 bps from 17.3% to 16.8%.

CBD overall average asking rent increased from $16.68 per square foot (psf) to $16.72 psf at the end of the quarter. Class A average asking rent remained the same from last quarter at $18.74 psf. Class B average asking rent increased from $14.86 psf to $14.88 psf. CBD average asking rents are down less than 1% from the $16.77 psf recorded at the end of the second quarter of 2019.

SPACE DEMAND / DELIVERIES



OVERALL VACANCY & ASKING RENT



MARKETBEAT

LOUISVILLE

Office Q2 2020

Suburban

The suburban office market had another solid quarter of leasing activity with 105,537 sf recorded during the second quarter. This brought the YTD total to 297,708 sf, almost 54,000 sf more than this point last year. Suburban Class A leasing activity for the second quarter was 98,046 sf and made up 93% of total suburban leasing activity. The Hurstbourne/Eastpoint and Northeast submarkets had the most activity with 62,562 sf and 35,338 sf respectively.

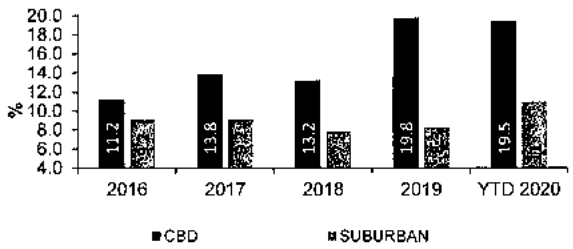
Overall net absorption for the suburban office market ended the second quarter at positive 28,700 sf which brought the YTD total to negative 36,290 sf. The Northeast submarket had positive 60,688 sf of net absorption for the quarter due to tenants being able to move in to the Olympia Two building which was completed at the end of the first quarter. Overall net absorption for the Class A suburban market was positive 35,843 sf while the Class B suburban market experienced 7,513 sf of negative absorption during the second quarter.

The overall vacancy rate decreased 30 bps from 10.3% to 10.0%. The Class A vacancy rate also decreased from 11.6% to 11.0% while the Class B vacancy rate increased from 8.6% to 8.7%. Due to the positive absorption into the new Olympia Two building, the Northeast vacancy rate decreased from 17.2% to 10.4%, a 680 bps change from first quarter to second quarter.

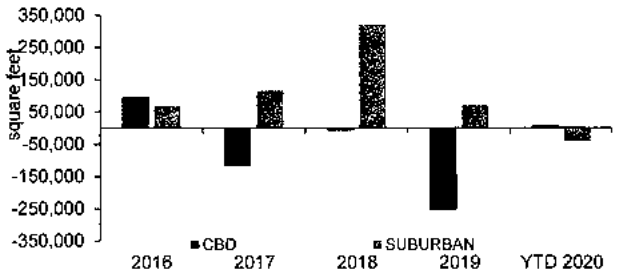
Overall average asking rent decreased from $20.14 psf to $19.96 psf. Class A suburban average asking rent decreased from $22.55 psf to $22.32 psf while Class B suburban average asking rent increased from $16.72 psf to $16.87 psf. Compared to this point last year, overall average asking rent has increased 8.6%.

Group RMC out of New York purchased the East End Office Portfolio from local company Ascent Properties. The portfolio consists of seven office properties in the Plainview/Middletown submarket and totals 515,000 sf. Group RMC bought the properties for a total of $44.2 million which breaks down to $85 psf.

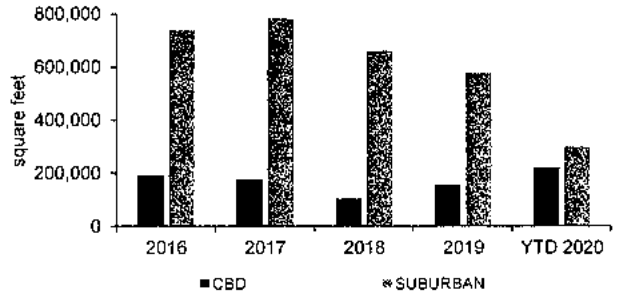
Class A Overall Vacancy Rates – CBD & Suburban



Class A YTD Overall Net Absorption – CBD & Suburban



YTD Leasing Activity – CBD & Suburban



Outlook

- Occupiers have begun and will continue to assess their office needs as a result of the pandemic. The companies who have been able to work effectively from home may look to reduce the amount of physical space they lease. Conversely, companies who have struggled working from home may wind up taking more space in order to spread out employees more effectively.
- Landlords may have to lower rents or provide more concessions in order to entice tenants not to reduce their footprint.
- Urban tenants may begin to look more seriously at suburban office space. While this is good news for the suburban market, the CBD market would certainly suffer.

MARKETBEAT

LOUISVILLE

Office Q2 2020

MARKET STATISTICS

SUBMARKET	INVENTORY (SF)	SUBLET VACANT (SF)	DIRECT VACANT (SF)	OVERALL VACANCY RATE	CURRENT QTR OVERALL NET ABSORPTION (SF)	YTD OVERALL NET ABSORPTION (SF)	YTD LEASING ACTIVITY (SF)**	UNDER CNSTR (SF)	OVERALL AVG ASKING RENT (ALL CLASSES)*	OVERALL AVG ASKING RENT (CLASS A)*
CBD	8,890,632	29,214	1,363,869	17.9%	25,674	14,060	219,444	0	$16.72	$18.74
SUBURBAN	11,688,977	44,866	1,126,559	10.0%	28,700	-36,290	297,708	167,011	$19.96	$22.32
Old Louisville	399,940	0	56,224	14.1%	0	0	0	0	$16.18	N/A
Hurstbourne / Eastpoint	4,907,307	41,924	492,183	10.9%	-20,633	-110,430	143,867	167,011	$21.61	$21.99
Plainview / Middletown	1,457,721	0	225,919	15.5%	-2,921	12,379	28,335	0	$17.65	$21.00
Southeast	1,182,652	0	34,769	2.9%	-4,342	-1,891	6,079	0	$16.62	$17.00
Northeast	896,861	0	93,617	10.4%	60,688	76,961	77,221	0	$25.14	$25.31
St. Matthews	1,402,562	2,942	114,021	8.3%	-4,092	-13,309	11,166	0	$17.09	$23.01
South Central	1,441,934	0	109,826	7.6%	0	0	31,040	0	$16.51	$18.50
LOUISVILLE TOTALS	20,579,609	74,080	2,690,428	13.4%	54,374	-22,230	517,152	167,011	$18.15	$20.49

**Rental rates reflect full service asking*

***Does not include renewals*

	INVENTORY (SF)	SUBLET VACANT (SF)	DIRECT VACANT (SF)	OVERALL VACANCY RATE	CURRENT NET ABSORPTION (SF)	YTD OVERALL NET ABSORPTION (SF)	YTD LEASING ACTIVITY (SF)*	UNDER CNSTR (SF)	DIRECT AVERAGE ASKING RENT*	OVERALL AVERAGE ASKING RENT*
Class A	9,861,459	44,866	1,366,229	14.3%	35,843	-34,148	326,399	119,011	$20.54	$20.49
Class B	10,065,353	29,214	1,255,580	12.8%	18,151	12,498	188,318	48,000	$15.70	$15.65
Class C	652,797	0	68,619	10.5%	370	-580	2,435	0	$11.88	$11.88

KEY LEASE TRANSACTIONS Q2 2020

PROPERTY	SUBMARKET	TENANT	SF	TYPE
4803 Olympia Park Plaza	Northeast	Undisclosed	34,388	Direct
10300 Ormsby Park Place	Hurstbourne / Eastpoint	Undisclosed	25,503	Direct
10200 Forest Green Boulevard	Hurstbourne / Eastpoint	Phia Group LLC	13,090	Sublease

KEY SALES TRANSACTIONS Q2 2020

PROPERTY	SUBMARKET	SELLER / BUYER	SF	PRICE / $ PSF
East End Office Portfolio	Plainview / Middletown	Ascent Properties LLC / Group RMC	515,000	$44M / $85

MARKETBEAT

LOUISVILLE

Office Q2 2020

OFFICE SUBMARKETS

Central Business District (CBD): Extends from River Rd. to York St. and from Hancock St. to Ninth St.

Old Louisville: Includes the downtown area immediately surrounding the CBD, as well as Old Louisville.

Hurstbourne/Eastpoint: Largest suburban market includes areas east of I-264, north of Shelbyville Rd. and south of Westport Rd.

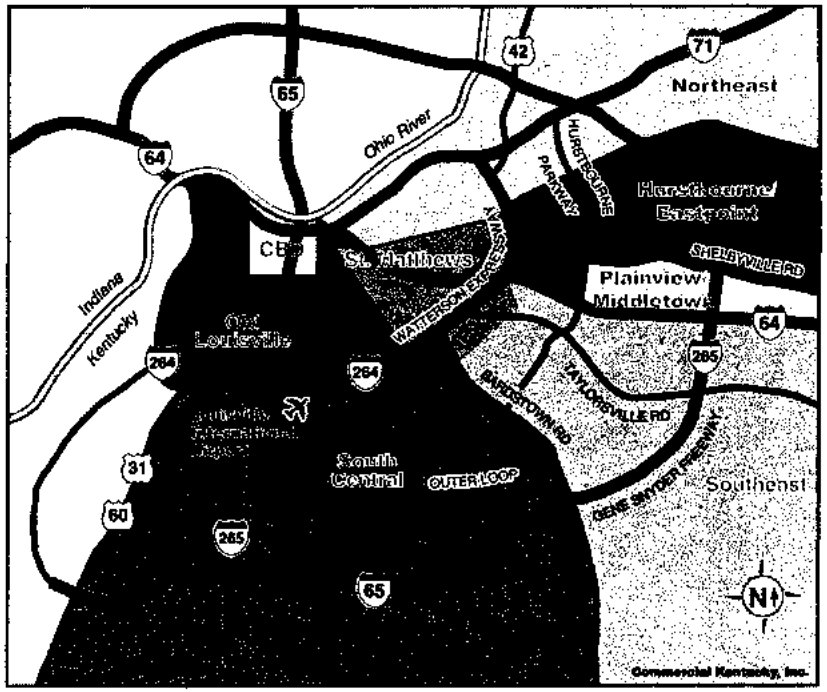
Plainview/Middletown: Contains the areas south of Shelbyville Rd., north of I-64 and east of Hurstbourne Pkwy.

Southeast: Includes the area along S. Hurstbourne Parkway, extending south from I-64 to Bardstown Rd.

Northeast: Embodies an area south of the Ohio River, north of Westport Rd. and east of I-264.

St. Matthews: Largely within I-264 and east of Bardstown Rd.

South Central: Encompasses an area southwest of Bardstown Rd. to Shively, which includes Louisville International Airport.



JOHNNY TOBE
Research Analyst
Tel: +1 502 589 5150
jtobe@commercialkentucky.com

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MARKETBEAT

LOUISVILLE

Industrial Q1 2020

U.S. ECONOMIC UPDATE

The arrival of the COVID-19 pandemic has created an economic shock that has likely pushed the global economy and the U.S. into recession. Policies initiated to "flatten the curve" of potential infection include the voluntary and mandated shutdown of large sectors and regions of the economy. Retail establishments, restaurants, passenger transportation, schools and leisure activities have almost all grinded to a halt while customers self-quarantine and practice social distancing.

RECORD-SETTING LAYOFFS, DECLINING EMPLOYMENT

Over the last two weeks (ending on March 28th), a cumulative 10 million people have applied for unemployment benefits—by far the largest number of applications in history since record-keeping began in 1967. Initial unemployment claims are a highly reliable leading indicator of trends in labor markets and therefore the economy at large. Given the size of the increase, along with other high-frequency data trends that are similarly bleak, it is widely believed that the U.S. economy has entered a recession. This was reinforced in early April when the Labor Department reported that payroll employment in the U.S. fell by 701,000 jobs in March, one of the largest declines in history. It's all but certain that even more jobs will be lost in the months ahead.

Given the way these events have unfolded and the huge number of layoffs, the current thinking among economic forecasters is that the second quarter of 2020 will see one of the largest real GDP declines in U.S. history. What is less clear is what the economic trajectory will be following Q2. As of this writing (4-7-2020), hopeful signs are emerging that policy steps to "flatten the curve" are beginning to work in certain areas, but many unknowns remain. It is too soon to say if these signs are sustainable and how they will impact the trajectory of the economy.

We continue to monitor developments extremely closely and are working around the clock to publish data and insight as quickly as possible.

To view our latest perspective on the coronavirus and its potential impact on CRE and the economy, access Cushman & Wakefield's COVID-19 resource page.

TRENDS AND INSIGHTS

Cushman & Wakefield Covid-19 Webinar Replay
Learn more on the evolving COVID-19 situation and its implication for **real estate occupiers and investors.**
Click to Replay

COVID-19: A Wholly Unprecedented Policy Response
On March 27, 2020, an enormous $2.2 trillion emergency coronavirus stimulus package was signed into law by President Trump. The legislative package—the Coronavirus Aid, Relief and Economic Security (CARES) Act—is the largest rescue package in U.S. history. Click for Summary

Lessons From Landlords In China's Post Covid-19 Recovery Phase
With local infections down, China is getting back to work. As the lights are turned back on in offices across the country, landlords and tenants alike are inevitably finding themselves in a new paradigm. Click for Article

2020 Asia Pacific Office Outlook
In this report, you will find detailed but succinct analysis of the trends in each of the region's key Grade A office markets over the next two years that we hope will help refine your organization's CRE strategy.
Click for Article

CUSHMAN & WAKEFIELD
WEEKLY COVID-19 UPDATES

MARKETBEAT

LOUISVILLE

Industrial Q1 2020

MARKET OVERVIEW

Leasing activity in the Louisville industrial market got off to a fast start with 1,241,424 square feet (sf) of space being leased in the first quarter. Warehouse/distribution buildings accounted for a majority of the leasing activity with 1,040,215 sf or 84% of total leasing activity. The submarket with the most leasing activity in the first quarter was the South submarket with a total of 600,722 sf.

Net absorption for the first quarter ended at positive 217,922 sf, which marked the 19th consecutive quarter of positive absorption. Bullitt County was the only submarket that experienced negative absorption with negative 495,233 sf of absorption. Haier fully vacated 611,000 sf on Omega Parkway which was the main cause for the negative absorption in Bullitt County this quarter.

The overall vacancy rate decreased 20 basis-points (bps) from 5.1% at the end of 2019 to 4.9% at the end of the first quarter. The West/Southwest submarket had the largest decrease in vacancy rate, from 3.9% to 3.0%, due to a 118,000 sf user sale. The vacancy rate in Bullitt County increased from 14.4% to 17.4% during the first quarter. This 300 bps increase can be attributed to the 611,000 sf Haier vacated.

Overall average asking rent ended the first quarter at $4.03 per square foot (psf), a decrease from the $4.21 psf at the end of 2019. The manufacturing average asking rent decreased from $3.38 psf to $3.24 psf while the warehouse/distribution average asking rent decreased from $4.18 psf to $4.04 psf. However, office service average asking rent increased from $8.20 psf to $8.34 psf.

BULK OVERVIEW

The Louisville bulk market finished the first quarter with 864,601 sf of leasing activity, which included three leases over 100,000 sf. Arvato leased 352,800 sf in the South submarket, Haier leased an additional 152,880 sf in the Southern Indiana submarket, and Amerisource Bergen leased 115,767 sf in the Bullitt County submarket.

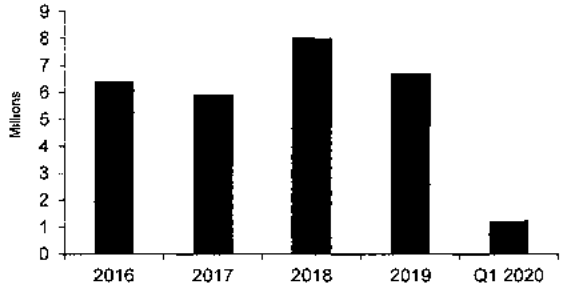
Net absorption in the bulk market was positive 62,560 sf for the first quarter despite the 611,000 sf vacated by Haier in Bullitt County. The South submarket, with positive 317,124 sf, was the submarket with the most positive absorption for the first quarter.

Construction remained rampant in the first quarter with an additional 942,118 sf of projects beginning since the end of 2019. The new construction started in the first quarter brought the total under construction in the bulk market to 5,463,645 sf with the majority being speculative construction. Although there was not any bulk construction completions in the first quarter, a handful of projects should be completed early in the second quarter. Additionally, a 708,500 sf speculative building developed by Van Trust in Southern Indiana and a 322,831 sf speculative building developed by Hunt Midwest in the East submarket will begin construction in April.

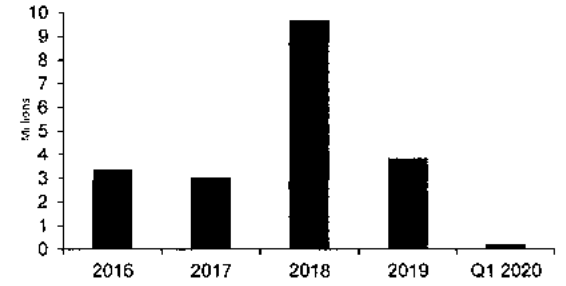
Overall vacancy rate in the bulk market decreased from 7.6% at the end of 2019 to 7.5% at the end of the first quarter. As new speculative construction comes to market, the overall vacancy rate will increase in the second quarter since there has been minimal preleasing.

Overall average asking rent increased from $4.01 psf to $4.03 psf during the first quarter. The overall average asking rent in the bulk market is up almost 3% from this time last year as more new construction continues to enter the market.

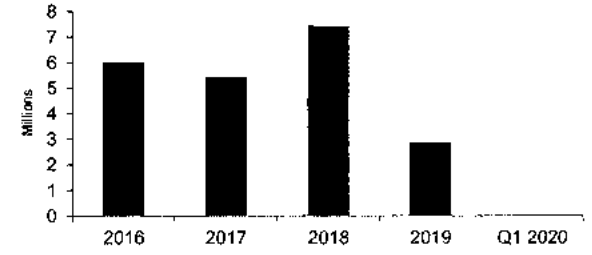
Leasing Activity – Overall (square feet)



Absorption – Overall (square feet)



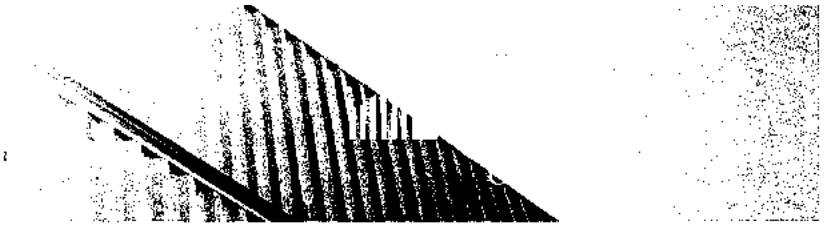
Construction Completions – Overall (square feet)



MARKETBEAT

LOUISVILLE

Industrial Q1 2020



MARKET STATISTICS

SUBMARKET	TOTAL BLDGS	INVENTORY (SF)	YTD USER SALES ACTIVITY (SF)	OVERALL VACANCY RATE	YTD OVERALL NET ABSORPTION (SF)	UNDER CNSTR (SF)	YTD CONSTR COMPLETIONS (SF)	*OVERALL WEIGHTED AVG. NET RENT (MF)	*OVERALL WEIGHTED AVG. NET RENT (OS)	*OVERALL WEIGHTED AVG. NET RENT (WD)
Central	**427**	**20,856,243**	**242,896**	**4.1%**	**86,780**	**0**	**0**	**$2.84**	**$7.23**	**$1.73**
Downtown	220	9,666,620	110,000	7.2%	86,780	0	0	$2.79	$5.84	$1.73
I-64	60	1,860,523	117,636	1.1%	0	0	0	N/A	$12.42	N/A
I-65	147	9,329,100	15,260	1.5%	0	0	0	$3.13	$8.03	N/A
East	**409**	**26,645,169**	**44,932**	**1.8%**	**38,035**	**0**	**40,000**	**$6.12**	**$9.11**	**$5.60**
Jeffersontown	266	12,926,645	44,932	2.7%	27,546	0	40,000	$9.96	$7.98	$5.52
Middletown / Eastpoint	81	3,682,921	0	1.9%	2,900	0	0	$5.62	$11.05	N/A
Westport Road	42	10,035,603	0	0.6%	7,589	0	0	N/A	$7.66	$5.95
South	**520**	**55,951,443**	**313,524**	**3.5%**	**166,626**	**1,646,897**	**0**	**$3.66**	**$6.50**	**$4.13**
Airport	184	30,632,866	313,524	3.1%	145,939	419,000	0	$3.41	N/A	$4.34
Bishop Lane	212	9,097,027	0	3.8%	-32,413	12,800	0	$3.96	$6.58	$3.87
Fern Valley	124	16,221,550	0	3.9%	53,100	1,215,097	0	N/A	$4.25	$3.98
West / Southwest	**181**	**21,930,713**	**118,000**	**3.0%**	**194,200**	**714,500**	**0**	**$1.03**	**$9.23**	**$3.69**
Iroquois	7	248,024	118,000	0.0%	118,000	0	0	N/A	N/A	N/A
Riverport	112	17,631,146	0	1.4%	76,200	714,500	0	N/A	$9.23	$3.69
Westend	62	4,051,543	0	10.4%	0	0	0	$1.03	N/A	N/A
Bullitt County	**63**	**16,291,297**	**0**	**17.4%**	**-496,233**	**2,205,258**	**0**	**N/A**	**N/A**	**$3.97**
Southern Indiana	**257**	**25,141,539**	**10,550**	**5.7%**	**227,684**	**1,009,790**	**0**	**$3.79**	**N/A**	**$3.83**
Floyd County	92	5,262,313	0	4.4%	-16,875	100,000	0	$3.95	N/A	$4.75
Clark County	165	19,879,226	10,550	6.0%	244,459	909,790	0	$3.77	N/A	$3.76
LOUISVILLE TOTALS	**1,857**	**166,816,404**	**729,902**	**4.9%**	**217,992**	**5,576,445**	**40,000**	**$3.24**	**$8.34**	**$4.04**

*Rental rates reflect asking $psf/year

MF = Manufacturing OS = Office Service/Flex W/D = Warehouse/Distribution

MARKET STATISTICS – BULK

SUBMARKET	TOTAL BLDGS	INVENTORY (SF)	YTD INVESTMENT SALES ACTIVITY (SF)	OVERALL VACANCY RATE	YTD OVERALL NET ABSORPTION (SF)	UNDER CNSTR (SF)	YTD CONSTR COMPLETIONS (SF)	YTD OVERALL LEASING ACTIVITY	*OVERALL WEIGHTED AVG NET RENT Q1 2019	*OVERALL WEIGHTED AVG NET RENT Q1 2020
Central	3	777,595	0	0%	0	0	0	0	N/A	N/A
East	24	4,948,430	0	1.7%	11,589	0	0	11,589	$5.95	$5.84
South	57	20,445,703	0	4.5%	317,124	1,634,097	0	448,645	$4.14	$4.34
West / Southwest	45	11,498,524	0	2.0%	76,200	714,500	0	135,800	$3.58	$3.69
Bullitt County	31	14,007,879	0	18.7%	-495,233	2,205,258	0	115,767	$3.95	$3.97
Southern Indiana	29	12,199,399	0	7.6%	152,880	909,790	0	152,800	$3.88	$3.81
LOUISVILLE TOTALS	**189**	**63,877,530**	**0**	**7.6%**	**62,660**	**6,463,645**	**0**	**864,601**	**$3.92**	**$4.03**

*Rates are defined by 100 CSF or more, Class A, B + Industrial and CBSER

MARKETBEAT

LOUISVILLE

Industrial Q1 2020

Key Lease Transactions – Q1 2020

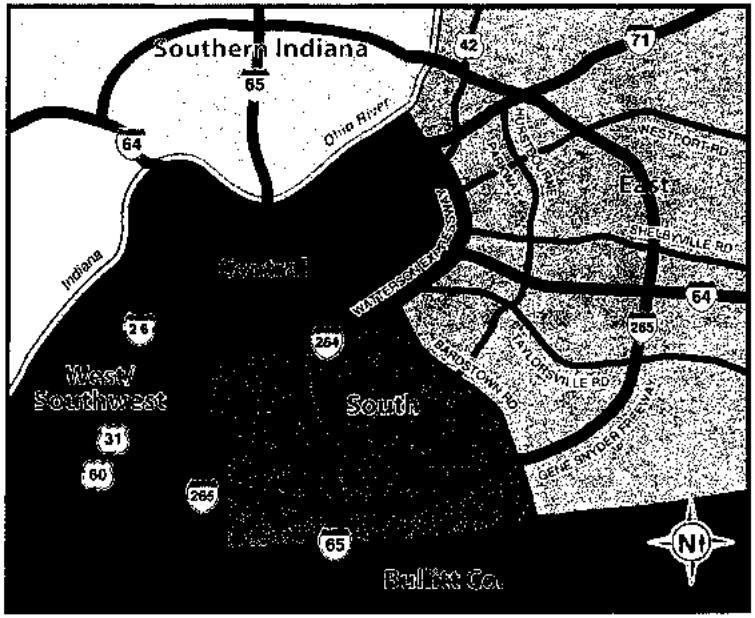
Property	SF	TENANT	TRANSACTION TYPE	SUBMARKET
2825 Transglobal Drive	352,800	Arvato	New Lease	South
201 Paul Garrett Avenue	152,880	Haier	New Lease	Southern Indiana
167 International Boulevard	115,767	Amerisource Bergen	New Lease	Bullitt

Johnny Tobe
Research Analyst
Tel: +1 502 589 5150
jtobe@commercialkentucky.com

Key Sales Transactions – Q1 2020

PROPERTY	SF	SELLER/BUYER	PRICE / $PSF	SUBMARKET
7110 Grade Lane	147,449	ISA Real Estate / River Metals Recycling	$4.3M / $29	South
3200 Pond Station Road	118,000	First Industrial LP / Copart	$7.8M / $66	West / Southwest

INDUSTRIAL SUBMARKETS



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MARKETBEAT

LOUISVILLE

Office Q1 2020

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The arrival of the COVID-19 pandemic has created an economic shock that has likely pushed the global economy and the U.S. into recession. Policies initiated to "flatten the curve" of potential infection include the voluntary and mandated shutdown of large sectors and regions of the economy. Retail establishments, restaurants, passenger transportation, schools and leisure activities have almost all grinded to a halt while customers self-quarantine and practice social distancing.

RECORD-SETTING LAYOFFS, DECLINING EMPLOYMENT

Over the last two weeks (ending on March 28th), a cumulative 10 million people have applied for unemployment benefits—by far the largest number of applications in history since record-keeping began in 1967. Initial unemployment claims are a highly reliable leading indicator of trends in labor markets and therefore the economy at large. Given the size of the increase, along with other high-frequency data trends that are similarly bleak, it is widely believed that the U.S. economy has entered a recession. This was reinforced in early April when the Labor Department reported that payroll employment in the U.S. fell by 701,000 jobs in March, one of the largest declines in history. It's all but certain that even more jobs will be lost in the months ahead.

Given the way these events have unfolded and the huge number of layoffs, the current thinking among economic forecasters is that the second quarter of 2020 will see one of the largest real GDP declines in U.S. history. What is less clear is what the economic trajectory will be following Q2. As of this writing (4-7-2020), hopeful signs are emerging that policy steps to "flatten the curve" are beginning to work in certain areas, but many unknowns remain. It is too soon to say if these signs are sustainable and how they will impact the trajectory of the economy.

We continue to monitor developments extremely closely and are working around the clock to publish data and insight as quickly as possible.

To view our latest perspective on the coronavirus and its potential impact on CRE and the economy, access Cushman & Wakefield's COVID-19 resource page.

TRENDS AND INSIGHTS

Cushman & Wakefield Covid-19 Webinar Replay
Learn more on the evolving COVID-19 situation and its implication for **real estate occupiers and investors.**
Click to Replay

COVID-19: A Wholly Unprecedented Policy Response
On March 27, 2020, an enormous $2.2 trillion emergency coronavirus stimulus package was signed into law by President Trump. The legislative package—the Coronavirus Aid, Relief and Economic Security (CARES) Act—is the largest rescue package in U.S. history. Click for Summary

Lessons From Landlords In China's Post Covid-19 Recovery Phase
With local infections down, China is getting back to work. As the lights are turned back on in offices across the country, landlords and tenants alike are inevitably finding themselves in a new paradigm. Click for Article

2020 Asia Pacific Office Outlook
In this report, you will find detailed but succinct analysis of the trends in each of the region's key Grade A office markets over the next two years that we hope will help refine your organization's CRE strategy.
Click for Article

CUSHMAN & WAKEFIELD
WEEKLY COVID-19 UPDATES

MARKETBEAT

LOUISVILLE

Office Q1 2020

CBD

The CBD office market started 2020 strong, reporting 116,212 square feet (sf) of leasing activity in the first quarter. Surprisingly, this first quarter number exceed the year end total of leasing activity in the CBD for 2018. This hot start to the year was highlighted by the Louisville Metro Government leasing over 51,000 sf to relocate some of their operations to the First Trust Centre. They will begin to move in to their new space during the second or third quarter.

Net absorption in the CBD for the first quarter was reported at negative 11,614 sf. Class A net absorption was reported at positive 7,170 sf and Class B reported negative 18,784 sf of net absorption. For the first time since the fourth quarter of 2018, CBD Class A net absorption was positive.

The vacancy rate rose 70 basis-points (bps) from 17.5% to 18.2% at the end of the first quarter. Class A dropped 30-bps to 19.5% where as Class B rose from 15.8% to 17.3%, a 150 bps increase.

CBD average asking rent decreased from $16.83 per square foot (psf) to $16.68 psf at the end of the first quarter. Class A average asking rent also decreased from the previous quarter, dropping from $18.81 psf to $18.74 psf. However, Class B average asking rents increased from $14.69 psf to $14.86 psf. Although overall average asking rent decreased this quarter, it is higher than the $16.44 psf observed at this point last year.

Suburban

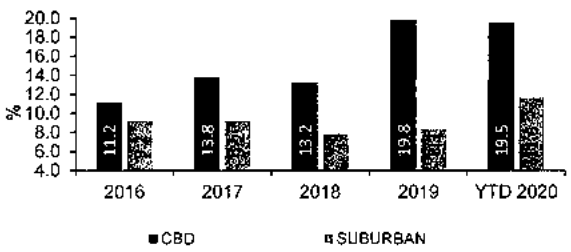
The suburban office market had another impressive quarter with regards to leasing activity. Overall, there was 192,171 sf of leasing activity with 122,568 sf of that in Class A properties. The Hurstbourne/Eastpoint submarket accounted for 42% of suburban leasing activity with 81,305 sf leased. Aperture and Clearpath leasing 28,713 sf and 20,416 sf respectively were the two largest leases coming out of the Hurstbourne/Eastpoint submarket this quarter.

Net absorption in the suburban submarket ended at negative 64,702 sf. Net absorption for Class A and Class B was negative 76,873 sf and positive 13,121 sf respectively.

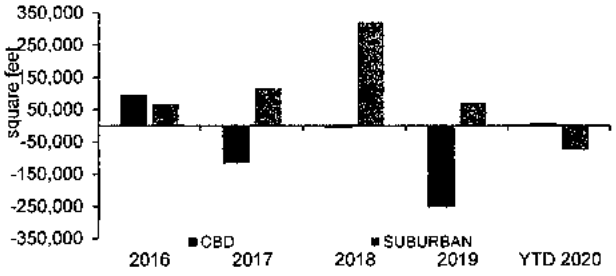
The suburban vacancy rate increased to 10.3%, up 170 bps from the end of 2019. The main cause for the increase was the completion of Olympia Two, a 135,917 sf building. The completion of this building also had an effect on the Class A vacancy rate as well as the Northeast submarket vacancy rate. Those vacancy rates increased to 11.6% and 17.2% respectively. However, some leasing activity has already occurred in the building which will drop the vacancy rates when tenants begin to move in later in the year.

Suburban average asking rent increased from $19.35 psf to $20.14 psf. Class A suburban average asking rent increased from $22.12 psf to $22.55 psf while Class B average asking rent decreased from $16.78 psf to $16.72 psf. Additionally, the Southeast, Northeast, and St. Matthews submarkets all saw an increase in average asking rent from the previous quarter with the biggest change occurring in the Northeast submarket. The Northeast average asking rent jumped up to $25.32 psf from $22.25 psf last quarter due to the completion of Olympia Two.

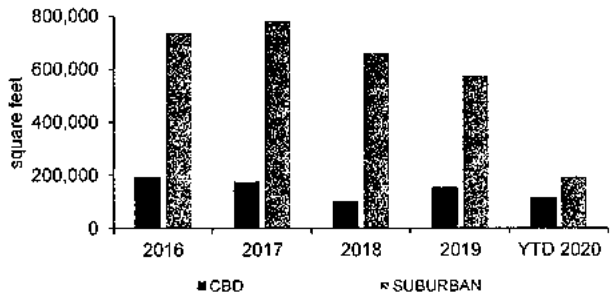
Class A Overall Vacancy Rates – CBD & Suburban



Class A YTD Overall Net Absorption – CBD & Suburban



YTD Leasing Activity – CBD & Suburban



MARKET STATISTICS

SUBMARKET	INVENTORY (SF)	SUBLET VACANT (SF)	DIRECT VACANT (SF)	OVERALL VACANCY RATE	CURRENT QTR OVERALL NET ABSORPTION (SF)	YTD OVERALL NET ABSORPTION (SF)	YTD LEASING ACTIVITY (SF)**	UNDER CNSTR (SF)	OVERALL AVG ASKING RENT (ALL CLASSES)*	OVERALL AVG ASKING RENT (CLASS A)*
CBD	8,990,632	29,214	1,589,543	18.2%	-11,614	-11,614	116,212	0	$16.68	$18.74
SUBURBAN	11,688,977	46,945	1,152,892	10.3%	-64,702	-64,702	192,171	167,011	$20.14	$22.55
Old Louisville	399,940	0	56,224	14.1%	0	0	0	0	$16.18	N/A
Hurstbourne / Eastpoint	4,907,307	44,003	466,712	10.4%	-87,038	-87,038	81,305	167,011	$21.75	$22.12
Plainview / Middletown	1,457,721	0	225,469	15.5%	12,829	12,829	26,435	0	$17.41	$21.00
Southeast	1,182,652	0	30,427	2.6%	2,451	2,451	6,079	0	$16.66	$17.00
Northeast	896,861	0	154,305	17.2%	16,273	16,273	41,863	0	$25.32	$25.49
St. Matthews	1,402,562	2,942	109,929	8.0%	-9,217	-9,217	5,429	0	$16.69	$22.03
South Central	1,441,934	0	109,826	7.6%	0	0	31,040	0	$16.51	$18.50
LOUISVILLE TOTALS	20,579,609	76,159	2,742,435	13.7%	-76,316	-76,316	308,383	167,011	$18.23	$20.67

**Rental rates reflect full service asking*

***Does not include renewals*

	INVENTORY (SF)	SUBLET VACANT (SF)	DIRECT VACANT (SF)	OVERALL VACANCY RATE	CURRENT NET ABSORPTION (SF)	YTD OVERALL NET ABSORPTION (SF)	YTD LEASING ACTIVITY (SF)*	UNDER CNSTR (SF)	DIRECT AVERAGE ASKING RENT*	OVERALL AVERAGE ASKING RENT*
Class A	9,861,459	44,866	1,401,784	14.7%	-69,703	-69,703	152,595	119,011	$20.75	$20.67
Class B	10,065,353	31,293	1,271,652	12.9%	-5,663	-5,663	155,788	48,000	$15.61	$15.56
Class C	652,797	0	68,989	10.6%	-950	-950	0	0	$11.86	$11.86

KEY LEASE TRANSACTIONS Q1 2020

PROPERTY	SUBMARKET	TENANT	SF	TYPE
200 South Fifth Street	CBD	Louisville Metro	51,160	Direct
1951 Bishop Lane	South Central	Norton Healthcare	31,040	Expansion
9960 Corporate Campus Drive	Hurstbourne / Eastpoint	Aperture	28,713	Direct
4803 Olympia Park Plaza	Northeast	Sprint	23,341	Direct
9960 Corporate Campus Drive	Hurstbourne / Eastpoint	Clearpath	20,416	Direct

KEY SALES TRANSACTIONS Q1 2020

PROPERTY	SUBMARKET	SELLER / BUYER	SF	PRICE / $ PSF
100 Mallard Creek Road	St. Matthews	WMRBNA Fund III LLC / Lakeview Mead LLC	76,999	$11M / $143

MARKETBEAT

LOUISVILLE

Office Q1 2020

OFFICE SUBMARKETS

Central Business District (CBD): Extends from River Rd. to York St. and from Hancock St. to Ninth St.

Old Louisville: Includes the downtown area immediately surrounding the CBD, as well as Old Louisville.

Hurstbourne/Eastpoint: Largest suburban market includes areas east of I-264, north of Shelbyville Rd. and south of Westport Rd.

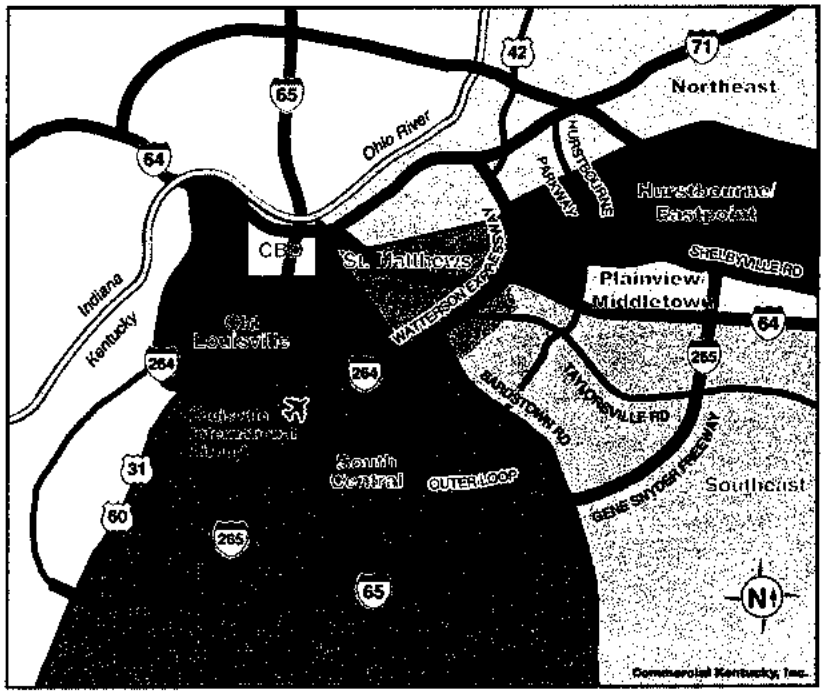
Plainview/Middletown: Contains the areas south of Shelbyville Rd., north of I-64 and east of Hurstbourne Pkwy.

Southeast: Includes the area along S. Hurstbourne Parkway, extending south from I-64 to Bardstown Rd.

Northeast: Embodies an area south of the Ohio River, north of Westport Rd. and east of I-264.

St. Matthews: Largely within I-264 and east of Bardstown Rd.

South Central: Encompasses an area southwest of Bardstown Rd. to Shively, which includes Louisville International Airport.



Johnny Tobe
Research Analyst
Tel: +1 502 589 5150
jtobe@commercialkentucky.com

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