

TO: Judge
FROM: Maggie
DATE: 9 August 1982
RE: Late charges (18%) in Taylor v. Mapco

You felt the 18% was out of line and you instructed the parties to brief the issue of late charges payable on the loan from First Maryland Leasecorp to Taylor, (which will be at least partially off-set by the amount recovered from Mapco).

Both Taylor and Leasecorp have briefed the issue.

Leasecorp, I believe, has the better of the argument: that the late charges are a valid part of the loan contract and should be enforced.

TAYLOR'S ARGUMENTS:

1. Leasecorp waived its option of having Md. law apply.

Clearly this isn't the case. We should use Md. law if it applies. Suing in Ky. shouldn't be a waiver of right to have proper law apply just because the proper law is not Ky. law.

2. Ky. law should govern because to apply Md. law would violate Ky. public policy.

On first reading, I thought this sounded like a good argument: Ky. has, by statute, voiced its policy against usurious interest (interest over a statutory amount), and we shouldn't enforce a contract against Ky. public policy.

However, see Headnotes 10 & 11 in Big Four Mills, Ltd. v. Commercial Credit Co., (Ky, 1948), (copy attached):

"Usury laws are not so distinctive a part of the public policy of the forum that the courts will, on the ground of public policy, decline to enforce any contract which would be invalid, if tested by them, though valid according to its proper law."

This Big Four Mills case is right on point and is still good law.

In this case, Ky. citizen borrowed from Md. lender. The parties stipulated in their agreement that Md. law would apply. Under Md. law, the amount of interest sought was not usurious, but under Ky. law it was usurious. Court held that Md. law applied, there being no indication that the parties acted in bad faith in making the agreement which prescribed Md. law.

(CONTINUED)

LEASECORP'S ARGUMENTS:

1. Leasecorp did not waive application of Maryland law by "choosing to adjudicate this matter in Ky."

Good argument. See above.

2. Application of Maryland law would not be against Kentucky public policy.

Again, see Big Four Mills.

3. Even if Kentucky law did apply, the statutes cited as showing the permissible maximum interest allowable don't apply to a lender like Leasecorp.

KRS 287.215 - applies to banks and trust companies. Leasecorp says it is neither, and says further that this statute is no expression of Ky. policy against interest like the interest in issue here: says purpose of statute was to give banks incentive to make small consumer loans, (citing Ky. Atty. General opinion).

KRS 291.500 - applies to industrial loan corporations. Leasecorp says it's not such a corp.

4. Maryland law should apply.

This appears correct. The parties agreed at the outset that Maryland law should govern their transaction. I haven't seen indication that parties were in bad faith when they so agreed. And to apply Maryland law would not violate Kentucky public policy.

5. Maryland law would provide for enforcement of the 18% late charge.

This also appears correct. See the Maryland statutes and the case supplied by Leasecorp appended to its memo.

THE BOTTOM LINE:

1. Maryland law should apply.
2. Maryland law apparently allows for the 18% late charges. Taylor has not argued to the contrary.

Judge:
You told them to brief the issue of late charges. Now Π & intervening Π have tendered briefs on prejudgment interest on the recovery from Mapco as well. Mapco objects to the filing of briefs on that issue.

check depo
re: nature of Co.

- Ky. Med. law
- late charges v. usury interest?
- Ky law state: late charges accrue if
- Ky def of lumb + trust co.

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
PIKEVILLE

CIVIL ACTION NO. 80-95

RODNEY E. TAYLOR, et al.

PLAINTIFFS

and

FIRST MARYLAND LEASECORP

INTERVENING PLAINTIFF

VS.

ORDER

MAPCO, INC.

DEFENDANT

* * * * *

For purposes of completing the record prior to trial of
this action, and the Court being sufficiently advised,

IT IS HEREBY ORDERED

That defendant MAPCO's pre-trial memorandum, tendered
May 21, 1981, be FILED, and

That plaintiffs' reply to defendant's counterclaim,
tendered November 21, 1980, be FILED,

On this _____ day of _____, 1982.

G. WIX UNTHANK, JUDGE

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
PIKEVILLE

CIVIL ACTION NO. 80-95

RODNEY E. TAYLOR, et al.
and
FIRST MARYLAND LEASECORP

PLAINTIFFS
INTERVENING PLAINTIFF

VS.

ORDER

MAPCO, INC.

DEFENDANT

* * * * *

Plaintiff Taylor has tendered a cross-claim in the above-styled action against Intervening Plaintiff First Maryland Leasecorp. First Maryland Leasecorp has opposed the amendment of plaintiff's complaint to include the cross-claim.

At the heart of the cross-claim is a debt owing from Taylor to First Maryland Leasecorp. Taylor says that Leasecorp alleged at trial an amount of \$6,229,562.30 owing to it, but that this was a total surprise to Taylor. Taylor says that, since Leasecorp undertook to pay his legal fees, Taylor was without representation at trial as to issues between himself and Leasecorp. So, Taylor seeks to amend by adding a cross-claim.

Leasecorp, in its opposition to the proposed amendment to the pleadings, argues that Taylor knew all along that Leasecorp would claim payment of the debt. It appears to the Court that Leasecorp's original pleading, its intervening complaint and cross-claim, did indeed raise the issue of Taylor's debt to Leasecorp. Considering, then, the state of the pleadings at the time of trial, there was no need for Taylor to be surprised at the evidence presented concerning his debt to Leasecorp. At this late date, an amendment to raise a cross-claim would not be in order.

For the reasons stated above, and the Court having been sufficiently advised,

IT IS HEREBY ORDERED

That plaintiff's motion for leave to amend its complaint be OVERRULED

On this _____ day of _____, 1982.

G. WIX UNTHANK, JUDGE

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
PIKEVILLE

CIVIL ACTION NO. 80-95

RODNEY E. TAYLOR, et al.
and
FIRST MARYLAND LEASECORP

PLAINTIFFS
INTERVENING PLAINTIFF

VS.

ORDER

MAPCO, INC.

DEFENDANT

* * * * *

There having been no objection voiced by other parties,
and the Court being sufficiently advised,

IT IS HEREBY ORDERED

That plaintiff's post-trial brief be FILED

On this _____ day of _____, 1982.

G. WIX UNTHANK, JUDGE

Judge -
I have to agree with
this brief. I think
they're entitled to 18%
Grey

Judge v. Casey

FILED JUL 21 1982

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
AT PIKEVILLE

Civil Action No. 80-95

RODNEY E. TAYLOR

PLAINTIFF

FIRST MARYLAND LEASECORP

INTERVENING PLAINTIFF

v.

MEMORANDUM OF INTERVENING PLAINTIFF
LEASECORP ON THE ISSUE OF LATE CHARGES

MAPCO, INC.

DEFENDANT

Preliminary Statement

This Memorandum is submitted pursuant to the Court's Order of July 8, 1982. Leasecorp's position is that the contract provisions for late charges are valid.

STATEMENT OF POINTS AND AUTHORITIES

1. Taylor was indebted to Leasecorp in the sum of \$6,229,562.30 as of May 10, 1982, with interest and late charges continuing to accrue 1
2. Taylor is a Virginia resident, having his principal place of business in Virginia. Leasecorp is a Maryland corporation with its principal place of business in Baltimore, Maryland. The loans are payable in Baltimore. The documents provide that Maryland law governs 1-2
3. Both statute and case law require application of Maryland law 2-3
KRS 355.1-105 2
Consolidated Jewelers, Inc. v. Standard Financial Corp., 325 F.2d 31 (6th Cir. 1963). 2
Big Four Mills v. Commercial Credit Co., Ky. 211 S.W. 2d 831 (1947). 3
Malone and Hyde, Inc. v. Maxwell, Ky., 557 S.W. 2d 908 (1977). 3
4. The 18% late charge is valid under Maryland law. 3-4
Maryland Com. Law Anno., §12-101, et seq 3-4
B. F. Saul Co. v. West End Park N., Inc., 250 Md. 707, 246 A. 2d 591 (1968). 4
5. Even if Kentucky law were applicable, the 18% late charge would be valid. 4-5
KRS 287.215. 4
KRS 291.480. 4-5
KRS 291.500. 4
OAG 78-221. 4
KRS 291.410 5
KRS 291.460 5

STATEMENT OF FACTS

The undisputed evidence in the Record shows that on May 10, 1982, at the commencement of trial, Taylor was indebted and in default to Leasecorp in the total sum of \$6,229,562.30 (Leasecorp Trial Exhibits Nos. 7, 12 through 18). This is composed of the principal indebtedness of \$3,716,527.86, accrued and unpaid interest to May 10, 1982 of \$1,566,681.75, and unpaid late charges to that date of \$946,352.69.

Leasecorp's loans to Taylor are set out in four loan and security agreements and the promissory notes made pursuant to the agreements. (Leasecorp Trial Exhibits 13 through 18). All of the agreements recite that Rodney E. Taylor had his principal place of business in Virginia. All recite that Leasecorp is a Maryland corporation, having its principal place of business in Baltimore, Maryland.

Paragraph 5(h) of the loan and security agreements dated July 26, 1977, February 22, 1979 and May 7, 1979 (Leasecorp Trial Exhibits 13, 14 and 17) provides that the proceeds of the loans will be used exclusively for business or commercial purposes. Paragraph 11 of each of those agreements provides that it is to be governed by laws of Maryland.

The promissory notes taken in connection with these agreements provide that Taylor is to pay on demand an 18% late charge on each overdue installment and further provide that the notes are repayable in Baltimore, Maryland and are governed by Maryland law.

The loan and security agreement of August 1, 1979 recites that Taylor's principal place of business is Virginia and that Leasecorp is a Maryland corporation, having its principal place of business in Baltimore. Paragraph 1(e) provides that any amount payable under the note or under the agreement shall

bear interest at 18% on any overdue amount. Paragraph 4(f) provides that the loan proceeds are to be used for the refinancing of the borrower's previously existing indebtedness, and Paragraph 14 provides that it is to be governed by the laws of Maryland. (Leasecorp Trial Exhibit 18). The promissory notes executed in connection with this agreement are repayable at Baltimore, Maryland.

STATEMENT OF THE ISSUES

Whether the Late Charge Provisions of the
Loan Documents between Taylor and Leasecorp
Are Enforceable

ARGUMENT

1. The Law of Maryland Governs the Enforceability of the Late Charge Provisions

The promissory notes and security agreements were made in Maryland between Leasecorp, a Maryland corporation, having its principal place of business in Baltimore, Maryland, and Taylor, a Virginia resident. The notes are payable in Baltimore, Maryland. The documents provide that they shall be governed by the laws of Maryland. Kentucky's only connection with the agreements between Taylor and Leasecorp is as the forum of this litigation.

Parties to a contract may stipulate in the contract as to what law governs. Section 1-105 of the Uniform Commercial Code, KRS 355.1-105, provides that parties to a transaction under the Uniform Commercial Code may agree as to what law governs their transaction, except for certain instances enumerated therein, none of which is applicable in this case.

The case law uniformly supports the view that Maryland law governs. In Consolidated Jewelers, Inc. v. Standard Financial Corp., 325 F. 2d 31 (6th Cir. 1963), a New York lender lent money to a Kentucky borrower under a contract providing that it was to be governed by the law of New York. The bor-

rower filed suit in Kentucky, claiming the contract violated the Kentucky usury statute. The Sixth Circuit held that the law of New York controlled, because the parties had agreed to its application, and the contract would be enforced according to its terms, even though it may have violated the Kentucky usury statute. The Court held that the parties may choose what law is to apply to a contract so long as the transaction was entered into in good faith.

In Big Four Mills v. Commercial Credit Co., Ky., 211 S.W. 2d 831 (1948), a Maryland lender lent money to a Kentucky borrower under a contract providing that it was to be governed by the laws of Maryland. The contract provided for a rate of interest which violated Kentucky's usury laws. The Court held that where residents of different jurisdictions contract for the loan of money, they are at liberty to regard it as a contract of either state and to stipulate for the higher rate of interest allowable in either. The Court held that Kentucky's usury law should not be used to impair a contract entered into in good faith under the laws of another state having a different statutory policy. See also Malone and Hyde, Inc. v. Maxwell, Ky., 557 S.W. 2d 908 (1977), holding that where a promissory note and security agreement provided that Tennessee law controlled, Tennessee law was dispositive.

2. The 18% Late Charge Is Valid under Maryland Law

The issue of late charges under Maryland law is governed by the Maryland interest and usury law, Maryland Commercial Law Annotated, §12-101, et seq, which provides that with respect to commercial loans over \$5,000, the parties can agree to any rate. §12-103(e). Section 12-101(c) provides that "a commercial loan" is a loan made to carry on a business or is a loan made to any business or commercial organization.

Under the Maryland statutory scheme, late charges on such loans are considered interest. Section 12-101(e) defines interest as follows:

" 'Interest' means, except as specifically provided in Section 12-105, any compensation directly or indirectly imposed by a lender for the extension of credit for the use or forbearance of money, including any loan fee, origination fee, service and carrying charge, investigator's fee, time-price differential, and any amount payable as a discount or point or otherwise payable for services."

Under this definition, a late charge would be interest, because it is compensation for the extension of credit.

B. F. Saul Co. v. West End Park N., Inc., 250 Md. 707, 246 A.2d 591 (1968).

The only mention of late charges per se in the Maryland Statute appears in 12-105(3), providing that a late charge of up to 5% may be collected and not considered interest. However, under the Saul case and under 12-101(e), any late charge in excess of 5% would be interest and be subject to no limitation.

3. Even If Kentucky Law Were Applicable,
the 18% Late Charge Provision Would Be
Enforceable

It has been suggested that under Kentucky law late charges in the instant case might be limited by either KRS 287.215 or KRS 291.480. Clearly, neither of these sections applies to Leasecorp.

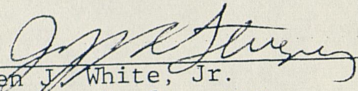
KRS 287.215 applies only to banks and trust companies. Leasecorp is neither. In any event, KRS 287.215 is a small loan statute enacted in the days when the legal rate of interest was 6% to avoid the usury statute and to give banks incentive for making small consumer loans. See Kentucky Attorney General's Opinion, OAG 78-221.

KRS 291.480 and 291.500 limit delinquency charges that

may be collected by industrial loan companies. Leasecorp is not an industrial loan corporation. Such a company must be licensed as such and is prohibited from making a loan in excess of \$10,000. KRS 291.410 and KRS 291.460. An industrial loan company is a small loan company. These statutes simply have no application to Leasecorp.

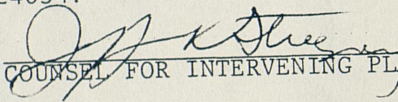
BOEHL STOPHER GRAVES & DEINDOERFER

BY


Galen J. White, Jr.
Jefferson K. Streepey
2300 United Kentucky Building
One Riverfront Plaza
Louisville, Kentucky 40202

COUNSEL FOR INTERVENING PLAINTIFF
502 589 5980

I hereby certify that a copy of the foregoing Memorandum of Intervening Plaintiff Leasecorp on the Issue of Late Charges was mailed this 20 day of July, 1982 to Hon. Ben B. Fowler, Stites, McElwain & Fowler, 200 McClure Building, Frankfort, Kentucky 40601; Hon. Donald H. Vish, Wyatt, Tarrant & Combs, 1100 Kincaid Towers, Lexington, Kentucky 40607; and Hon. James G. Park, Buchanan, Ingersoll, Rodewald, Kyle & Berger, 57th Floor, 500 Grant Street, Pittsburgh, Pennsylvania 15219., and Hon. John G. Rocovich, Jr., First National Exchange Bank Bldg., Roanoke, VA 24034.


COUNSEL FOR INTERVENING PLAINTIFF

355.1-104. Construction against implicit repeal.—This chapter being a general act intended as a unified coverage of its subject matter, no part of it shall be deemed to be impliedly repealed by subsequent legislation if such construction can reasonably be avoided. (Enact. Acts 1958, ch. 77, § 1-104, effective July 1, 1960.)

Kentucky Law Journal. Whiteside, Lincoln Bank Case, 50 Ky. L. J. 61 (1961).
Lewis, Kentucky's Commercial Code—Some Initial Problems in Security, The

DECISIONS UNDER PRIOR LAW

1. Repeals by Implication.

Repeals by implication were not favored, and a statute would not be construed as repealing a prior statute unless it was so clearly repugnant as to admit of no other reasonable construction. *Tipton v. Brown* (1939), 277 Ky. 625, 126 S. W. (2d) 1067. See *Demunbrun v. Browning* (1949), 311 Ky. 71, 223 S. W. (2d) 372.

Collateral References. 15 Am. Jur. (2d), Commercial Code, § 3.

Applicability of constitutional requirement that repealing or amendatory statute refer to statute repealed or amended, to repeal or amendment by implication. 5 A. L. R. (2d) 1270.

355.1-105. Territorial application of the act—Parties' power to choose applicable law.—(1) Except as provided hereafter in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such agreement this chapter applies to transactions bearing an appropriate relation to this state.

(2) Where one of the following provisions of this chapter specifies the applicable law, that provision governs and a contrary agreement is effective only to the extent permitted by the law (including the conflict of laws rules) so specified:

Rights of creditors against sold goods. KRS 355.2-402.

Applicability of the article on bank deposits and collections. KRS 355.4-102.

Bulk transfers subject to the article on bulk transfers. KRS 355.6-102.

Applicability of the article on investment securities. KRS 355.8-106.

Policy and scope of the article on secured transactions. KRS 355.9-102 and 355.9-103. (Enact. Acts 1958, ch. 77, § 1-105, effective July 1, 1960.)

Kentucky Law Journal. Young, Scope, (1960); Cullen, Conflict of Laws Problems and Functions of the Uniform Commercial Code, 48 Ky. L. J. 191 (1960).
Code, 48 Ky. L. J. 417 (1960).

DECISIONS UNDER PRIOR LAW

ANALYSIS

1. Contracts.
2. Indorsements.
3. Conditional sales contracts.

1. Contracts.

Matters bearing upon the execution, the interpretation, and the validity of a contract were determined by the law of the place where the contract was made. Matters connected with its performance were regulated by the law prevailing at the place of performance. Matters respecting the remedy, such as the bringing of suits, admissibility of evidence, statutes of limitation, depend-

ed upon the law of the place where the suit was brought. *Scudder v. Union Nat. Bank* (1875), 91 U. S. 406, 23 L. Ed. 245.

While there was occasional conflict of authority as to which law prevailed where the contract was made in one state and was to be performed in another, the authorities were uniform that where the contract was not only made in one state but by its terms was to be performed there, its validity had to be determined by the laws of the state where it was made and was to be performed. *Arnett v. Pinson* (1908), 33 K. L. R. 36, 108 S. W. 852.

"There being no language, either in the statute or committee report, which denies tax free treatment under Section 355 to a transaction solely on the grounds that it represents an attempt to divide a single trade or business, the Commissioner's regulations which impose such a restriction are invalid, and can not be sustained." 33 T.C. at page 739.

Failing to find any ambiguity in the language of the statute, we do not consider the legislative history to offer any support to the position of the United States. In point of fact, such history as is presented to us by the briefs of the litigants appears clearly to support the contention of the taxpayer that Congress had no such purpose as is expressed in the Treasury Regulation.

We conclude that the trial court correctly determined that as applied to the facts of this case, Section 1.355-1(a) is invalid to the extent that it provides "Section 355 does not apply to the division of a single business."

The judgment of the trial court is affirmed.



CONSOLIDATED JEWELERS, INC.,
Plaintiff-Appellant,

v.

STANDARD FINANCIAL CORPORATION,
Defendant-Appellee.

No. 15173.

United States Court of Appeals
Sixth Circuit.

Dec. 5, 1963.

Action by Kentucky borrower against New York lender to recover for usury under money lending contract. The United States District Court for the Western District of Kentucky, Henry L.

Brooks, J., sustained motion which was to dismiss complaint for failure to state claim upon which relief could be granted but which was treated as a motion for summary judgment, and the borrower appealed. The Court of Appeals, Phillips, Circuit Judge, held that contract which provided that New York law would apply had vital elements associated with New York and had been entered into in good faith, that lender had right under contract to determine aggregate amounts of its advancements and to revoke borrower's authority to make collections on accounts receivable assigned lender, and that district court was not required to hear evidence as to averments relating to parties' real intentions and oral agreements not contained in written contract.

Judgment affirmed.

1. Contracts §144

General rule is that two parties to a contract can stipulate that contract will be controlled by law of a particular state which bears a reasonable relation to the transaction, but, under Kentucky law, vital element of contract must be associated with the particular state and transaction must have been entered into in good faith.

2. Contracts §144

Vital elements of money lending contract were connected with State of New York whose law was sought to be invoked by contract, and transaction was entered into in good faith, where contract had to be accepted by New York lender in New York, advances were made by deposits in Kentucky borrower's New York bank account and were secured by assignment of accounts receivable sent to New York, and assigned installment contracts were held in New York.

3. Usury §2(1)

Claim of bad faith cannot be made against foreign lender for purpose of making law of foreign state inapplicable to money lending contract which states that it is to be controlled by foreign state's law, even if lender thereby intends to avoid Kentucky usury laws, if

real situs of transaction is not in Kentucky, and lender's connections with foreign state are sufficient to justify contracting with reference to foreign state's laws. KRS 360.010(1), 360.020; General Business Law N.Y. § 374, subd. 1.

4. Usury ⇨2(1)

Under Kentucky conflict-of-law rule, Kentucky courts would apply New York law forbidding corporate party to complain or defend on ground of usury, where money lending contract which made New York law govern contract had vital elements connected with New York and had been entered into in good faith. General Business Law N.Y. § 374, subd. 1.

5. Courts ⇨359

Federal district court sitting in Kentucky was required to apply Kentucky conflict-of-law rule in determining whether New York law would apply to contract between New York corporation and Kentucky corporation.

6. Pawnbrokers and Money Lenders ⇨6

Lender had right to determine, in its sole discretion, aggregate amounts of its advances to borrower where money lender had expressly contracted to advance borrower up to 50% of unpaid balance of prime paper assigned to and held by lender.

7. Pledges ⇨28

Pledgee of accounts receivable has duty not to do any act which will damage value of pledged collateral.

8. Pawnbrokers and Money Lenders ⇨6

Lender had right to revoke borrower's authority to make collection on accounts receivable assigned lender, where money lending contract gave lender option to make collections directly from borrower's customers whose accounts had been assigned to lender.

9. Contracts ⇨143, 218

Court of Appeals will not remake contract or add a condition which was not written into it.

10. Interest ⇨2

Kentucky statute would not entitle borrower to receive interest on reserves

of accounts receivable held by lender under money lending contract which contained no provision for interest on reserves, where contract provided that New York law would apply, vital elements of contract were associated with New York, and transaction had been entered into in good faith. KRS 360.060.

11. Federal Civil Procedure ⇨2555

Disposal of case upon motion which was to dismiss complaint for failure to state claim upon which relief could be granted but which was treated as motion for summary judgment was proper, where matters outside pleadings were presented to and not excluded by court, and all parties had reasonable opportunity to present all pertinent material. Fed. Rules Civ.Proc. rule 12(b), 28 U.S.C.A.

12. Federal Civil Procedure ⇨887

General averments of conclusions stated in pleadings do not require district court to hear evidence where pleadings are at variance and inconsistent with unambiguous language of contract filed as an exhibit thereto and made a part thereof.

13. Pleading ⇨312

Under New York and Kentucky law, recitals of an exhibit attached to a pleading will govern when exhibit is foundation of a pleading if allegations of pleading vary from recitals of exhibits.

14. Evidence ⇨441(1), 461(1)

District court was not required to hear evidence as to averments set forth in complaint concerning real intention and oral agreements of parties to money lending contract, where the intentions and agreements were not contained in written contract.

15. Evidence ⇨441(1)

Under New York and Kentucky law, all prior and contemporaneous representations, negotiations and agreements on subject matter of a written contract are merged into the written instrument.

Irwin G. Waterman, Louisville, Ky.,
Carl Bensinger, Louisville, Ky., on brief;

Morris &
counsel, f

Thoma
Bullitt, 1
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Before
O'SULLI
Judges.

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Morris & Garlove, Louisville, Ky., of counsel, for appellant.

Thomas W. Bullitt, Louisville, Ky., Bullitt, Dawson & Tarrant, Louisville, Ky., of counsel, for appellee.

Before CECIL, Chief Judge, and O'SULLIVAN and PHILLIPS, Circuit Judges.

PHILLIPS, Circuit Judge.

This case involves a contract for the lending of money by appellee, a New York corporation, to appellant, a Kentucky corporation. The principal issue presented on this appeal is whether the contract is governed by the laws of Kentucky, under which the prescribed rate of interest is usurious,¹ or by the laws of New York, under which the rate of interest is lawful.²

Appellant operates retail credit jewelry stores in Louisville, Kentucky. Ninety-five per cent of its business consists of installment sales. Appellee is a commercial financial institution incorporated under the laws of New York, maintaining its only office in New York City, and is engaged principally in time sales financing and the lending of money secured by accounts receivable.

Appellee is not domesticated to do business in Kentucky, but was held by the District Court to have sufficient "minimal contacts" with Kentucky with regard to the transaction in question so as to be subject to substituted service of process upon the Secretary of State and so as to be within the jurisdiction of Kentucky courts.³

1. K.R.S. 360.010(1) fixes the maximum legal rate of interest in Kentucky at six per cent per annum. K.R.S. 360.020 provides that all contracts for more than the maximum legal rate of interest are void as to the excess over legal interest.

2. The New York General Business Law, § 374, subsection 1, provides that "No corporation shall hereafter interpose the defense of usury in any action." This statute eliminates any defense based on a plea of usury. *Elias v. Schwartz*, 22 Misc.2d 129, 201 N.Y.S.2d 223; *Margulis v. Messinger*, 34 Misc.2d 699, 210 N.Y.S.2d 855; *Central Trust Co. v. Simmons*

The contract, dated November 25, 1958, contains an express provision that it did not become effective until accepted by appellee at its office in New York and that "all transactions hereunder shall be governed and construed by the laws of the State of New York." An arrangement was provided for a revolving loan of money by appellee to appellant secured by a pledge of all accounts receivable owned by appellant at the time of the agreement and by all future accounts receivable arising out of retail sales of merchandise in the ordinary course of appellant's daily business during the existence of the contract. The rate of interest initially was fifteen and one-half per cent, and subsequently was increased to as much as seventeen and one-half per cent.

Appellant filed this suit in the Circuit Court of Jefferson County, Kentucky, and it thereafter was removed to the U. S. District Court on grounds of diversity of citizenship. Appellant sued to recover usury and for money damages totaling \$158,000, claiming: (1) that the law of Kentucky should be applied contrary to the express terms of the contract, and that the interest charges made by appellee were usurious under Kentucky law; (2) that the contract was harsh and oppressive and that appellee had acted in bad faith in reducing its advances to appellant while continuing to require an assignment of all of appellant's accounts, thereby damaging and destroying appellant's business; (3) that appellee maliciously had damaged appellant's business and impaired its accounts receivable po-

Motor Corp., 28 Misc.2d 826, 215 N.Y.S.2d 555; *Franklin Nat. Bank of Long Island v. Bush Prefabricated Structures, Inc.*, Sup., 219 N.Y.S.2d 281; *Rosenbaum v. Rose*, 35 Misc.2d 431, 230 N.Y.S.2d 742; *Yorktown Management Co. v. Record Realty Co.*, City Civ.Ct., 236 N.Y.S.2d 866; *Isle of Wight Co. v. Smith*, 51 Hun 562, 4 N.Y.S. 73.

3. See K.R.S. 271.385. The order of the District Court overruling appellee's motion to dismiss this action on jurisdictional grounds is not at issue on this appeal.

sition by demanding direct payment from appellant's customers on the assigned installment contracts without a proper explanation of the circumstances; and (4) that appellee was required under K.R.S. 360.060 to pay interest on the reserve of accounts receivable which it held.

The District Court sustained appellee's motion to dismiss the complaint for failure to state a claim upon which relief can be granted, treating it as a motion for summary judgment as provided in Rule 12(b), Federal Rules of Civil Procedure.

We affirm the judgment of the District Court.

[1] It is well established that two parties to a contract can stipulate that the contract will be controlled by the law of a particular state which bears a reasonable relation to the transaction. *Seeman v. Philadelphia Warehouse Co.*, 274 U.S. 403, 47 S.Ct. 626, 71 L.Ed. 1123; *Sheerin v. Steele*, 240 F.2d 797 (C.A.6); *Blackford v. Commercial Credit Corp.*, 263 F.2d 97 (C.A.5); Restatement, Conflict of Laws §§ 332a, 334d (Tent. Draft No. 6, 1960); Goodrich, Conflict of Laws § 111. This is the law of Kentucky, subject to two conditions or requirements for application of the rule: (1) some vital element of the contract must be associated with the state whose laws are designated to control, and (2) the transaction must have been entered into in good faith. *Big Four Mills, Ltd. v. Commercial Credit Co.*, 307 Ky. 612, 211 S.W. 2d 831.

[2] We find that more than one vital element of the contract in this case is connected with the State of New York, whose law is sought to be invoked. The contract by its terms was not effective until accepted by appellee in New York. Advances by appellee to appellant were made by deposits in appellant's bank account with the Chase Manhattan Bank in New York. The advances were secured by an assignment of accounts receivable sent each week to New York. All installment contracts assigned by appellant were held by appellee in fireproof files in New York.

Schedules made up in Kentucky were sent by mail to New York and accepted by appellee in New York. These "vital elements" closely parallel those involved in *Big Four Mills v. Commercial Credit Co.*, supra, and fully satisfy the standards prescribed in that case.

In the *Big Four Mills* case, the Court of Appeals of Kentucky stated as an additional standard that the transaction must have been entered into in good faith, saying that if its terms and the place of its making and performance were simply devices to evade the usury laws of Kentucky, the Kentucky court would not be bound to apply the law of Maryland which denies a corporation the defense of usury. The court then proceeded to hold that under a contract strikingly similar to the one here involved, an agreement between two corporations for payment of interest in excess of the maximum Kentucky rate did not constitute bad faith.

The good faith requirement, in this context, was well explained by Mr. Justice Stone: "The effect of the qualification [of good faith] is merely to prevent the evasion or avoidance at will of the usury law otherwise applicable, by the parties' entering into the contract or stipulating for its performance at a place which has no normal relation to the transaction and to whose law they would not otherwise be subject." *Seeman v. Philadelphia Warehouse Co.*, 274 U.S. 403, 408, 47 S.Ct. 626, 628, 71 L.Ed. 1123.

[3, 4] Here the parties did not stipulate a forum having no normal relation to the transaction. To the contrary, a number of vital elements of the contract were related to New York, as hereinabove set forth. As said by Judge Brooks, the District Judge, in this case:

"The *Big Four Mills* case demonstrates conclusively that no claim of bad faith can be made against a foreign lender, even one who intends to avoid Kentucky's usury laws; if the real situs of the transaction in question is not in Kentucky and if the nonresident lender's connections

with another state are sufficient to justify contracting with reference to the laws of that state. There is nothing devious about a New York corporation, having its principal place of business in New York, loaning money in New York under a contract negotiated in part and entered into in New York and to be performed in large part in New York, and the fact that the defendant had sufficient contact with this State to be amenable to process here does not alter the fact that this is essentially a New York transaction. New York law does not permit a corporate party to complain or defend on the ground of usury, *Isle of Wight v. Smith* [51 Hun. 562], 4 N.Y.S. 73 (Sup.Ct., 2d Dep.); 55 Am.Jr. [Jur.], Usury, Section 104, p. 395 (1946), and under the Kentucky conflicts-of-law rule her courts would apply the New York law in this case. *Big Four Mills Co. v. Commercial Credit Co.*, supra."

[5] We hold that this was a correct application of Kentucky law. Under the rule of *Klaxon Co. v. Stentor Electric Mfg. Co.*, 313 U.S. 487, 61 S.Ct. 1020, 85 L.Ed. 1477, the District Court was required to apply the law of the State in which it was sitting.

Appellant also asserts that it is entitled to damages on the ground that at the time of the making of the contract, "the appellee knew that the amount of its advances permissible under the contract would not permit the appellant to maintain its business" and that the action of appellee in curtailing the advances to appellant while taking as additional collateral all accounts receivable "effectively dried up the appellant's business."

[6] We agree with the holding of the District Court that appellee did not violate the contract by these actions. Under its express provisions, appellee agreed to advance to appellant up to fifty per cent of the unpaid balance of prime paper assigned to and held by appellee. Appellee had the right to determine, in its

sole discretion, the aggregate amounts of its advances.

[7] Appellant further complains that, after it had made demands upon appellee for usury and damages for allegedly wrongful actions, appellee notified obligors of accounts receivable and installment obligations to make future payments by mail directly to appellee's New York offices; and that as a result of such notices several hundred of appellant's customers have complained, refused to make payments, closed their accounts, sought out the Better Business Bureau, consulted attorneys, and otherwise indicated a state of confusion, a refusal to pay their accounts and dissatisfaction with appellant's stores. Appellant relies upon the principle that a pledgee of accounts receivable is under a duty not to do any act which will damage the value of the pledged collateral.

[8] As held by the District Court, the contract unquestionably gave appellee the right to revoke appellant's authority to make collections on assigned accounts. Appellee had the right under the contract, at its option, to make collections directly from those customers of appellant whose accounts had been assigned.

[9] The provisions of the contract in these respects are clear and unambiguous. This Court will not remake the contract or add a condition which was not written into it. *Pennsylvania Railroad Co. v. Chesapeake & Ohio R. Co.*, 229 F.2d 721, 726 (C.A.6). As said by this Court in *Columbia Gas Construction Co. v. Holbrook*, 81 F.2d 417, 419:

"We are not here concerned with the fairness of the arrangement. The court has no power to make a new contract for the parties, and to strain at construction where the terms are clear would be the writing of an agreement into which the parties had not entered."

[10] Further, we agree with the trial court that K.R.S. 360.060 does not entitle appellant to receive interest on the reserve of accounts receivable which it

held. The contract contains no provision for interest on such reserves, and, as held by the District Court, this Kentucky statute would no more apply to transactions under this New York contract than would the Kentucky usury laws. See *Big Four Mills v. Commercial Credit Co.*, *supra*.

[11-13] Finally, it is our opinion that the District Court properly disposed of this case on appellee's motion to dismiss the complaint for failure to state a claim upon which relief could be granted, treating the motion as one for summary judgment, matters outside the pleadings having been presented to and not excluded by the court, and all parties having been given reasonable opportunity to present all material made pertinent to such a motion. Rule 12(b), Federal Rules of Civil Procedure. General averments of conclusions stated in the pleadings do not require the District Court to hear evidence, when the pleadings are at variance and inconsistent with the clear and unambiguous language of the contract filed as an exhibit thereto and "made a part hereof as if fully copied herein." Both New York and Kentucky apply the general rule that in case of a variance between the allegations of a pleading and the recitals of an exhibit thereto attached, the latter will govern when the exhibit is the foundation of the pleading. *Kucker v. Gates Container Corporation*, 263 App.Div. 1006, 33 N.Y.S.2d 608, *aff'd*, 289 N.Y. 664, 45 N.E. 2d 170; *Ingram v. State Property & Buildings Commission*, 309 S.W.2d 169 (Ky.1958).

[14, 15] Likewise, the District Court was not required to hear evidence as to averments set forth in the complaint as to the real intentions and oral agreements of the parties not contained in the written contract. Under both New York law and Kentucky law, all prior and contemporaneous representations, negotiations and agreements on the subject matter of a contract are merged into the written instrument. See, e. g., *Saul v. Arthur Rosenberg Co.*, Sup., 109 N.Y.S.2d 589; *Bradford Co. v. Dunn*, 250 N.Y. 461, 166

N.E. 167; *Bennett v. Consolidated Realty Co.*, 226 Ky. 747, 11 S.W.2d 910, 61 A.L.R. 453; *Loveland, et al. v. Hays*, 208 Ky. 155, 270 S.W. 722.

The judgment of the District Court is affirmed.



QUALITY CASTINGS COMPANY,
Petitioner,

v.

**NATIONAL LABOR RELATIONS
BOARD, Respondent.**

No. 15223.

United States Court of Appeals
Sixth Circuit.

Dec. 7, 1963.

Employer petitioned the Court of Appeals to review and set aside an order of the National Labor Relations Board issued against the employer, and the Board filed a petition for enforcement of its order. The Court of Appeals, *Kalbfleisch*, District Judge, held that evidence was insufficient to sustain the finding of the Board that employer was motivated by a desire to discriminate against 64 striking employees, and that proof of such motivation is necessary.

Board's petition for enforcement of its order denied, and order set aside.

1. Labor Relations — 368

Failure of employer to include in eligibility requirements of profit-sharing plan 64 employees, who had not returned to work before official termination of strike, did not constitute per se violation of National Labor Relations Act and thus unfair labor practice, irrespective of motivation of employer in formulating plan. National Labor Relations Act, §§ 7, 8(a) (1, 3) as amended 29 U.S.C.A. §§ 157, 158(a) (1, 3).

MALONE AND HYDE, INC., Appellant,

v.

Kenneth R. MAXWELL and Robert G. King, Appellees.

Court of Appeals of Kentucky.

Nov. 11, 1977.

A creditor on refusal of payment of his account instituted action against the debtor, a grocery store operator, and a purchaser of the inventory, fixtures, cash and bank account of the store. Summary judgment was rendered by the Fayette Circuit Court, Civil Branch, Fifth Division, Charles M. Tackett, J., in favor of the plaintiff creditor on the ground of violation of the Bulk Sales Act. The grocery store operator and secured creditor appealed. The Court of Appeals, White, J., held that a security agreement incorporating a "future advances" clause also secures a separate open account between the parties for purpose of the security interest exemption from the Bulk Sales Act.

Reversed.

1. Secured Transactions ⇐111

Where note provided that it and all subsequent agreements were to be governed by law of Tennessee, Tennessee law was dispositive as to interpretation of language of promissory note and accompanying security agreement. T.C.A. § 47-9-204.

2. Secured Transactions ⇐114

Open account between grocery store operator and corporation came within future advances clause incorporated in security agreement which was assigned to such corporation, and open account as such was also secured by collateral named in the security agreement. KRS 355.6-103(3), 355.9-204(3); T.C.A. § 47-9-204.

3. Fraudulent Conveyances ⇐47

Where open account as such was secured by collateral named in security agree-

ment, transfer by debtor to assignee of the agreement was within exception to Bulk Sales Act. KRS 355.6-103(3), 355.9-204(3); T.C.A. 47-9-204.

William Miles Arvin, Nicholasville, for appellant.

John R. Adams, Hays & Moss, Lexington, for appellee, Kenneth R. Maxwell.

Thomas W. Miller, Miller, Griffin & Marks, Lexington, for appellee, Robert G. King.

Before WHITE, PARK and WINTER-SHEIMER, JJ.

WHITE, Judge.

This appeal concerns the question of whether a security agreement incorporating a "future advances" clause also secures a separate open account between the parties for purposes of the KRS 355.6-103(3) security interest exemption from the Bulk Sales Act.

The facts are quite simple and largely uncontroverted. On September 26, 1973, Robert G. King signed a promissory note and accompanying security agreement which was subsequently assigned to appellant Malone and Hyde, Inc. As defined in the security agreement, the term "secured party" included an assignee, such as Malone and Hyde, Inc., who was a holder of the security agreement. The security interest was perfected by filing in the Fayette County Court Clerk's office on October 23, 1973. The note and agreement were to secure the sum of \$369,200.00, which was obtained by King in order to purchase and operate a Pic Pac grocery store located in Lexington, Kentucky. The note provided that it and all subsequent agreements be governed by the law of Tennessee. The security agreement gave the secured party a security interest in various fixtures and appliances used in the store and:

including all of Debtor's inventory located in Pic Pac # 120, whether now in

existence or hereafter acquired, entered into or created, and any and all products or proceeds thereof, together with inventory returned or repossessed from sale, disposition or otherwise, and all other goods of the same class whether now owned or hereafter acquired by Debtor, and the proceeds thereof.

The security agreement also contained a future advances clause which stated that the above described collateral also secured the payment of:

(III) all other money heretofore or hereafter advanced by Secured Party to or for the account of Debtor at the option of Secured Party, and all other present or future, direct or contingent liabilities and indebtedness of Debtor to Secured Party of any nature whatsoever and any extensions or renewals thereof.

In September and October of 1975, Kenneth R. Maxwell supplied \$4,276.86 worth of merchandise to Robert King's Pic Pac store. On November 3, 1975, King defaulted on the payment of his obligation to Malone and Hyde. King accepted Malone and Hyde's proposal that he assign his interest in the inventory, fixtures, cash and bank account to Malone and Hyde, Inc. in exchange for their forgiveness of the balance of the September 12, 1973 note (\$204,348.00) and an open account in the amount of \$182,002.77.

Kenneth R. Maxwell demanded payment of the account, and upon a refusal to pay, instituted this action against both Robert G. King and Malone and Hyde, Inc. Maxwell alleged they were liable because of their refusal to pay for the merchandise and because they failed to comply with KRS 355.6-102, et seq. (Bulk Sales Law). Summary judgment was rendered in favor of Kenneth R. Maxwell against the defendants on the basis that the open account was not secured by the security agreement and therefore the assignment was made only partly in settlement of a security interest and as a result Malone and Hyde, Inc. was not entitled to the KRS 355.6-103(3) exemption. Malone and Hyde, Inc. has appealed.

[1] A preliminary matter needs to be disposed of first. Though neither party argued the law of Tennessee in the briefs or orally, it is clear that Tennessee law is dispositive as to the interpretation of the language of the promissory note and accompanying security agreement. However, after a comparison of the applicable law of Tennessee and Kentucky, we are persuaded that there would be no difference in the interpretation. See 8A *Tennessee Code Annotated* § 47-9-204 (1964). *Murdock Acceptance Corp. v. Jones*, 50 Tenn.App. 431, 362 S.W.2d 266 (1961). *Future Advance Clauses in Tennessee—Construction and Effect*, 5 *Memphis State L.Rev.* 586 (1975).

[2, 3] All the parties agree that the transfer between King and Malone and Hyde, Inc. was a bulk transfer. On appeal, Malone and Hyde, Inc. contends that the "future advances" clause in the security agreement covers the open account. Appellant argues that therefore the unpaid balance of the note and the open account were secured, and as a result, the transfer falls within the KRS 355.6-103(3) exception. We agree.

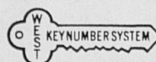
KRS 355.6-103(3) provides as follows:

The following transfers are not subject to this article:

(3) Transfers in settlement or realization of a lien or other security interest. KRS 355.9-204(3) provides for the inclusion of future advances clauses in the security agreement. We hold that the open account between King and Malone and Hyde, Inc. clearly comes within the future advances clause incorporated in the security agreement by the parties. As such, the "open account" is also secured by the collateral named in the security agreement and the transfer by King to Malone and Hyde, Inc. is within the exception to KRS 355.6-103(3).

The judgment is reversed.

All concur.



TITLE 12.

CREDIT REGULATIONS.

*Subtitle 1. Interest and Usury.***§ 12-101. Definitions.**

(a) *In general.* — In this subtitle the following words have the meanings indicated.

REVISOR'S NOTE

This subsection is new language used as the standard introductory language to a definition section.

(b) *Borrower.* — "Borrower" means a person who borrows money under this subtitle.

REVISOR'S NOTE

This subsection is new language added to indicate that, in this subtitle, the term "borrower" relates only to a person who borrows money under the provisions of this subtitle and not, for example, under any other credit law.

(c) *Commercial loan.* — "Commercial loan" means a loan which is made:

- (1) Solely to acquire or carry on a business or commercial enterprise; or
- (2) To any business or commercial organization.

REVISOR'S NOTE

This subsection is new language derived from former Article 49, § 7. It is added to make consistent the meaning of the term "commercial loan" as used in this subtitle, whatever the amount of the loan. Compare § 12-103 (e) (2) ("commercial loan in excess of \$5,000"); § 12-105 (b) (1) ("commercial loan secured by inventory or accounts receivable"); and § 12-105 (b) (4) ("commercial loan not in excess of \$5,000").

In paragraph (1) of this subsection, the term "commercial enterprise," which more closely conforms to the concept of "carry on a business," is substituted for the somewhat ambiguously broad term "commercial investment." No substantive change is intended.

The former specific reference to "a person . . . owning or desiring to acquire a business . . ." is deleted, therefore, as redundant.

With respect to § 12-103 (e) (2), a change may result from the revision of this subsection: A loan in excess of \$5,000 to a business or commercial organization will be exempt, whether or not it is made "solely to . . . carry on business." The Commission believes, however, that the quoted qualification, as it appeared in former § 7, was intended merely to apply to a "person . . . desiring to acquire a business," and not to any "business or commercial organization."

(d) *Effective rate of simple interest.* — "Effective rate of simple interest" means the yield to maturity rate of interest received or to be received by a lender on the face amount of a loan, computed in accordance with § 12-107 of this subtitle.

REVISOR'S NOTE

This subsection is new language added to clarify the meaning of the term "effective rate of simple interest" as used in this subtitle. It combines without substantive change the definition of that term contained in B.F. Saul Co. v. West End Park N., Inc., 250 Md. 707, 717 (1968), and, by cross-reference, provisions of

former Article 49, § 2 (b) — now § 12-107 of this subtitle — which relate to the computation of the interest rate when charges are assessed at the inception of a loan. See also revisor's note to § 12-107.

With respect to the limitation on the charging of points, see § 12-108.

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(e) *Interest*. — “Interest” means, except as specifically provided in § 12-105, any compensation directly or indirectly imposed by a lender for the extension of credit for the use or forbearance of money, including any loan fee, origination fee, service and carrying charge, investigator’s fee, time-price differential, and any amount payable as a discount or point or otherwise payable for services.

REVISOR’S NOTE

This subsection formerly appeared as Article 49, § 1 (a).

The last sentence of former § 1 (a), which states the “intention” to prohibit “discounting” or “add on” or similar devices is deleted as unnecessary in light of the provisions of § 12-108, and as inconsistent with § 12-107. In this regard, see *B.F. Saul Co. v. West End Park N., Inc.*, 250 Md. 707, 716 (1968).

The phrase “but not limited to” is deleted as unnecessary since use of the word “including” is not intended in any sense to be exclusionary or limiting; the maxim of expression *inclusio est exclusio alterius* and doctrines of similar implication are not intended, therefore, to be made applicable by reason of deletion.

The only other changes are in style.

Notwithstanding the reference to “time-price differentials”, the Attorney General has opined that this subtitle does not apply to true credit, or “time,” sales. 55 Op. Att’y Gen. 17 (1970); see also *Falcone v. Palmer Ford*, 242 Md. 487 (1965) and *Rothman v. Silver*, 245 Md. 292 (1967). This does not mean, however, that a transaction simply described as a “time sale” is exempt from the subtitle if, in reality, it is a disguised loan designed to circumvent the State usury laws. 55 Op. Att’y Gen. 17 (1970). Credit sales are regulated, *inter alia*, by the Retail Credit Accounts Law (Subtitle 5 of this title), the Retail Installment Sales Act (Subtitle 6 of this title), and the provisions of Real Property, Title 10, Subtitle 1 relating to land installment contracts.

(f) *Lender*. — “Lender” means a person who makes a loan under this subtitle.

REVISOR’S NOTE

This subsection is new language added to indicate that, in this subtitle, the term “lender” relates only to a person who lends money under

the provisions of this subtitle and not, for example, under any other credit law.

(g) *Person*. — “Person” includes an individual, corporation, business trust, estate, trust, partnership, association, two or more persons having a joint or common interest, or any other legal or commercial entity.

REVISOR’S NOTE

This subsection is new language setting forth a broad, standardized definition of the word “person” as used in this article. It is a synthesis of the U.C.C. definitions of “person” and “organization” contained in § 1-201 (28) and (30)

of this article, except that the reference to “government or governmental subdivision or agency” is not included. This definition is in no way intended to change the existing law, merely to clarify it.

(h) *Point*. — “Point” means a fee, premium, bonus, loan origination fee, service charge, or any other charge equal to 1 percent of the principal amount of a loan which is charged by the lender at or before the time the loan is made as additional compensation for the loan.

REVISOR’S NOTE

This subsection is new language added to clarify the meaning of the term “point” as used in this subtitle. It combines without substantive change the definition of that term contained in *B.F. Saul Co. v. West End Park N., Inc.*, 250 Md. 707, 713 (1968), and provisions of former Article

49, § 2 (a) — now § 12-108 of this subtitle — which relate to the limitation on the charging of points. See revisor’s note to § 12-108. The words “at or before” are used in this subsection for purposes of clarity.

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simple interest" required by this subsection, as revised. Consequently, the net result of § 5 (c) can be more simply achieved by deletion of the "equal or substantially equal" requirement and omission of § 5 (c).

The provisions of former § 5 (a) (1) are deleted as unnecessary since they merely restate, albeit in somewhat different language, the requirements of § 12-106 (b) (1) (iii).

The only other changes are in style.

(d) *Loan guaranteed by federal agency — Federal maximum.* — A lender may charge interest at any rate not in excess of that permitted by federal law if the loan is:

- (1) Secured by a mortgage or deed of trust;
- (2) Insured or guaranteed in full or in part by the Federal Housing Administration, Veterans Administration, or any other federal agency or instrumentality; and
- (3) Made in full compliance with applicable federal law.

REVISOR'S NOTE

This subsection is new language derived without substantive change from former Article 49, § 12.

The former reference to federal "rules, regulations or directives" is deleted as unnecessary since it is encompassed within the general reference to "federal law."

The specific cross-references contained in former § 12, as well as the provision that the loan is permissible "unless otherwise provided in . . . this article [or] this Code", are deleted as unnecessary within the new structure of this subtitle.

(e) *Commercial and corporate loans — No maximum.* — A lender may charge interest at any rate if the loan is:

- (1) A loan made to a corporation; or
- (2) A commercial loan in excess of \$5,000.

REVISOR'S NOTE

This subsection is new language derived without substantive change from former Article 23, § 125 and former Article 49, § 7.

The word "charge" is substituted for "charge, contract for, and receive" to conform to the

usage elsewhere in this title. The right to charge presupposes the right to contract and receive, and no change of meaning is intended.

The term "commercial loan" is defined in § 12-101 of this subtitle.

(An. Code 1957, art. 23, § 125, art. 49, §§ 3, 5, 7, 12-14; 1975, ch. 49, § 3.)

Maryland Law Review. — For note on the usury laws and the corporate exception, see 23 Md. L. Rev. 51 (1963).

This section is constitutional. Penrose v. Canton Nat'l Bank, 147 Md. 200, 127 A. 852 (1925); Carozza v. Federal Fin. & Credit Co., 149 Md. 223, 131 A. 332 (1925).

It repeals usury statutes as to corporations. United Divers Supply Co. v. Commercial Credit Co., 289 F. 316 (5th Cir. 1923).

And it lays down a rule of substantive law applicable in whatever jurisdiction suit on a Maryland contract is brought. United Divers Supply Co. v. Commercial Credit Co., 289 F. 316 (5th Cir. 1923).

Charge of usury immaterial. — See Kinsey v. Drury, 146 Md. 227, 126 A. 125 (1924).

Individuals secondarily liable on corporate debt may not plead usury. — The denial of the right to plead usury extends to individuals who

become accommodation endorers, sureties or guarantors of a corporate borrower's loan contracts. Reamer v. Kessler, 233 Md. 311, 196 A.2d 896 (1964).

Lenders and corporate borrowers may agree on interest rate. — Lenders and corporate borrowers (including national banks) are free to agree upon interest rate. Penrose v. Canton Nat'l Bank, 147 Md. 200, 127 A. 852 (1925); Carozza v. Federal Fin. & Credit Co., 149 Md. 223, 131 A. 332 (1925).

The effect of this section is to leave lenders and corporate borrowers free to agree upon any rate of interest above the regular limit. General Inv. Funds Real Estate Holding Co. v. Gildenhorn, 260 Md. 170, 271 A.2d 650 (1970).

Corporation formed for purpose of loan. — Where applicant for a loan was told that loan would be made only if a corporation was formed, and thereupon the applicant and his wife formed

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127 A. 852 (1925);
Credit Co., 149 Md.

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to agree upon any
limit. General
Holding Co. v.
A.2d 650 (1970).

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a corporation to which they conveyed their joint property which was used as security for the loan, the property then being reconveyed to them, held that wife (one of the incorporators) as successor to husband on his death, could not contend that the corporate form of the transaction was so unreal as to prevent the lender from asserting the provision of this section that no corporation shall interpose the defense of usury. *Rabinowich v. Eliasberg*, 159 Md. 655, 152 A. 437 (1930).

Decree for interest on overdue interest. — Where deed of trust securing corporation bonds provides for payment of interest on overdue interest installments, decree should make provision for interest as 6% on overdue and unpaid coupons, as corporation cannot raise question of usury. *Union Trust Co. v. Harrison's Nurseries, Inc.*, 181 Md. 291, 29 A.2d 668 (1943).

§ 12-104. Interest not considered usurious.

Interest at a rate otherwise allowed by this subtitle is not usurious solely because of any one or more of the following:

(1) For a period of less than one year, interest is calculated on the premise that there are 360 days in the year and 30 days in each month, which may include the date of the loan and the date due or paid;

(2) Interest on a periodic payment of principal is computed to the due date; or

(3) Except for loans made under § 12-103 (c):

(i) Interest-drop calculations are made on sums not in excess of multiples of \$100, without regard to interim partial payments; or

(ii) Interest-drop calculations are made on periods not in excess of one year, without regard to interim partial payments. (An. Code 1957, art. 49, § 4; 1975, ch. 49, § 3.)

REVISOR'S NOTE

This section formerly appeared as Article 49,

§ 4.

The only changes are in style.

§ 12-105. Charges not considered interest.

(a) *Governmental charges.* — Fees and charges collected at the direction of and actually paid to a government or governmental agency may be collected and are not interest under this subtitle.

REVISOR'S NOTE

This subsection is new language derived without substantive change from former Article 49, § 1 (b) (3).

(b) *Service, late, and prepayment charges.* — If the loan contract provides for them, the following fees and charges also may be collected and are not interest under this subtitle:

(1) A service charge for investigation and the continued servicing of collateral for a commercial loan secured by inventory or accounts receivable;

(2) A service charge made by a broker or dealer dealing in investment securities if:

(i) Money is advanced on the security of pledged investment securities; and

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(ii) Services are rendered in the collection, crediting, and disbursement of income on the investment securities and in the furnishing of income tax and other information in connection with that income;

(3) A delinquent or late charge of the greater of \$2 or 5 percent of the total amount of any delinquent or late periodic installment of principal and interest, if:

(i) The delinquency has continued for at least 15 calendar days; and

(ii) A delinquent or late charge has not already been charged for the same delinquency; and

(4) A prepayment charge or penalty on a prepayment of the unpaid principal balance of the loan, except that if the loan is secured by a home, by a combination of home and business property, or by agricultural property, or if the loan is a commercial loan not in excess of \$5,000, the charge or penalty:

(i) May be imposed only on prepayments made within three years from the date the loan is made; and

(ii) May not exceed an amount equal to two months' advance interest on the aggregate amount of all prepayments made in any 12-month period in excess of one-third of the amount of the original loan.

REVISOR'S NOTE

This subsection is new language derived without substantive change from former Article 49, § 1 (b) (1), (2), (4), and (5).

With respect to paragraph (1) of this subsection, "commercial loan" is defined in § 12-101 of this subtitle.

In paragraph (2) of this subsection, the technically more correct term "investment securities" is substituted for "securities." In this regard, see Title 8 of this article.

In paragraph (4) of this subsection, the phrase "not in excess of \$5,000" is substituted for

"under \$5,000." Section 12-103 (e) generally exempts commercial loans "in excess of \$5,000" from the provisions of this subtitle; a change, therefore, is required here to avoid an unintended gap with respect to a loan which is exactly \$5,000. Reference to a charge provided for in the "original contract" is deleted as unnecessary in light of the introductory language of this subsection; and the anomalous reference to "original mortgage" is corrected to refer to "original loan."

(c) *Actual expenses.* — The following charges, if actual expenses of the lender, also may be collected and, if not retained by him, are not interest under this subtitle:

(1) Charges by the lender's attorney for service rendered in connection with the preparation, closing, or disbursement of the loan;

(2) Charges for the payment of any property expense, tax, or governmental charge; and

(3) Charges for the payment of any premium and cost for insuring:

(i) The lender against loss or liability on or in connection with the loan; or

(ii) The life or health of the borrower.

REVISOR'S NOTE

This subsection is new language derived without substantive change from former Article 49, § 1 (b) (6).

The qualification "if not retained by him" is added to the general introductory language of this subsection to conform to the interpretation given this provision in *B.F. Saul Co. v. West End Park N., Inc.*, 250 Md. 707, 723 et seq. (1968):

"... [T]he determining factor, in the event of any ambiguity as to whether or not a fee or charge should be included as interest, is whether such charge is retained by the lender and, is so, it should be treated as interest." See also *Equitable Life Assurance Soc'y v. Insurance Commissioner*, 251 Md. 143 (1968).

session of the receptacle if the officers of the corporation had not have had access to it.

For these reasons, in my opinion, the trial court should have directed a verdict for the defendant on count 4.

I would reverse the judgment in this case.

B. F. SAUL COMPANY, ET AL. v. WEST END
PARK NORTH, INC., ET AL.

[No. 189 (Adv.), September Term, 1968.]

DECLARATORY JUDGMENTS—*Interest And Usury Law—Justiciable Controversy—Question Of Usury As To Corporate Parties May Be Moot However Valid Questions Presented Regarding Disclosure Provisions Of Act And Usury Provisions Applicable Under Ultimate Home Mortgage Financing To Individual Residential Property Owners.*
pp. 710-711

USURY—"Points" Defined—*Charge Or Fee Commonly Called "Points" To Be Computed Over Term Of Loan Not To Be Considered Interest Paid In Initial Year Of Loan—Not Usurious If Annual Effective Rate Of Simple Interest Does Not Exceed Eight Per Cent (8%).*
pp. 713-716

USURY—*Charging Of "Points" Prohibited With Regard To Conventional Home Mortgage Loans By Act But Not Eliminated As To FHA, VA Or Other Loans Guaranteed By Federal Government Where Maximum Interest Rate Not More Than Seven Per Cent (7%).*
pp. 716-717

INTEREST—*Effective Rate Of Simple Interest Required In Disclosure Statement Furnished To Borrower Pursuant To Sec. 10(a)(2) Of Act Refers To The Yield To Maturity Rate Received By Lender After Deducting Any Premium, Discount Or Points.*
p. 717

INTEREST—*Interest—Rate Of Interest Set Forth In Agreement Required By Section 3 Of Act Is Rate Of Interest Which Appears On Face Of Mortgage And Mortgage Note, If Latter Used.*
pp. 717-718

USURY—"Points" Charged To Seller—*No Difference, Where Charging Of "Points" Permitted, Whether "Points" Collected From Seller Or Borrower, Must Be Included Within Computation Of The Interest Rate.*
pp. 718-719

USURY—Prepayment Of Loan—If Annual Effective Interest Rate Within Legal Rate Of Interest, Lender Entitled To Accept Prepayment Of Principal Without Rebate—Where Borrower Exercises Option To Prepay, Transaction Not Usurious As Long As Interim Payments Of The Effective Interest Rate Would Have Been Legal In Contemplation Of Continued Payments To Maturity. pp. 719-720

USURY—Commercial Loans—Disclosure Provisions—Commercial Loans In Excess Of \$5,000 Are Exempt From Usury Regulations As Well As Disclosure Or "Truth In Lending" Provisions Of Act. pp. 720-722

USURY—Construction Loans—Disclosure Provisions Of Section 10(a)(2) Of Act Requiring Interest Rate Be "Stated In Percentage Calculated To The Nearest 2/10 of 1%" Complied With If Lender Sets Forth In Disclosure Statement The Maximum Amount Of Interest To Be Collected As Anticipated Under The Contract Of Indebtedness As Of The Date Of Its Execution. p. 722

USURY—Charges As Interest—Expenses Other Than Those Specially Enumerated And Excluded As Interest By The Act Shall Be Considered As Interest Determining Factor, In Event Of Ambiguity, As To Whether A Fee Or Charge Should Be Included As Interest Is Whether Such Charge Is Retained By Lender, If So It Should Be Treated As Interest. pp. 723-724

USURY—Charges As Interest—Appraisal Fees, Fees For Title Examinations, Commissions On Fire And Life Insurance If Retained By Lender Construed As Interest. pp. 727-728

Decided October 2, 1968.

Three appeals in one record from the Circuit Court for Prince George's County (POWERS, J.).

Bills for declaratory decree filed by West End Park North, Inc.; Bass Brothers, Inc. and Pettit & Griffin, Inc., whose business is residential construction, against B. F. Saul Company, Frederick W. Berens, Inc. and Weaver Bros. Inc., corporate

mortgage banking firms, seeking to have the court declare what the Legislature intended as to House Bill No. 11 (Chapter 453, Law of Maryland 1968) and requiring the defendants to carry out the terms of their commitments, were consolidated for trial and the State of Maryland was permitted to intervene.

From a decree requiring the mortgage banking firms to carry out their commitments, B. F. Saul Company, Frederick W. Berens, Inc. and Weaver Bros., Inc., appeal.

Decree affirmed in part, reversed in part and case remanded for the entry of a decree in accordance with this opinion: appellants and appellees to share costs equally.

The cause was argued before HAMMOND, C. J., and MARBURY, BARNES, McWILLIAMS, FINAN, SINGLEY and SMITH, JJ.

Hal C. B. Claggett, with whom were Thomas A. Farrington and Sasscer, Claggett, Powers & Channing on the brief, for appellants.

William L. Kahler, with whom were DeBlasis & Kahler on the brief, for corporate appellees.

Thomas A. Garland, Assistant Attorney General, with whom was Francis B. Burch, Attorney General, on the brief, for State of Maryland, other appellee.

Amicus curiae brief filed by Maryland Bankers Association. Norwood B. Orrick on the brief.

FINAN, J., delivered the opinion of the Court.

This is an appeal from a declaratory decree entered in equity by the Circuit Court for Prince George's County pursuant to the Uniform Declaratory Judgment Act Code (1967 Repl. Vol.), Art. 31A §§ 1-16 construing Chapter 453, 1968 Laws of Maryland (House Bill No. 11) which repeals §§ 1-16 of Art. 49 of the Maryland Code entitled "Interest and Usury" and replaces it with §§ 1-11. The new law, hereinafter referred to as the Act, had an effective date of July 1, 1968.

The three plaintiffs are corporations whose principal business is residential construction and development and the three defendants are corporate lenders. In each instance the defendant had entered into a contract with the plaintiff to supply it with money for the permanent financing of mortgage loans to be made to prospective home purchasers, either insured by the Federal Housing Administration (FHA), or guaranteed by the Veterans Administration (VA). In each instance the commitment was well in excess of a half million dollars (\$500,000).

Subsequent to the passage of the Act, each mortgage loan broker notified the developers that they could not honor their original financing commitment because of the ambiguity created by the Act with regard to the legal rate of interest, the computation of points and uncertainty regarding the judicial interpretation which might be given to certain fees and charges set forth in the Act and normally paid by the borrower or seller and at times retained by the lender. The purpose of the plaintiffs in the action below was to seek clarification of provisions of the Act, so that the loan commitments made on the part of the mortgage brokers might be specifically enforced by the developers. After answers were filed by the defendants the cases were consolidated in the court below and the Attorney General was permitted to intervene on behalf of the State of Maryland.

This Court is somewhat hard pressed to discern in these proceedings a justiciable matter because all parties are corporate entities whose common gravamen is the possibility of unwitting exposure to penalties attached to usurious interest as provided by § 3 of the Act. It was thought that Art. 23 § 125 of the Code (1967 Repl. Vol.) which provides "No corporation shall interpose the defense of usury in any action," provided an escape hatch which would exculpate the corporate plaintiffs from any usurious conduct and thus render the question of usury moot. However, we do acknowledge a valid question regarding the applicability of the disclosure provisions of the Act, commonly referred to as the "Truth in Lending" provision, found in Section 10, as the same may relate to the parties to this action and their transactions. We are also aware that the home mortgage financing ultimately contemplated by the par-

ties, and the purpose for which they have entered into a commitment agreement, would involve, in practically every instance, individual residential property owners to which transactions the provisions in the Act pertaining to usury, as well as disclosure, would be applicable. We therefore are of the opinion that we have a justiciable matter before us.

At the beginning of the 1968 Session of the General Assembly of Maryland, the Legislature addressed itself to the crisis precipitated by the demand for higher interest rates for home financing, induced by a tight money market, juxtaposed against Maryland's Usury Law (Code Art. 49, § 1) which established the maximum legal rate of interest at six per cent (6%).

To alleviate the situation, House Bill No. 11 was introduced which permitted the lender and borrower to agree to an interest rate not to exceed a legal maximum of eight per cent (8%). However, the Act coupled the raise in interest rates with certain restrictive provisions designed to regulate unscrupulous lenders, and by § 2(A) specifically prohibited the practice of charging "points," except for business or commercial borrowers of more than \$5,000 and in the case of " * * * any loan guaranteed or insured by FHA, VA or any other instrumentality of the Federal Government where the maximum interest rate is not more than 7%; * * * ." The Act also contained a "truth in lending" provision which required that certain disclosures be made by the lender to the borrower.

Long before the Governor's imprimatur was on the Act, home mortgage brokers were posing, not the metaphysical question of "how many angels may be balanced on the point of a needle," but the very mundane question of how many "points" may be charged at the inception of the loan while keeping the transaction within the framework of the legal maximum interest rate of eight per cent (8%). If for example, in the case of \$10,000 mortgage loan, bearing interest at six per cent (6%) per annum, payable over a 20 year term, a fee of five "points" were to be charged at the inception of the loan and the "points" were to be construed as interest payable during the initial year of the loan, the interest rate for the first year would be eleven per cent (11%) and obviously usurious. On the other hand, if the five "points" were to be computed or spread over the twenty

year life of the loan it would come within the permissive rate of the Act, as we shall later illustrate.

The legal acceptance of the spreading of "points" was the main issue presented to the court below and argued on appeal, however, the "truth in lending" or disclosure provisions of the Act, as well as the treatment to be given other items of expense attendant to the consummation of a mortgage financed real estate transaction, were challenged for ambiguity.

The consternation within the home mortgage market created by the possible legal construction which might be placed on various provisions of the Act, wrought little short of havoc.¹

For the sake of clarity our discussion of the Act will be divided into four categories: (1) the proper method for computing interest in determining if a given loan is usurious; (2) the treatment to be given interest when the loan is prepaid; (3) the nonapplicability of the disclosure provisions of the Act to commercial loans in excess of \$5,000 and the manner in which disclosure regarding the interest in construction loans may be met; (4) which of the many items involved in the settlement of a loan are required to be considered as interest and which are not.

The lower court in an able opinion by POWERS, J., specifically delineated answers to the problems encountered under the above categories with the exception of that of prepayment of the loan, under category 2. The primary question before the court below was the manner in which interest should be computed and we agree with its concept of the spreading of "points" over the

1. POWERS, J. in the opinion of the lower court described the disruptive influence caused by the passage of the Act on the mortgage loan market in the following graphic language:

"While accomplishing the important purpose of increasing the maximum legal rate of interest to 8%, the Act was not received by those concerned as a model of clarity or simplicity nor was there complete unanimity in the interpretation of its many provisions. Most out of state sources of substantial funds, including Federal National Mortgage Association, became unavailable, stagnation of the home building business was threatened, and many wondered if the Act would accomplish the purpose for which it was intended."

life of the loan in computing the effective interest rate. We further agree with the court's treatment of expenses collected by the lender at the time of the consummation of the transaction and its designation as to which items should or should not be construed as interest. However, we disagree with the court's conclusion that the disclosure provisions of the Act were intended to be applicable to commercial loans in excess of \$5,000. We shall discuss all categories seriatim.

I

All parties agree that the most troublesome problem raised by the Act is the manner in which "points" should be treated in context with the term "interest," "stated interest" and "effective rate of simple interest," all terms used rather inartistically, in various sections of the Act. To fully understand this problem a brief discussion of the anomalous term "points" should be helpful.

Our search reveals that there is no mysterious connotation to the word "point." It simply denotes a fee or charge equal to one per cent (1%) of the principal amount of the loan which is collected by the lender at the time the loan is made. It may be used interchangeably with the term "bonus," "premium," "loan origination fee" or "service charge." The basic tenet to remember is that it is a fee or charge which is collected only once, at the inception of the loan, and is in addition to the constant long term stated interest rate on the face of the loan.

This Court discussed the question of a "bonus" in *Birmingham v. Maryland Land and Homestead Association*, 45 Md. 541 (1876) and again we find the use of the term "premium" in *Washington National Building and Loan Association v. Andrews*, 95 Md. 696, 53 A. 573 (1902). Mr. James D. Laudeman, Jr., Chairman of the Legislative Coordinating Committee of the Savings and Loan Industry in Maryland, a member of the American Bar Association Committee on Real Estate, Probate and Trust Law and a member of the Governor's Study Commission on Interest and Usury Laws, testified as an expert witness on the custom and usage of "points" in the home mortgage finance industry in Maryland. He emphasized the acceleration given to the practice of exacting points since the

advent of the FHA and VA programs to the extent that today it is a term given universal acceptance in the lending industry throughout the country.²

One theory advanced in justification for charging "points" is the recoupment of the administrative or operating costs attendant to negotiating the loan. See 91 A. L. R. 2d 1392 *Anno: Usury-Procuring Money Loaned-Expense* § 3.

To bring into focus the tolerance allowable for "points" within the framework of the eight per cent (8%) legal maximum interest rate permitted by the Act, when dealing with FHA or

2. Excerpts from testimony of James D. Laudeman, Jr.: "With the introduction of the FHA and VA programs, however, the amount of the points or the amount of the premium that was paid rapidly became standardized at one per cent of the amount of the loan because the regulations issued by the two agencies both expressly allowed the lender to collect and the borrower to pay an amount equal to one per cent of the amount of the loan. VA Regulations, Section 36:4312, subsection (d), part I B, and FHA Regulations, Section 203.27, subsection (a) (2).

"Since the late 1940's the term 'point' has been a term of general usage in the mortgage lending industry to describe a fee or charge of one per cent of the amount of the loan collected at the time the loan is made but it was not until the Virginia Legislature early in 1968 enacted Section 6.1-319 of the Code of Virginia that the word had any legislative definition.

" * * * 'For the purpose of this section the term points is defined as the amount of money, or other consideration, received by the lender, from whatever source, as a consideration for making the loan and not otherwise expressly permitted by the statute.'

"So Virginia defined the term 'point' in putting it into their act.

"The Maryland Legislature then enacted House Bill 11 which makes several references to the word 'point' thus indicating that the term was intended to have the meaning generally associated with it in the industry.

"On May 29, 1968, the President of the United States signed Public Law 90-321, the 1968 Consumer Protection Act. Section 106 of that Act, in defining the term 'Finance Charge,' states that it consists of 'interest, time price differential, and any amount payable under a point, discount, or other system of additional charges.'

VA guaranteed or insured loans or those insured by any other instrumentality of the Federal Government as provided by § 2(A), we can employ no better example than that used by the lower court to illustrate both the problem and the answer.

Let us assume that the borrower has applied for a loan of \$10,000 bearing interest at the rate of six per cent (6%), with the interest and unpaid balance being paid in fixed monthly installments over a period of twenty (20) years, with a charge of five "points" being deducted by the lender. This \$10,000 loan with five "points" charged results in a five per cent (5%) discount applied to the principal sum and yields a \$9,500 net loan to the borrower.³

The borrower who thus receives a net of \$9,500 after deducting five "points" and pays back \$10,000, plus interest, in monthly installments over twenty (20) years is not paying the \$500 deducted from the face amount of the loan in the first year but is paying a small portion of this each month over the entire twenty (20) years.

The determinative factor as to whether or not the interest in such a case is usurious is the annual effective rate of interest (not to be confused with the term "stated interest"). If the annual effective rate of interest does not exceed eight per cent (8%) then it is not usurious and this annual effective rate of interest is computed as follows, again borrowing the example used by the court below:

"The dollar amount of interest payable during the life of the loan is ascertained by multiplying the amount of each monthly payment by the number of months and subtracting the net principal of the loan. Hence, in the case of a \$10,000 loan at six per cent (6%)

3. Section 2B of the Act: "In the event that charges or fees which, under this Article are deemed interest, are assessed at the inception of the contract of indebtedness, the rate of interest required in Section 10 of this Article shall be determined in the same manner as if fees and charges had not been assessed except that the principal of the loan used in determining the rate of interest shall be the face value of the loan less any fees or charges which are interest."

with five points deducted, payable over 20 years, with the fixed monthly payment of \$71.65:

\$71.65 X 240 (20 years X 12 mos.) = \$17,196.00
total paid by borrower

Less net loan after subtracting points deducted 9,500.00

Total dollar amount of interest paid for the use of \$9,500.00 during life of loan 7,696.00

The stated rate of interest in the note itself is ... 6%

The current yield to the lender, who receives interest at the rate of \$600.00 per year for a \$9,500.00 loan, is \$9,500.00 divided into \$600.00 = ... 6.31%

But because the lender not only receives a current yield of 6.31% but during the life of the loan also receives back the \$500.00 deducted from the face amount of the loan, he has a yield to maturity of ... 6.65%⁴

(6.65% being the annual effective rate of interest)

The 6.65% annual yield to maturity set forth in the above example is the annual effective rate of interest and is not usurious.⁵ Adopting the validity of the above illustration this Court concludes that the charge of a fee, commonly called "points" made at the inception of the loan, should not be considered interest paid in the initial year of the loan but is to be computed or spread over the term of the loan.

Although the Act manifests legislative hostility to the charging of points, as may be deduced from § 2(A), yet the language of § 2(B) expresses an expectation of the usage of points with regard to the FHA, VA and other federally insured or guaranteed loans. We do not think it was the intent of the Legislature that Maryland should be different from other jurisdictions, where such charges made at the inception of the loan, are not

4. Yield figure obtained from "Prepayment Mortgage Yield Table for Monthly Payment Mortgages," Sec. Ed., p. 338.

5. Were the 5 points to have been construed as interest during the initial year of the loan the transaction would be usurious as the interest during the first year would have been 11%.

construed as usurious when the amount obtained plus the interest actually charged spread over the life of the loan is less than the legal maximum interest. 57 A. L. R. 2d 649 *Anno: Usury-Interest In Advance* § 6. We think that the Legislature, although eliminating "points" with regard to conventional home mortgage loans, (§ 2(A)), did not intend to eliminate them with regard to FHA and VA loans, or other loans guaranteed by an instrumentality of the federal government where the maximum interest rate was not more than seven per cent (7%), but rather to regulate them. (§ 2(B)).

We think this Court also should attempt to resolve any ambiguities occasioned by the usage in various sections of the Act of the term "interest" (§ 1(A)), "simple interest" (§ 3) "effective rate of simple interest" (§ 10(a) (2)), and "stated rate" (§ 8 (2)) and their interrelation with each other.

"Interest" is defined in § 1(A) of the Act as follows:

"(A) The term interest as used in this Article means any compensation imposed directly or indirectly by a lender for the extension of credit for the use or forbearance of money, including but not limited to loan fees, service and carrying charges, discounts, interest, time-price differentials, investigators' fees and any amount payable under a point, discount, origination fee or other system of additional services except as specifically provided in this section. * * *

"Simple interest" is that paid on the principal lent as distinguished from compound interest which is interest paid on unpaid interest. See 47 CJS 11, § 1. The "effective rate of simple interest," as we have already stated, refers to the yield to maturity rate received by the lender after deducting any premium, discount or points. We think that the Legislature intended that this "effective rate" should be the rate recited in the disclosure statement which the lender must furnish to the borrower pursuant to § 10(a) (2).

Section 3 of the Act which provides that the interest rate, by written agreement between the borrower and the lender, may be

as high as eight per cent (8%) per annum simple interest on the unpaid balance requires that:

"* * * This agreement must set out the annual rate of interest which is charged, stated in percentage and be a separate instrument from the contract of indebtedness * * *."

It is our interpretation of the language used in § 3 that it was the intent of the Legislature that the rate of interest set forth in the agreement required by § 3 should be the rate of interest which appears on the face of the mortgage and mortgage note, if the latter is used. This would be the stated rate of interest. See also § 8(2). Referring to the example previously used in this opinion, it would be the six per cent (6%) item illustrated therein. Again, we emphasize that the test as to whether the loan is usurious would be the amount of the effective annual interest rate (yield to maturity) which in our example is 6.65%. This latter figure, as we have already stated, should appear in the disclosure statement.

Any discussion regarding the proper computation of interest and the treatment of "points" in relation to the rate would be incomplete without a clarification regarding "points" which are charged to the seller. We think that § 2(A) adequately covers this question and that it makes no difference whether the "points" are to be collected from the seller or the borrower insofar as their being included within the computation of the interest rate is concerned. The pertinent language in § 2(A) states "a charge or fee commonly called 'points' or mortgage origination fee, and *extracted by a lender from either the borrower or any other person* as additional compensation for the loan of money * * *." (Emphasis supplied.); obviously, the seller in any transaction comes within the definition of "any other person." The fact that § 2(A) specifically prohibits such charges with regard to conventional loans, that is, loans other than FHA, VA or those guaranteed by other federal instrumentalities where the maximum rate is not over seven per cent (7%), leaves but one conclusion and that is that points were to be permitted with regard to those loans guaranteed by FHA, VA or other federal instrumentalities and that "points" col-

lected from the seller must be incorporated in the computation of the interest rate. See Opinion of the Attorney General, June 7, 1968 (Daily Record June 18, 1968).

II

The question of the manner in which interest should be treated under the Act when the prepayment of the loan occurs was not pressed in the court below nor did the court discuss it in its opinion, however, we think it germane to the issues presented on this appeal. The problem which arises is that prepayment of the loan has the effect of increasing the interest yield to the lender and accordingly, depending upon the construction adopted, may render the loan usurious.

It must be remembered that the loan agreement between the lender and the borrower is prospective in its operation and it is reasonable to anticipate that there will be compliance with its terms. We are of the opinion that where the annual effective interest rate is within the legal rate of interest, there can be no question but that the lender is entitled to accept prepayment of all the outstanding principal without rebate. Such actually would be the case in the event of foreclosure of the mortgage lien. In cases where the loan contract provides for prepayment of the loan at the election of the borrower (FHA and VA mortgages provide for such an election) should the borrower exercise this option to prepay the loan and such action in fact renders the effective interest rate greater than eight per cent (8%), the transaction is not usurious as long as the interim payments of the effective interest rate would have been legal in contemplation of continued payments to the maturity specified in the contract/55 Am. Jur. 360, *Usury*, Sec. 48; 75 A. L. R. 2d 1265; 130 A. L. R. 73; 100 A. L. R. 1431; 84 A. L. R. 1283. See Opinion of the Attorney General, July 11, 1968 (Daily Record, October 1, 1968).

It would appear that the Legislature recognized the possibility of prepayment of the loan and intended that this could be accepted without requiring a rebate on the part of the lender. Section 1(B) (2) specifically provides that the collection of a prepayment penalty be allowed, where such is provided in the original loan contract, during the first three years of a loan se-

cured by certain types of property, including homes, and prohibits prepayment penalties thereafter. Section 1(B) (2) is silent as to any rebate requirements in the event of prepayment; this gains significance by contrast with § 5(a) wherein it is specifically provided, in case of loans not secured by real property, that rebate be made of any excess interest, by way of refund to the borrower or by a credit to his account, should an excess occur by reason of prepayment of a loan prior to maturity.

III

The question as to legislative intent regarding the application of the disclosure or "truth in lending" provision of the Act, § 10 raises two issues of general concern to the mortgage industry: (a) whether the disclosure provisions of § 10 apply to commercial loans in excess of \$5,000; and (b) the difficulty of accurate disclosure of interest in construction loans.

(a)

Section 7 of the Act specifically exempts from the disclosure provisions required by § 10 any loan in excess of \$5,000 made " * * * to any business or commercial organization or to a person or persons owning or desiring to acquire a business as a sole proprietor or joint venture, if the loan is transacted solely for the purpose of carrying on or acquiring a business or commercial investment, * * *." The lower court is of the opinion that although § 7 exempted the commercial loans described therein from the provisions regarding usury, that nonetheless commercial transactions were subject to the disclosure provisions set forth in § 10 of the Act. We disagree with the lower court's interpretation.

In order to divine the legislative intent behind the disclosure provisions of § 10, it is necessary to consider the primary objective sought to be achieved by the Act, which was to provide protection for the home buyer from sharp practices of some lenders. The entire rationale of the Act is predicated on the recognition of the naivete of laymen who do not engage in a sufficient number of mortgage transactions to acquire any degree of expertise and whose exposure is oft-times limited to a once in a lifetime mortgage contract. Clearly, protection for the vast majority of the public who fall into this category is needed

and can best be achieved by the disclosure statement required by § 10, which puts them on notice as to the rate and amount of interest they will pay, as well as other charges incident to the closing of the transaction, prior to the execution of the contract of indebtedness.

On the other hand the borrower for commercial purposes usually possesses a degree of sophistication regarding the practices of the market place and is prompted to make his deal where money is cheapest.

We think the lower court was overly impressed by the evidence concerning an earlier draft of § 10(a) of the Act which contained provisions requiring a written statement setting forth certain information and which excluded business and commercial loans from its application, and from which draft the words accomplishing the exclusion were ultimately stricken by amendment. The lower court concluded that the deletion of the words of exclusion indicated a legislative intent to subject commercial loans to the disclosure provision. We, however, are of the opinion that the reason the words exempting commercial loans from the disclosure provisions were stricken from the earlier draft of § 10, was for the reason that they constituted excess verbiage. The answer is simple, why should specific language be needed in § 10 to exclude commercial loans from the application of its disclosure provisions when such loans had already been excluded from the operation of the Act by § 7? We think § 7 goes that far and that it was the legislative intent that § 7 should have a broad effect. Section 7 commences with the clear introductory clause that reads: "7. Notwithstanding the other provisions of this article," and then proceeds to exclude commercial loans in excess of \$5,000.

It is true that the main thrust of § 7 is to cover the usury provisions of the Act; however, we think that the disclosure provisions of § 10 were included in the Act to fortify the control over interest sought to be achieved by § 7, *ergo*, since commercial loans in excess of \$5,000 are exempted from the usury regulations in § 7 there would be little or no practical benefit derived from subjecting such loans to the disclosure provisions of § 10, and we do not think the legislature intended such an exercise in futility.

29 =
§ 12-103(e)

We think the reading of the statute as a whole supports our conclusion regarding the nonapplication of the disclosure provisions to commercial loans exempted by § 7. We are not unmindful that this technique has frequently been employed by this Court.

"In ascertaining the intention of the legislature, all parts of a statute are to be read together to find the intention as to any one part, and all parts are to be reconciled and harmonized if possible." *McConihe v. Comptroller*, 246 Md. 271, 275, 228 A. 2d 432, 434 (1967), and cases cited therein."

(b)

In the case of construction loans, the industry shies away from the requirement in the disclosure provision of § 10(a) (2) which provides that the interest rate be "stated in percentage calculated to the nearest 2/10 of 1%." The mortgage brokers contend that a construction loan is a hybrid transaction providing for the release of mortgage money in stages as the construction advances and that both principal and interest are frequently subject to final adjustment. It is argued that the nature of the loan renders a precise determination of interest inordinately difficult, if not impossible, at the time the contract of indebtedness is executed. Not wanting to be accused of financial legerdemain, the lenders have asked for guidance which will give legal sanction to some elasticity in this area. In the lower court, Powers, J., was of the opinion that there would be compliance with the disclosure provisions of § 10, if the lender set forth in the disclosure statement the "maximum amount of interest 'to be collected' as anticipated under the contract of indebtedness as of the date of its execution, * * *."

We find the lower court's construction to be a practical and sensible solution to a problem which the lenders may have over-endowed with technicalities. One of the cardinal rules of statutory construction is that wherever possible an interpretation should be given to the statutory language which will not lead to oppressive, absurd or unjust consequences. *Kolb v. Burkhardt*, 148 Md. 539, 129 A. 670 (1925); *Bouse v. Hutzler*, 180 Md. 682, 26 A. 2d 767 (1942); *Rogan v. Baltimore & O. R. Co.*, 188 Md. 44, 52 A. 2d 261 (1947).

IV

Subsections 1(B) (1) through §§ 1(B) (5) of § 1(B) of the Act enumerate those charges which may be imposed by the lender and which by the express language of the Act are removed from the definition of interest. Subsection 1(B) (6) represents an attempt to set forth and limit actual legitimate expenses that have no relation to any compensation paid to the lender, and although §§ 1(B) (6) provides that any other expenses (than those listed in §§ 1(B) (6)) shall be considered interest, it must be construed as meaning that any other expenses other than those specifically enumerated and excluded from being interpreted as interest, in §§ 1(B) (1) through 1(B) (5), shall be considered as interest. In other words § 1(B) (6) must be read in harmony with §§ 1(B) (1) through 1(B) (5) and not as qualifying the items exempted from interest therein. *McConihe v. Comptroller*, 246 Md. 271, 275, 228 A. 2d 432, 434 (1967).

The parties to this action entered into a stipulation in the lower court, setting forth the various charges and fees collected by the lender and the manner in which they were customarily treated prior to the effective date of the Act. The court below elaborated in detail on each item set forth in the stipulation and the construction which should be given them when viewed in light of the charges and fees enumerated in §§ 1(B) (1) through 1(B) (6) of the Act. We think it did so with sufficient clarity to enable the parties to ascertain, by virtue of the guidelines given, whether a specific item set forth in the stipulation should, or should not, be included in the computation of interest. We adopt the lower court's classification of specific items as set forth in its order, with what we hope to be appropriate comment, by way of supplemental explanation. The main thrust of the lower court's rationale is that the determining factor, in the event of any ambiguity as to whether or not a fee or charge should be included as interest, is whether such charge is retained by the lender and, if so, it should be treated as interest. That such a construction is a projection of the intent of the Legislature becomes manifest upon reading the Act. The lower court in the following portion of its opinion expressed it well:

"All of the charges customarily made at the time of settlement and not retained by the lender appear to come within either § 1(B) (3), § 1(B) (4) or § 1(B) (6).

Conversely any charge retained by the lender is suspect and therefore deemed interest. A significant test is determining whether charges made to the borrower are to be deemed interest is whether or not they are retained by the lender. The intent obviously was that it is through 'padded' charges made by an unscrupulous lender that additional compensation for the use of the money could be realized."

The interest rates and points to be charged by the three appellants were as follows: B. F. Saul Company, $6\frac{1}{2}\%$ interest per annum and 5 points (1 point to be paid by the purchaser and 4 points by the seller), term of the loan 30 years; Frederick W. Berens, Inc., $6\frac{3}{4}\%$ interest per annum and $7\frac{1}{2}$ points (1 point to be paid by purchaser and $6\frac{1}{2}$ by seller), term of the loan 30 years; Weaver Bros., Inc., $6\frac{3}{4}\%$ interest per annum and 7 points (1 point to be paid by the purchaser and 6 points by the seller); all lenders intended to spread the points over the term of the loan. The lower court in the first four paragraphs of its decree found that an actual controversy exists and that in all three instances the commitment of the lenders (appellants) does not violate the interest and usury provisions of Chapter 453 of the Laws of 1968 of the General Assembly (House Bill No. 11).

The court proceeded in its decree to classify the various fees and charges itemized in the stipulation and the other issues raised by the parties. A proper understanding of what the lower court ordered in its decree and those portions of it with which we agree, requires us to set forth the remaining portion of the decree verbatim:

"5. That under Chapter 453 of the Laws of Maryland, 1968, the charge of a fee commonly called 'points' together with other charges which are considered as interest under the Act and which points and charges are made at the outset of the transaction should be

computed as interest over the term of the loan even though paid in the initial year of the loan.

6. That the interest rate to be stated in the agreement required in § 3 and the effective rate of simple interest to be stated as required by § 10(a) (2) is to be based on the full amount paid by the borrower for the use of the money.

7. That § 10 of Chapter 453 requires that the disclosure statement be furnished to borrowers in business or commercial transactions concluded under § 7 of said chapter.

8. That the provisions of § 10 apply to a construction loan when the length of time and dates of funding parts of the loan must await subsequent developments, and all that is required of the lender is to furnish the information on the basis of the provisions of the loan agreement as written, without responsibility to anticipate the various contingencies which might arise.

9. That § 1(B) (6) and the other provisions of § 1(B) are not in conflict but that the terms 'actual expenses collected by the lender are specifically enumerated in this section' as set forth in § 1(B) (6) includes those enumerated in § 1(B) (1) through § 1(B) (5).

10. That generally any charge made by a lender in connection with the loan, even though for one of the classes of expenses enumerated in § 1(B) (6), if retained by the lender constitutes interest under the Act.

11. That with specific reference to the items of expense before the Court in the present cases:

The cost of a Credit report not retained by the lender and required by FHA and VA loan procedures is within the terms of § 1(B) (6) (C) as a cost for insuring the lender 'against loss or liability on or in connection with the loan.'

The cost for Appraisal fees required by FHA and VA loan procedures is exempt from the calculation of interest under § 1(B) (3) and in other cases under

§ 1(B) (6) (C) provided the charge is not retained by the lender.

Title examination fees are not interest under § 1(B) (6) (C) provided the same are not retained by the lender.

Charges for preparation of deed of trust and note and title insurance charges not retained by the lender but paid to the persons furnishing the services and insurance are not interest under § 1(B) (6) (C).

Charges for recording the deed of trust and the recordation tax are paid to the Clerk of the Circuit Court under requirements of law and are not interest under § 1(B) (3).

Tax assessor's fee is a cost of acquiring the certificate as to the status of real estate taxes on the security property. It is a necessary expense and paid to a governmental agency and is not interest under § 1(B) (3).

Notary fee is a charge imposed by a public officer for the required acknowledgment of legal documents and is not interest under § 1(B) (6) (C).

Sums charged and retained in escrow by the lender on account of future taxes are held for the account of the borrower and are not to be considered interest.

Charges for fire insurance premiums, life or health insurance premiums and monthly payments to escrow accounts and renewals thereof, provided that such charges are actually paid to the insurer and are not retained by the lender, except during the period of any escrow accrual, are not interest.

Charges collected for FHA insurance premiums are collected at the direction of FHA, a governmental agency and constitute premiums for insuring or indemnifying the lender. They are not to be considered interest under either § 1(B) (3) or § 1(B) (6) (C).

Charges for the cost of a survey are necessary to securing an unqualified title certificate or title insurance policy and are not interest under § 1(B) (6) (C) when paid to the surveyor.

Charges for VA inspection fee and VA funding fee are requisite to the securing of a VA guarantee and are not interest under § 1(B) (6) (C); * * *"

The only portions of the decree with which we disagree are paragraph No. 7, wherein the court states that the disclosure provisions of § 10 of the Act applies to commercial loans in excess of \$5,000 (§ 7) and that portion of paragraph No. 6 relating to the manner in which interest shall be set forth in the loan agreement. For reasons stated in some detail elsewhere in this opinion we reverse those portions of the decree.

We should like to point out that the stipulation of the parties reveals that with regard to some items of cost the lender retains all or a portion of the fee. This practice should be modified to comply with the guidelines furnished by the court, should the lender desire that such charges not be computed as interest.

The FHA retains all of the appraisal fee and since this is a governmental agency this fee is specifically excluded from interest by virtue of § 1(B) (3). However, VA appraisals are not paid to the VA and in the case of Frederick W. Berens, Inc. and B. F. Saul Company, are retained by them as the appraisal is done by a staff appraiser on the lenders' payroll. In such a case the appraisal fee would be computed as interest.

Weaver Bros., Inc., on occasion does its own title work through house counsel and retains the fee. In such an instance this charge should be included in the interest. Also, a salaried house counsel of Weaver Bros., Inc., receives the fee for preparation of the deed of trust and note. Although the house counsel's salary is unrelated to the fees which he retains, since he is an employee of the lender, we construe this practice as retention by the lender and it should be construed as interest.⁶

6. We do not wish to further complicate this opinion by commenting on the question of the propriety of such an arrangement whereby lender's house counsel is paid for title work and preparation of instruments where the charge is made to the borrower, however, reference is made to § 47 of the "Canons of Professional Ethics of the American Bar Association" and the provisions regarding unauthorized practice of law found in Code Art. 27, § 14 (1967 Repl. Vol.)

Weaver Bros., Inc., and B. F. Saul Company are also licensed insurance brokers and retain a commission on fire insurance. Under such a practice the commission should be treated as interest.

All appellants in their role as lenders receive the benefit of life insurance commissions on some contracts, however, there is no requirement that the borrower obtain life insurance through any institutions made available by the lender. When commissions are actually retained by the lender such a commission should be included as interest.

For the reasons stated in this opinion the decree of the lower court is affirmed with the exception of paragraph No. 7, holding the disclosure provisions set forth in § 10 applicable to commercial transactions concluded under § 7 of the Act and that portion of paragraph No. 6 as to the manner in which interest should be stated in the loan agreement.

Decree affirmed in part, reversed in part and case remanded for the entry of a decree in accordance with this opinion: appellants and appellees to share costs equally.

PETITIONS FOR WRIT OF CERTIORARI
TO
COURT OF SPECIAL APPEALS
OF MARYLAND

deposited by such fiduciary with such federal reserve bank for its account as such fiduciary.

(2) This section shall apply to any fiduciary, and any custodian for fiduciaries, acting on June 21, 1974, or who thereafter may act regardless of the date of the agreement, instrument or court order by which it is appointed.

(3) As used in this section, "fiduciary" includes an executor, administrator, trustee under any trust, express, implied, resulting or constructive, guardian, conservator, receiver, trustee in bankruptcy, assignee for the benefit of creditors, partner, agent, officer of a corporation, public or private, public officer or any other person acting in a fiduciary capacity for any person, trust or estate. (Enact. Acts 1974, ch. 193, § 1; 1980, ch. 396, § 88, effective July 1, 1982.)

287.214. Rate of interest allowed on loans of \$15,000 or less. —

Notwithstanding the provisions of any other law, a bank, trust company or combined bank and trust company may take, receive, reserve and charge on money due or to become due on any contract or other obligation in writing, where the original principal amount is fifteen thousand dollars (\$15,000) or less, interest at any rate allowed national banking associations by the laws of the United States of America. (Enact. Acts 1979 (Ex. Sess.), ch. 17, § 1, effective February 13, 1979.)

287.215. Authority to charge interest in advance — Installment loans with interest in advance — Exceptions — Restrictions on installment loans. —

(1) (a) In addition to the powers heretofore granted, any bank or trust company or combined bank and trust company shall have the power to lend money repayable in installments; to charge or to receive in advance interest therefor in the case of a loan having a maximum maturity of not more than five (5) years and thirty-two (32) days; to contract for a charge for a secured or unsecured installment loan, and which under its terms shall be repayable in installments over a period of not exceeding ten (10) years and thirty-two (32) days, which charge shall be at a rate not exceeding eight dollars (\$8.00) per one hundred dollars (\$100) per annum upon the principal amount of the loan which charge or charges shall be for the entire period of the loan and may be collected in advance only if the maximum maturity of the loans does not exceed five (5) years and thirty-two (32) days.

(b) If the maturity of the loan exceeds five (5) years and thirty-two (32) days but does not exceed ten (10) years and thirty-two (32) days the charge of interest may not be discounted or received in advance but may be added on to the principal amount of the loan and shall not be discounted.

(c) If any scheduled payment or deferred payments are more than twice as large as the average of the earlier scheduled payments, the debtor and creditor shall agree that the debtor has the right to finance the amount of such payment or deferred payments at the time they are due without penalty. The terms of the refinancing which are agreed to by the debtor and the creditor shall be no less favorable to the debtor than the terms of the original loan.

(2) In addition to the charge permitted by this section, no further amount shall be directly or indirectly charged, contracted for, or received on any such installment loan, except lawful fees actually paid to a public officer for filing, recording, or releasing any instrument securing the loan and delinquent charges as hereinafter set out, and except an investigation fee not exceeding one dollar (\$1.00) for each fifty dollars (\$50.00) or fraction thereof upon the first eight hundred dollars (\$800) of the principal amount of such loans.

(3) Delinquency charges may be made not to exceed five cents (5¢) for each dollar of each installment more than ten (10) days in arrears, and only one (1) delinquency charge shall be made on any one (1) installment. No delinquency charge shall exceed five dollars (\$5.00) on any one (1) installment. In addition to such delinquency charges, attorney's fees not exceeding fifteen percent (15%) of the unpaid balance and court costs may be collected, provided that the note is referred to an attorney not a salaried employee of the holder for collection.

(4) The lending institution shall permit the borrower to repay his loan in whole or in part at any time. If a loan is paid in full prior to maturity, the lending institution shall make a rebate at a rate not less than in accordance with the Rule of 78s if the maximum financing charge permitted hereunder has been taken. If a lesser charge has been taken, the rebate shall be at not less than a proportional rate. Provided, however, the lending institution shall be permitted in computing rebates to retain a minimum charge of ten dollars (\$10.00) to cover its acquisition costs and where the amount of credit for anticipation of repayment is less than one dollar (\$1.00), no rebate need be made.

(5) In the case of loans made under this section the corporation shall not take any assignment, pledge or transfer of wages to be earned or paid in the future, nor any first lien or first mortgage on real estate as security, except such lien as is created by virtue of a judgment or decree or first mortgage liens on loans on unimproved real estate not exceeding ten (10) acres in size or on real estate on which there is located or to be located a residential mobile home. Nothing in this section is intended to prevent lending institutions from making loans under the provisions of the National Housing Act or any other federal legislation, which loans are hereby authorized.

(6) No lending institution under this section shall split up or divide a loan or permit any person to become obligated to it under more than one (1) contract of loan at the same time for the purpose of obtaining a greater charge than would otherwise be permitted by this section.

(7) Every note evidencing a loan made under this section shall contain the following information and provisions: The original principal amount of the loan excluding any charge made under this section; a statement of the total charge for the loan; the amount and the date of each installment; the date of final maturity; an agreement that the borrower may repay the loan in whole or in part at any time, and that if the loan is paid in full before final maturity, the borrower will receive a refund of the unearned portion of the charge as required by this section. At the time the loan is made, the lending

institution shall give the borrower either a copy of the note, or a statement of the transaction containing the provisions and information required to be contained in the note. The lending institution shall deliver a receipt for each payment.

(8) In advertising for loans subject to this section, every advertisement shall conform to the following requirement: Any statement of the amount of the loan shall be the original principal amount showing in detail any charge made under this section.

(9) KRS 288.420, 288.620 and 360.010 shall not apply to loans made under authority of this section, but said sections shall remain in full force and effect for all other purposes. Nothing in this section shall be construed to impair the validity or effect of said sections with respect to loans other than those made pursuant to this section nor shall anything in this section be construed to impair the validity or effect of KRS 360.025.

(10) Any contract of loan in the making or collection of which any act shall have been done which constitutes a willful violation of any provision of this section shall be void, and the bank, trust company, or combined bank and trust company shall have no right to collect or receive any interest or charges whatsoever on such loan, but the unpaid principal of the loan shall be paid in full to the lending institution. (Enact. Acts 1946, ch. 60; 1962, ch. 79; 1972, ch. 267, § 1; 1974, ch. 184, § 1; 1980, ch. 78, § 1, effective April 1, 1980.)

Compiler's Notes. The National Housing Act, referred to in subsection (5), is compiled as 12 U.S.C. § 1701 et seq.

Cross-References. Bonds of fiduciaries, KRS 62.060.

Fiduciary bank or trust company not to make investments in own stock, KRS 386.025.

Kentucky Law Journal. Murrell, The Uniform Consumer Credit Code: Changes It Would Make in Kentucky Law, 60 Ky. L.J. 62 (1971).

Opinions of Attorney General. The practice of a loan investment company organized under KRS 291.120 (repealed) of securing its loans by liens on real estate was in direct violation of subsection (5) of this section. OAG 60-849.

Because the language of the statute clearly excludes additional charges by the lender, no other charges may be levied by the lending loan and investment company, including attorneys' fees for the examination except those expenses specifically excepted by the statute. OAG 61-5.

If the customer makes prescribed monthly payments to the bank on his debt not in excess of \$5,000, the customers revolving credit account may be an instalment loan as outlined in this section and the bank may charge an interest rate not to exceed the legal maximum of six dollars per one hundred dollars per year on the first \$2,000 of principal

and five dollars per one hundred dollars per year on the excess over \$2,000. OAG 61-60.

A bank or trust company which lends money repayable in instalments pursuant to this section may not levy any delinquency or interest charge on an overdue instalment obligation except those charges as are expressly allowed in this section. OAG 72-767.

If a bank makes a loan under KRS 360.010 secured by a first mortgage, a second mortgage on the same real estate is prohibited by subsection (6) of this section. OAG 74-304.

Under this section a bank may not carry two or more loans to a particular borrower at the same time, if one of the loans is made pursuant to this section, and, if a second loan is made under these circumstances, it would be void as a wilful violation of the statute and the bank would be barred from receiving any interest or charges on the loan. OAG 74-304; 75-84.

Installment loans may be made by a bank under either this section or KRS 360.010; if a loan is made for more than \$15,000, any rate may be charged, and the 5 and 10 year restrictions of this section, the only purpose of which is to limit the amount of interest, would not be applicable. OAG 78-221.

Interest may be added on in advance, discounted or computed in any manner the bank sees fit on such loans of over \$15,000. OAG 78-221.



COMMONWEALTH OF KENTUCKY
OFFICE OF THE ATTORNEY GENERAL
FRANKFORT

ROBERT F. STEPHENS
ATTORNEY GENERAL

THOMAS C. JACOBS
DEPUTY ATTORNEY GENERAL

April 6, 1978

Hon. Stuart A. Handmaker
Attorney at Law
Handmaker, Weber and Meyer
Twenty Third Floor
Citizens Plaza
Louisville, KY 40202

OAG 78 221

Dear Mr. Handmaker:

In your letter of February 13, 1978, you have asked the following question:

"May a bank organized and licensed under the provisions of Chapter 287 of the Kentucky Revised Statutes make a loan in excess of \$15,000, repayable on an installment basis, at an interest rate in excess of 8-1/2% per annum, with interest charged in advance, the loan being secured by a first mortgage on real estate?"

The simple answer to the question, thus stated, is "Yes".

The question that you presented is one which we understand to have arisen by virtue of the apparent conflict between KRS 287.215 and KRS 360.010. Upon study, we have reached the conclusion that the two cited Sections are not in conflict, but, rather, are supplementary to each other; that is, a bank may lend money under the provisions of either of the cited Sections.

KRS 287.215, which is contained in the chapter relating to banks and trust companies, provides that, "In addition to the powers heretofore granted, any bank. . .shall have the power to lend money repayable in installments; [under the terms and for the charges specified in the Section]". Subsection 9 of the cited statute provides that, "KRS. . .360.010 shall not apply to loans made under authority of this Section."

Hon. Stuart A. Handmaker
April 6, 1978
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KRS 360.010 provides in part that, "The legal rate of interest is 6% per annum, but any party or parties may agree, in writing, for the payment of interest in excess of that rate as follows. . . (b) at any rate on money due or to become due upon any contract or other obligation in writing where the original principal amount is in excess of \$15,000. . . and no law of this state prescribing or limiting interest rates shall apply to any such agreement or to any charges which pertain thereto or in connection therewith. . .".

Subsection 2 of KRS 360.010 provides that any state bank may charge \$10.00 for any loan even if the legal interest does not amount to that sum.

The sole significance of the last referenced citation, that a bank can charge a \$10.00 minimum fee, is that it indicates the clear intention of the Legislature that the pertinent provisions of KRS 360 apply to banks, as well as to unlicensed lenders. Thus, installment loans may be made by a bank under either KRS 287.215 or KRS 360.010. If a loan is made for more than \$15,000.00, any rate may be charged, and the 5 and 10 year restrictions of KRS 287.215, the only purpose of which is to limit the amount of interest, would not be applicable.

With regard to the second part of your question, it is our opinion that so called "add on and discount" rates may be charged on loans of over \$15,000. The question of whether interest is charged in advance, in arrears, currently, as incurred, or in whatever manner, is merely another method of determining the amount or rate of interest to be paid.

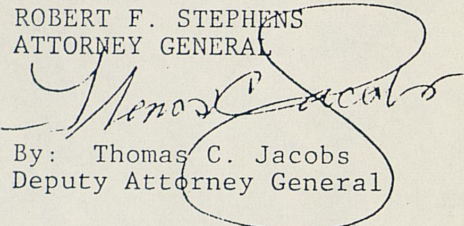
KRS 287.215 was enacted nominally to grant banks additional powers, but in reality to avoid the then stricter usury laws, affording banks the incentive to make small loans to consumers. Until this statute was enacted, the cost of servicing such consumer loans and the risks involved were simply too great to attract banks' money away from other more attractive loan opportunities. By permitting add on or discount rates, the General Assembly effectively raised permissible interest rates without amending KRS 360.010. It is thus clear that interest may be added on in advance, discounted, or computed in any manner the bank sees fit on such loans. To hold otherwise would be in obvious disregard of Legislative intent.

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If additional information is necessary, please feel free
to call or write at your convenience.

Sincerely,

ROBERT F. STEPHENS
ATTORNEY GENERAL


By: Thomas C. Jacobs
Deputy Attorney General

/mcs

INDUSTRIAL LOAN CORPORATIONS

291.410. Definitions for KRS 291.410 to 291.600. — As used in KRS 291.410 to 291.600, unless the context otherwise requires:

- (1) "Commissioner" means the commissioner of banking and securities;
- (2) "Certificate holder" means an industrial loan corporation organized under the provision of KRS 291.410 to 291.600 to which a certificate, as defined in subsection (3) of this section, has been issued by the commissioner.
- (3) "Certificate" means a written instrument issued by the commissioner authorizing the corporation therein named to do business under the provisions of KRS 291.410 to 291.600, except when used in the phrase "certificate of investment." (Enact. Acts 1962, ch. 166, § 1; 1966, ch. 255, § 237.)

Opinions of Attorney General. If an industrial loan company maintains a specific place of business to serve a community it may also make loans by mail. OAG 67-347.

Branches of an industrial loan company can be established in a county other than the county in which is located its principal place of business. OAG 70-164.

291.420. Organization of industrial loan corporation — Name. —

(1) Any five (5) or more persons may organize an industrial loan corporation in any city upon the terms and conditions and subject to the liabilities prescribed in KRS 291.410 to 291.600.

(2) No person shall engage in the industrial loan business in this state other than in the corporate form as provided in KRS 291.410 to 291.600.

(3) The name of the corporation shall not contain the words "bank" or "trust" or the phrase "loan association," nor shall these words be used in any printed or advertising matter to refer to the corporation. Such corporation need not use the word "incorporated" in addition to its corporate name, either in its place of business or on any printed matter or advertising matter. No certificate of incorporation of an applicant having the same name as a corporation authorized to do business under the laws of this state or a name so nearly resembling it as to be calculated to deceive shall be approved by the commissioner, except to a corporation formed by reincorporation, reorganization, merger or consolidation of other corporations, or upon the sale of the property or license of a corporation. (Enact. Acts 1962, ch. 166, § 2 (1) to (3).)

291.430. Capital stock requirements — Statement of assets and liabilities — Fees. — (1) The capital stock of any such industrial loan corporation shall not be less than one hundred thousand dollars (\$100,000) if located in counties containing a city of the first or second class, or not less than fifty thousand dollars (\$50,000) if located in any other county. The amount of the capital stock shall be paid in full, and in money, before the corporation may transact any business other than that relating to its formation and organization.

(2) At the time an industrial loan corporation applies for a certificate it shall file with the commissioner a statement verified by its president and

secretary showing its assets and liabilities, and the address at which it proposes to operate its business. A separate certificate shall be required for each place of business.

(3) Each industrial loan corporation at the time of making application shall pay fifty dollars (\$50.00) to the commissioner as a fee for investigating the application, and the additional sum of two hundred and fifty dollars (\$250) as an annual fee for the privilege of doing business for the period terminating on the succeeding January 15. If the application is filed after June 30 in any year, the payments shall be one hundred and twenty-five dollars (\$125) as a fee for the privilege of doing business in addition to the fee for investigation. The annual fee shall be paid for each place of business. In addition to the annual fee for the privilege of doing business, every corporation organized under the provisions of KRS 291.410 to 291.600 shall pay a fee for examinations by the department of banking and securities, which fee shall be computed by the department of banking and securities on the basis of fair compensation for time and actual expenses. (Enact. Acts 1962, ch. 166, § 2 (4) to (6).)

291.440. Investigation of applicant — Approval of articles of incorporation and application. — (1) Before delivering the articles of incorporation to the secretary of state for recording, a copy of the articles shall be presented to the commissioner for approval. Upon receipt of such articles, the commissioner shall first determine whether or not the articles comply with the provisions of KRS 291.410 to 291.600 and, if he so finds, he shall promptly notify the industrial loan companies in the locality in which the proposed office or offices are to be located, specifying a time within which they may file objections. The commissioner shall then inquire into the advisability of approving the application by investigating:

(a) The moral character and financial responsibility of the incorporators and principals of the applicant.

(b) The public necessity for such association in the community to be served; and

(c) The reasonable probability of its usefulness and success. In so doing he shall determine whether or not the industrial loan company can be established without undue injury to properly conducted existing industrial loan companies, in connection with which the incorporators and principals shall furnish such information as they may desire and as the commissioner may require.

(2) After allowing the specified time for the filing of objections, the commissioner shall approve the application if he finds that the moral character and financial responsibility of the incorporators and principals are sound and such as to justify public confidence and to insure the reasonable probability of the success of the corporation, that the incorporators and principals have complied with the provisions of KRS 291.410 to 291.600, that the incorporation is advisable and, after investigation, there is reason to believe that no undue injury to properly conducted existing industrial loan companies will result. Unless the application, after investigation, meets all of the above requirements, the commissioner shall disapprove it. (Enact. Acts 1962, ch. 166, § 3.)

291.450. Certificate of approval — Denial — Appeal. — (1) The commissioner shall upon approval issue a certificate of approval in triplicate, one (1) copy of which shall be delivered to the applicant and one (1) copy to the secretary of state which shall constitute the authority of the secretary of state to file and record the articles as provided in the General Corporation Law.

(2) Upon the receipt of payment of fees and filing of the articles of incorporation by the secretary of state, the commissioner shall issue a certificate or certificates authorizing the corporation to operate an industrial loan business in this state at the places specified, such certificates to be in such form as the commissioner prescribes.

(3) The commissioner shall mail one (1) copy of the certificate to each office of the corporation and shall retain one (1) copy, which shall be filed in the office of the commissioner.

(4) If the commissioner does not approve the application, he shall notify the applicant of the denial and return the sum paid by the applicant as a fee for the privilege of doing business, retaining the fifty-dollar investigation fee.

(5) The commissioner shall approve or deny every such application within sixty (60) days after the filing thereof with the fees paid, unless the time is extended by the commissioner for good cause.

(6) All findings of the commissioner, together with a summary of the evidence supporting them, shall be filed in the office of the commissioner as public records.

(7) The certificate or certificates issued to the corporation shall expire on the succeeding January 15, and shall be renewed only on compliance with the provisions of KRS 291.410 to 291.600.

(8) Whenever the commissioner denies any application for certificate under the provisions of KRS 291.410 to 291.600, he shall forthwith file in his office a written order to that effect, stating his findings with respect thereto and the reasons for his action. The commissioner shall also forthwith serve upon the applicant for a certificate a copy of the order. The applicant may appeal to the Circuit Court of Franklin County within thirty (30) days after service of a copy of the order.

(9) The corporation shall not conduct any industrial loan business until it receives a certificate from the commissioner stating that it has fully complied with all the provisions of KRS 291.410 to 291.600, and that the requisite capital is in good faith subscribed and paid in cash. (Enact. Acts 1962, ch. 166, § 4.)

291.460. Powers of industrial loan company. — An industrial loan company organized under KRS 291.410 to 291.600 may:

(1) Lend money and receive interest therefor at a rate of seven dollars (\$7.00) per one hundred dollars (\$100) per annum of the principal amount of the loan not exceeding seven thousand five hundred dollars (\$7,500) and require and receive uniform weekly or monthly instalment payments. The amount of interest computed as provided in KRS 291.410 to 291.600 may be charged or received in advance or may be added to the principal amount of

the loan. Such loans shall be repayable in substantially equal instalments over a period not exceeding five (5) years and thirty-two (32) days, and the principal amount of the loan, (excluding charges) shall not exceed seven thousand five hundred dollars (\$7,500).

(2) Sell or negotiate bonds, notes and certificates of investment for the payment of money at any time, either fixed or uncertain, and receive payments therefor in instalments or otherwise; provided, that nothing herein contained shall be construed to create any liability on demand. No certificate holder making loans under KRS 291.410 to 291.600 shall directly or indirectly advertise for or accept deposits, demand or otherwise, except an industrial loan company organized under KRS 291.410 to 291.600 may advertise the sale of certificates of investment as authorized under KRS 291.410 to 291.600.

(3) Charge for a loan made pursuant to this section one dollar (\$1.00) for each fifty dollars (\$50.00) or fraction thereof loaned for expenses, including any examination or investigation of the character and circumstances of the borrower, comaker or surety, and the drawing and taking acknowledgment of necessary papers or other expenses incurred in making the loan. Such charge shall be permitted only on the first two thousand dollars (\$2,000) loaned. No charge shall be collected unless a loan has been made as a result of such examination or investigation.

(4) An industrial loan company organized under KRS 291.410 to 291.600 in addition to its powers heretofore granted shall be authorized to charge interest on loans or extensions of credit in the same manner and at the same rate as is permitted by KRS 287.215 for banks or trust companies or combined banks and trust companies, and provided further that the principal amount of such loan or extension of credit exclusive of interest or other charges shall not exceed ten thousand dollars (\$10,000). (Enact. Acts 1962, ch. 166, § 5; 1972, ch. 317, § 1; 1980, ch. 108, § 1, effective July 15, 1980.)

Kentucky Law Journal. Murrell, The Uniform Consumer Credit Code: Changes It Would Make in Kentucky Law, 60 Ky. L.J. 62 (1971).

Opinions of Attorney General. An industrial loan company can advertise that it will lend money on a term note at six percent per annum without engaging in false advertising or deceptive acts under KRS 360.255 and 367.170 unless the ad is merely used to get the borrower into the loan office and then the term loan is not made as asked for but the industrial loan is given instead. OAG 74-220.

An industrial loan company may not make loans to customers in excess of the statutory limitations and any such loan would subject it to action by the commissioner of banking and securities under KRS 291.550. OAG 75-257.

"Principal amount" refers to the original

principal sum loaned and to which sum the allowable interest rate is applied. OAG 76-464.

This section permits only two ways of computing interest: (a) the discount method and (b) the add on method. Interest can only be computed under permissible principal amount and the maximum principal amount can never exceed \$7,500 and since in order to give the borrower the full amount of \$7,500 where the interest is taken out in advance it would be necessary for the principal amount of the loan to exceed \$7,500, which would be in direct violation of this section, the terms "principal amount" and "net proceeds to borrower" cannot be equated and the term "excluding charges" at most only reflects the point that the principal interest or charges are mutually exclusive. OAG 76-464, withdrawing OAG 72-329.

NOTES TO DECISIONS

1. Certificate of Investment.

A certificate of investment is a writing evidencing an obligation on the part of the company to repay a sum of money to an investor at any time, either fixed or uncertain, and to receive payments therefor in installments or otherwise, other than an

obligation to repay on demand and there is no requirement in this chapter for industrial loan companies to register such certificates with the division of securities. *Allstate Indus. Loan Plan, Inc. v. Mihalek*, 555 S.W.2d 585 (Ky. 1977).

291.470. Limitations on loans and terms thereof. [Repealed.]

Compiler's Notes. This section (Acts 1962, ch. 166, § 6(1)) was repealed by Acts 1972, ch. 317, § 2.

291.480. Additional charges prohibited — Allowed collateral. — In addition to the charge permitted by KRS 291.410 to 291.600, no further amount shall be directly or indirectly charged, contracted for or received on any such instalment loan, except lawful fees actually paid to a public official for filing, recording or releasing any instrument securing the loan, delinquency and deferral charges as set out in subsection (1) of KRS 291.500. Provided, however, that the certificate holder may request, as collateral for any loan, and collect premiums for:

(1) Notwithstanding the provisions of this or any other law:

(a) A certificate holder may request a borrower to insure tangible personal property, except household goods, offered as security for a loan not exceeding seven thousand five hundred dollars (\$7,500) under KRS 291.410 to 291.600 against any substantial risk of loss, damage or destruction for any amount not to exceed the actual value of such property or the approximate amount of the loan, whichever is lesser, and for a term and upon conditions which are reasonable and appropriate considering the nature of the property and the maturity and other circumstances of the loan; provided, such insurance is sold by a licensed agent, broker or solicitor.

(b) A certificate holder may also request as security for any loan obligation insurance on the life of the borrower, or one (1) of them if there are two (2) or more. The initial amount of credit life insurance shall not exceed the total amount repayable under the contract of indebtedness and, where an indebtedness is repayable in substantially equal instalments, the amount of insurance shall at no time exceed the scheduled or actual amount of unpaid indebtedness, whichever is greater. Not more than one (1) policy of life insurance may be written in connection with any loan transaction under KRS 291.410 to 291.600.

(c) In accepting any insurance provided for by KRS 291.410 to 291.600 as security for a loan the certificate holder, its officers, agents or employees may deduct the premiums or identifiable charge therefor from the proceeds of the loan, and remit such premiums to the insurance company writing such insurance and any gain or advantage to the certificate holder or any employee, officer, director, agent, affiliate or associate from such insurance or its sale, shall not be considered as additional or further charge in con-

nection with any loan made under KRS 291.410 to 291.600. The arranging for and collecting of an identifiable charge shall not be deemed the sale of insurance.

(d) Every insurance policy or certificate written in connection with a loan transaction pursuant to paragraph (b) of this subsection shall provide for cancellation of coverage and a refund of the premium or identifiable charge unearned upon the discharge of the loan obligation for which such insurance is security without prejudice to any claim.

(e) Whenever insurance is written in connection with a loan transaction pursuant to KRS 291.410 to 291.600, the certificate holder shall deliver or cause to be delivered to the borrower a policy, certificate or other memorandum which shall show the coverages and the costs thereof, if any, to the borrower within thirty (30) days from the date of the loan.

(f) All such insurance shall be written by a company authorized to conduct such business in this state and the certificate holder shall not require the purchase of such insurance from any agent or broker designated by the certificate holder nor shall the certificate holder decline existing coverages which equal or exceed the standards of KRS 291.410 to 291.600;

(2) Insurance on real property pledged as security for a loan in an amount not to exceed the actual value of such property or the approximate amount of the loan whichever is lesser;

(3) Accident and health insurance on not less than a fourteen-day retroactive basis, covering one (1) borrower in aggregate amount not to exceed the approximate amount of the loan with each periodic indemnity payment not to exceed the original indebtedness divided by the number of periodic instalments; all subject to the general provisions and limitations of KRS 291.410 to 291.600. Premium rates for accident and health insurance written pursuant to KRS 291.410 to 291.600 shall be reasonable in relation to benefits, and shall be filed with the commissioner of insurance. (Enact. Acts 1962, ch. 166, § 6(2) (cl. a-c); 1972, ch. 317, § 3.)

Opinions of Attorney General. In order to avoid violating subsection (1)(b) of this section and subsection (2) of KRS 288.560, insurance regulation I-19.06 should be amended to provide that the allowable insuring of joint lives (in cases involving a debtor's spouse who is a cosigner to a credit or finance transaction)

does not pertain to small loan companies and industrial corporations. OAG 73-434.

An industrial loan company may not make loans to customers in excess of the statutory limitations and any such loan would subject it to action by the commissioner of banking and securities under KRS 291.550. OAG 75-257.

291.490. Operation of insurance agency in same office. — Nothing in KRS 291.410 to 291.600 shall be construed to prevent a certificate holder from conducting or operating an insurance agency in the same office. (Enact. Acts 1962, ch. 166, § 6 (2) (last para.).)

291.500. Delinquency charges. — (1) Delinquency charges may be made not to exceed five cents (5¢) for each dollar of each instalment more than ten (10) days in arrears, and only one (1) delinquency charge shall be made on any one (1) instalment. No delinquency charge shall exceed five dollars (\$5.00) on any one (1) instalment. A certificate holder and borrower

may agree in writing to a deferral of all or part of one or more unpaid instalments, and the certificate holder may make and collect a charge not exceeding a rate of seven dollars (\$7.00) per one hundred dollars (\$100) per annum. In addition to such charges attorneys' fees not exceeding fifteen percent (15%) of the unpaid balance and court costs may be collected, provided that the note is referred to an attorney not a salaried employee of the holder for collection.

(2) The certificate holder shall permit the borrower to repay his loan in whole or in part at any time. If a loan is paid in full prior to maturity, the certificate holder shall make a rebate at a rate not less than in accordance with the Rule of 78s if the maximum financing charge permitted under KRS 291.410 to 291.600 has been taken. If a lesser charge has been taken, the rebate shall be at not less than a proportional rate. Provided, however, the certificate holder shall be permitted in computing rebates to retain a minimum charge of ten dollars (\$10.00) to cover its acquisition costs and where the amount of credit for anticipation of repayment is less than one dollar (\$1.00), no rebate need be made. (Enact. Acts 1962, ch. 166, § 6(3), (4); 1972, ch. 317, § 4.)

Opinions of Attorney General. The commissioner of banking may, under the authority of subsection (2) of KRS 291.530, promulgate a regulation requiring that all rebates paid by industrial loan companies on loans paid to maturity as required by subsection (2) of this section shall be on the basis of the rule of 78ths, also known as the sum of the digits method. OAG 68-172.

Persons paying an instalment loan in full prior to maturity shall be given a rebate of unearned interest to be computed by the applicable method provided by this section, depending upon whether or not the maximum interest rate has been charged. OAG 75-457.

The rate of interest for deferral time is precisely the maximum rate permitted for instalment loans of industrial loan companies under KRS 291.460 and thus when this section is read as a whole the practical and

statutorily intended effect of a deferral is merely to change the original maturity date to a later date under a maximum rate of interest permitted for the original; therefore, the rebate method applicable should simply be applied to provide a refund of unearned interest extending over the remaining time left under the original loan as extended or modified by the deferral agreement. OAG 75-457.

This section guarantees that an industrial loan certificate holder will derive a minimum of \$10.00 for his trouble in making the loan; however, in computing the rebate, if the interest to be retained by the lender is in excess of \$10.00, then the interest to be retained and the rebate to the borrower are computed under the applicable method set out in this section. OAG 76-233.

291.510. Restrictions on security — Contents of notes — Advertising. — (1) In the case of loans made under KRS 291.410 to 291.600 the certificate holder shall not take any assignment, pledge or transfer of wages to be earned or paid in the future, nor any first lien or first mortgage on real estate as security, except such lien as is created by virtue of a judgment or decree. Nothing in KRS 291.410 to 291.600 is intended to prevent lending institutions from making loans with second or other junior mortgages on real estate as security, which loans are hereby authorized.

(2) No certificate holder shall split up or divide a loan, or permit any person to be obligated to it under more than one (1) contract of loan at the same time for the purpose of obtaining a greater charge than would otherwise be permitted under KRS 291.410 to 291.600.

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terial alteration. . . ." In *Franco v. Bank of Forest Park*, 118 Ga App 700, 705 [5 UCC Rep 1252] (165 SE2d 593), this court pointed out that certain notations on the note did not alter or change "the obligations of the note itself, and absent that, the alteration does not operate to discharge the parties from their obligations."

In the case sub judice, in the "Guaranty of Payment" the defendant agreed that the plaintiff bank could "surrender, compromise, substitute or exchange any property in which you [the bank] may have a *security interest* securing repayment of the note . . ." See *Dunlap v. C. & S. DeKalb Bank*, 134 Ga App 893, 896 (216 SE2d 651). Therefore, the deletion of the words "listed below" could not possibly have materially altered the terms of the contract since the defendant had already yielded to the plaintiff bank any rights regarding the security which this language might refer to. Since we have determined that this was not a material alteration within the purview of Code Ann § 109A-3-407, the defendant failed to raise an issuable defense and the trial judge did not err in granting plaintiff's motion for summary judgment.

Judgment affirmed. MCMURRAY, P.J., and POPE, J., concur.

FALL RIVER SAVINGS BANK v. LEBEL

Massachusetts District Courts, Appellate Division, February 10, 1982
No. 294

[§ 3606.2] Effect of release of one joint and several maker of note.

Where defendants A and B jointly and severally executed and delivered to plaintiff bank a promissory note and after default and foreclosure sale the bank released defendant B from her obligation and agreed not to seek further payment on the note from her upon the payment of \$500, the conduct of the bank did not discharge defendant A as a matter of law under § 3-606 where there was no evidence to show that A's right to obtain contribution or indemnity was impugned or that the bank unjustifiably impaired any collateral for the underlying obligation. There was no evidence that A stood as surety for B, or that the bank knew or had reason to know of any right of recourse by A against B. The burden was on A to offer such evidence. In the absence of proof, the agreement not to look to B did not entitle A to be deemed discharged.

UCC Section Cited: § 3-606.

Appeal from the Fall River District Court. Before RIDER, P.J., WELSH and SILVA, JJ.

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Edwin A. Macy, Fall River, for plaintiff.
 Gilbert E. Poisson, Fall River, for defendant.

WELCH, J. This is a civil action in contract for the recovery of a deficiency alleged to be due on a promissory note after foreclosure sale of a mortgage on certain real estate in which the defendants owned the equity of redemption. Both defendants were comakers of the promissory note which was secured by the mortgage.

The defendants answered by way of a general denial. No other defenses were pleaded in the answer.

The court found in favor of the plaintiff against the defendant Armand Lebel in the sum of \$4300.00 and dismissed the complaint as to the defendant Janet Lebel.

Neither party filed requests for rulings of law, but the trial court sua sponte reported the case to the appellate division for determination. General Laws Chapter 231 § 108.

2. We proceed to a consideration of the questions raised by the report. The memorandum of decision which was adopted by the trial judge as his voluntary report indicated the following:

The defendants jointly and severally executed and delivered to the plaintiff a promissory note in the principal sum of \$18,500.00 on January 5, 1972. The note was secured by a mortgage on certain real estate. After a default, a foreclosure sale was conducted, leaving a deficiency of \$4,758.32. This action was commenced by the bank as holder of the note to recover the deficiency.⁵ As a result of negotiations between the agent of the plaintiff and the defendant Janet Lebel, the bank executed and delivered to the defendant Janet Lebel a release of attachment of real estate standing in her sole name and orally agreed not to seek further payment on the note from her. Although the report does not so indicate, the brief of the defendant Armand Lebel indicates that Janet paid the sum of \$500.00 for the release of attachment and promise not to pursue her for the balance due on the note.⁶ The trial judge awarded the sum of \$4300.00 to the plaintiff against the defendant Armand Lebel and dismissed the action as to the defendant Janet Lebel.

⁵ There is no indication in the report that a notice of intent to sue for deficiency was given pursuant to GL c 244 § 17B. We shall assume that such a notice was given, since it was a condition precedent to recovery.

⁶ The brief of the appellant is not part of the record on appeal. We shall assume this is true for purposes of this appeal.

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We reiterate that the defendant answered by way of a general denial and was not entitled as of right to raise the issue of discharge at trial. Discharge is an affirmative defense which ought to have been set up by the defendant in his answer if he intended to rely on it. *Shapiro v. Lyon*, 254 Mass 110, 116 (1925); *Belli v. Forsyth*, 301 Mass 203, 206 (1938). The burden was on the defendant to prove that he was discharged. See *Abraim v. Pereira*, 336 Mass 460, 462 (1957). Since the case was tried on that theory, we choose not to disregard it on appeal. *Baker v. Commercial Union Ins. Co.*, — Mass — (1981).

The issue presented is whether or not the conduct of the bank as described in the report released and discharged the Defendant Armand as a matter of law. We shall assume in favor of the defendant that he neither knew of nor consented to the bank's actions as regards Janet nor ratified the same afterwards.

The general rule is that payment of a lesser sum than the amount due on a liquidated or undisputed obligation will not afford consideration for a promise not to look to the obligor paying such sum for payment of the balance due. *Smith v. Bartholomew*, 1 Metc 276 (1840); *Foakes v. Beer*, LR 9 AC 605 (1884). The bargained for release of real estate attachment by the creditor in addition to the payment would afford sufficient consideration for such a promise. We therefore pass the question of the enforceability of the promise of the creditor by the defendant Janet Lebel.

The rule at common law was that the release of one or more joint or joint and several obligors without an effective reservation of rights or without the consent of the remaining obligors constituted a discharge of the underlying obligation and consequently the remaining obligors. *Hale v. Spaulding*, 145 Mass 482 (1888). This principle was recognized in the common law of this Commonwealth from the earliest times. See *Ruggles v. Patten*, 8 Mass 480, 482 (1812). There were certain formal requirements: To be effective, the release had to be written and under seal. *Hale v. Spaulding*, supra, p 483. The writing had to manifest an unequivocal intention to discharge the obligor from an existing or an assumed duty. *Corbin, Contracts*, (One Volume ed 1952) § 1238, p 993. An oral statement by a creditor to one of the debtors that the debt was discharged was not legally operative as such. *Corbin*, supra, § 1240, p 993. Of equal importance was the requirement that the release be a sealed instrument. *Shaw v. Pratt*, 22 Pick 305 (1837); *Gold Medal Sewing Machine v. Harris*, 124 Mass 206, 208 (1878). Understandably, courts have disfavored the common law rule relating to dis-

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charge restricting its operation within narrow limits where discharge was effected only by formal release under seal. The main cause for disenchantment is that the rule generally operates directly contrary to what may be supposed to be the actual intent of the parties.

In the real world of commerce, it is neither unusual nor unreasonable for a creditor to release one of several joint obligors in exchange for something less than or different from performance of the underlying obligation, with the expectation to look to the remaining obligors for satisfaction of the balance. Yet, a written release under seal by the creditor to one joint debtor extinguished the obligation, thereby frustrating the reasonable expectation of the creditor and giving an unearned windfall to the remaining debtors, a result none of the parties contemplated. Painfully aware of the gap between judicial conceptualization and the realities of the market place, courts resorted to a number of legal fictions and similar devices to avoid the inexorable operation of the inflexible rules as to discharge. Among these is the venerable "covenant not to sue" and a release with an express reservation of rights, the latter of these being first conceived as a contradiction in terms. The principal objection to this approach is that the result in a given case turned rather upon the form of the instrument used (usually a function of the legal astuteness of the parties or their attorneys) than the actual intent of the parties. The assumption underlying the common law rule as to discharge of joint or joint and several obligors was an erroneous application of the law of contradiction. It was thought impossible that at the same time an obligation might be deemed discharged as to one joint obligor but not as to others, due to the unitary nature of the performance due. There were a number of other reasons offered for the existence of the rule, none of which were entirely satisfactory. Corbin, *supra*, § 931, p 897.

The point of departure for modern jurisprudence on this issue is markedly different. Instead of focusing on the indivisibility of the obligation itself and the fact that a single performance is due, it concerns itself primarily with the jural relations among the joint obligors, as impacted by the conduct of the obligee towards the one relieved of his obligation. Concepts from the law of suretyship originally developed in equity were found to be well suited to the task. Instead of examining the form of the instrument, the crucial question for judicial inquiry now became to what degree, if at all, does the release, forbearance or covenant not to sue impede the

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rights of the joint obligors to exoneration, reimbursement and subrogation from one another. The rights to obtain contribution or indemnity from joint obligors was early recognized in the law of contracts, and afforded an equitable basis for adjusting the losses among such obligors. Courts under this approach undertake to examine whether the actions of the creditor in excusing one joint obligor have prejudiced the rights of the others to obtain indemnification, exoneration or subrogation, or impaired collateral for the obligation. *Stanley v. Ames*, — Mass — (1979) Mass Adv Sh 1612, 1615-1617 [26 UCC Rep 978]; see *Rose v. Homsey*, 347 Mass 259, 261 [2 UCC Rep 129] (1964); *Priggen Steel Buildings Co. v. Parsons*, 350 Mass 62, 64 [3 UCC Rep 89] (1966); Restatement of Contracts, Second, § 294.

The Uniform Commercial Code adopts this modern approach. GLC 106, § 3-606 provides, in part, as follows:

"§ 3-606. Impairment of recourse or of Collateral. (1) The holder discharges any party to the instrument to the extent that without such party's consent the holder

"(a) without any express reservation of rights releases or agrees not to sue any person against whom the party has to the knowledge of the holder a right of recourse or agrees to suspend the right to enforce against such person the instrument or collateral or otherwise discharges such person . . . ; or

"(b) unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse. . . ."

The report does not contain any evidence tending to show that Armand's right to obtain contribution or indemnity was impugned, or that the plaintiff unjustifiably impaired any collateral for the underlying obligation. There is no evidence or other indication that Armand stood as surety for Janet, and more importantly, that the plaintiff knew or had reason to know of any right of recourse by Armand against Janet. The burden was on Armand to offer evidence on these issues. See *Palumbo v. DiMare*, 299 Mass 212 (1938); *Nashua Savings Bank v. Abbott*, 181 Mass 531 (1902). In the absence of proof, the agreement not to look to the defendant Janet does not entitle the defendant Armand to be deemed discharged.

We have deliberately eschewed the mire of technicalities long associated with the form of instrument to effect the release. We observe that the defendant Armand might have had his rights against Janet determined in the instant case by filing an appropriate crossclaim, thereby avoiding circuitry of action. Since such crossclaims are per-

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33 UCC REPORTING SERVICE

missive and not mandatory, a separate action would seem to be open if Armand has any claim against Janet.

We determine that there was no prejudicial error in the entry of judgment for the plaintiff against the defendant Armand Lebel and dismissing the action as to the defendant Janet Lebel. An order is to enter dismissing the report.

VAN BALEN v. PEOPLES BANK & TRUST CO.

Arkansas Court of Appeals, December 9, 1981;
rehearing denied January 20, 1982
3 Ark App 243, 626 SW2d 205

[¶ 3606.4] Impairment of collateral—burden of proof.

While the guarantors of a note, in showing that the holder failed to perfect its security interest in part of the collateral, met their UCC § 3-606 burden of proving that the collateral was impaired, they did not meet the second burden imposed by that Code section—a showing of the extent to which the collateral was impaired. Since the release of guaranty is only pro tanto—a release only to the extent by which the security has been impaired—the failure of the guarantors to meet the second burden precluded them from exercising their rights to pro tanto release. Two judges dissent, contending that the guarantors should have been discharged because (1) Arkansas case law has always favored guarantors; (2) if a guarantor, under UCC § 3-606(1)(a), is fully discharged where a modification or extension in payments is made in the underlying written obligation, then the guarantor, under UCC § 3-606(1)(b), should be fully discharged when the collateral has been impaired; and (3) the guarantors did not have access to the information necessary to prove the extent of the impairment of the collateral since the debtor had filed for bankruptcy and the secured party had never perfected its security interest, thereby giving the trustee in bankruptcy priority and possession of the collateral.

UCC Section Cited: § 3-606.

Appeal from Johnson Chancery Court.

Rose Law Firm, by Thomas P. Thrash and Herbert C. Rule, III,
Little Rock, for appellants.

Young & Finley, Russellville, for appellee.

CRACRAFT, J. Appellants, Frank G. Van Balen and Betty A. Van Balen, appeal from a decree of the Chancery Court of Johnson County in which judgment was entered against them as guarantors of de-

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§ 3-606(1)(a) discharges the other co-maker to the extent of only one-half the liability on the note since one co-maker would have the right of recourse against the other co-maker for only one-half the note. Therefore, it was error to totally release one co-maker from obligation on a note from which the bank had totally discharged the other co-maker without the consent of the first and without expressly reserving its rights.

[§ 3606.2, § 3606.6] Effect of release, express reservation.

When a release is executed on an instrument covered by the UCC and that release has the consent of the other co-maker or contains an express reservation of rights against the other co-maker, § 3-606(1)(a) and (2)(c) operate to preserve the right of the other co-maker for payment from the released co-maker of any sum paid by the other co-maker which exceeds his one-half liability on the note. But when such a release is executed without consent or express reservation of rights, § 3-606(1)(a) operates to discharge the other co-maker's liability to the extent of one-half the note since that was the amount of recourse against the discharged co-maker that the other co-maker had if consent had been obtained or rights expressly reserved.

[§ 3606.2, § 3606.4(5)] Co-maker's liability following release of other co-maker—effect of impairment of collateral on liability.

Where the bank holding a note released one set of co-makers from their obligation under the note without the consent of the other set of co-makers and without an express reservation of rights, the unreleased co-makers were discharged from liability on one-half the note, and were entitled to be discharged from their remaining liability on the note to the extent of the value of any impaired collateral under § 3-606(1)(b).

UCC Sections Cited: § 1-201(29), § 3-606.

Appeal from the Circuit Court of Jasper County. Before GREENE, C.J., TITUS and CROW, JJ.

Thomas E. Klinginsmith and Thomas L. Williams, Carthage, for plaintiffs-respondents.

Jerry E. Wells, Joplin, for defendant-appellant.

GREENE, C.J. Defendant, United Missouri Bank of Carthage, appeals from an order and judgment of the trial court sustaining John and Mary Bishop's motion for summary judgment on count II of their first amended petition, and for summary judgment in the Bishops' favor on the bank's counterclaim. Count II of the first amended petition sought a declaratory judgment that the Bishops, as comakers, were discharged under § 400.3-606¹ from any obligation on a promissory note since the other comakers to that note had

¹ All statutory references are to RSMo 1978.

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been released by the bank. The bank's counterclaim was for the unpaid balance of the note.

Summary judgments are authorized only when 1) there is no issue as to any material fact, and 2) the party requesting the summary judgment is entitled to it as a matter of law. *Clevenger and Wright Co. v. A.O. Smith Harvestore Products, Inc.*, 625 SW2d 906, 908 (Mo App 1981). Our review of the record is made in the light most favorable to the defendant bank. *Kinder v. Notorangelo*, 615 SW2d 433, 434 (Mo App 1980).

Based on the pleadings, affidavits, depositions, and interrogatories, the material facts before the trial court at the time it entered summary judgment were as follows.

On January 31, 1977, John and Mary Bishop and Henry and Elizabeth Mohr executed a promissory note for \$115,000 in favor of the United Missouri Bank of Carthage. This note enabled Mr. and Mrs. Mohr to buy a 49% interest in the AirCo Tool Engineering Company owned by the Bishops. Almost \$84,500 of the loan proceeds were actually used to pay some of the Bishops' prior loans at the bank, and the remaining \$30,500 were credited to the company's account at the bank.

Collateral given to support the loan was 1) an assignment, with power of attorney, to the bank of John Bishop's rights in an assignment of inheritance from the Mohrs to him in Henry Mohr's grandmother's estate; 2) an assignment of a \$125,000 life insurance policy on the life of Henry Mohr; 3) a note for \$75,000 from the Bishops secured by a deed of trust on the AirCo Tool Building; and, 4) a note for \$35,000 secured by a second deed of trust on the Mohr residence which had been assigned to John Bishop.

The note matured on January 31, 1979. Attempts by the bank to secure payment on the note failed, and in July 1979, the bank began foreclosure proceedings on the Mohr residence under a first deed of trust held by the bank. The Mohrs then filed a petition in bankruptcy. Subsequent negotiations between the bank and the Mohrs resulted in releases being prepared and executed by both sides on February 27 and March 2, 1981. In these releases, the Mohrs pledged to dismiss their petition in bankruptcy, transfer the title of their residence to the bank, and pay the bank \$2,500 within 15 days after the receipt by them of any inheritance of \$2,500 or more from Mr. Mohr's grandmother's estate. The bank, in exchange for those promises by the Mohrs, released the Mohrs from the \$115,000

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note and two other notes, and also released any interest it may have had against the estate of Henry Mohr's grandmother.

Prior to the execution of the releases, the Bishops were advised by the bank at various times as to the status of its legal proceedings against the Mohrs and the Bishops' liability on the note for any balance it was unable to collect from the Mohrs. The Bishops, however, were not informed by the bank about the possibility of the Mohrs being released from the note, nor were they informed about the releases at the time of the actual execution of the releases. The bank never sought or received the consent of the Bishops to release the Mohrs from the note. Also, the bank never expressly reserved its rights on the note against the Bishops prior to or contemporaneous with the execution of the releases.

The Bishops promptly filed suit for a declaratory judgment that they were no longer obligated on the note, when they eventually discovered that releases had been executed by the bank and the Mohrs. After amending their pleadings, the Bishops moved for summary judgment on count II in which they contended that as comakers they were discharged from obligation on the note under § 400.3-606. In its judgment on count II, the trial court 1) found that the releases executed by the bank and the Mohrs were for the purpose of fully and forever compromising, discharging and releasing all claims of every kind, character, and description; 2) found that the releases were executed without notice to, or the consent of, the Bishops and without an express reservation of rights by the bank against the Bishops; 3) ordered the return or release of the collateral the Bishops had pledged with regard to the note; and 4) sustained the Bishops' motion for summary judgment against the bank on its counterclaim for the balance due on the note.

On appeal, the defendant bank claims that the trial court erred in granting the summary judgment because 1) material facts were at issue on whether the Bishops were comakers or sureties, on whether the Bishops consented to the releases, and on whether the bank expressly reserved its rights; 2) comakers are not covered by § 400.3-606; and, 3) it failed to make a finding on the extent of the impairment of the Bishops' right of recourse against the Mohrs on the note, and failed to determine the value of any impaired collateral.

Our review of these allegations of trial court error is limited to determining whether the trial court's judgment is supported by substantial evidence, is not against the weight of the evidence, and is

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a correct declaration or application of law. *Murphy v. Carron*, 536 SW2d 30, 32 (Mo banc 1976).

In applying that standard of review to the bank's first issue, we find that there were no material facts at issue, and that there were only questions as to the legal effect of certain facts upon the question of what was the Bishops' status on the note (comaker, surety, etc.) and upon whether there was consent or an express reservation of rights. We also find, without an extensive review at this point of the facts already presented above, that that part of the trial court's judgment finding that the Bishops were comakers on the note, that there was no consent, and that there was no express reservation of rights satisfies the review standards of *Murphy v. Carron*, supra.

The bank's second issue on appeal regarding the application of § 400.3-606 to comakers raises a novel question of law in Missouri. No other Missouri appellate court has been forced to directly confront the issue of whether § 400.3-606 applies to comakers as well as to sureties and accommodation makers.²

Section 400.3-606 provides that:

"(1) The holder discharges any party to the instrument to the extent that without such party's consent the holder

"(a) without express reservation of rights releases or agrees not to sue any person against whom the party has to the knowledge of the holder a right of recourse or agrees to suspend the right to enforce against such person the instrument or collateral or otherwise discharges such person, except that failure or delay in effecting any required presentment, protest or notice of dishonor with respect to any such person does not discharge any party as to whom presentment, protest or notice of dishonor is effective or unnecessary; or

"(b) unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse.

"(2) By express reservation of rights against a party with a right of recourse the holder preserves

"(a) all his rights against such party as of the time when the instrument was originally due; and

"(b) the right of the party to pay the instrument as of that time; and

"(c) all rights of such party to recourse against others."

² In *Wirth v. Heavey*, 508 SW2d 263, 266 [14 UCC Rep 873] (Mo App 1974), the Kansas City Court of Appeals refused to discharge a comaker under § 400.3-606 by ruling that even if that section applied to comakers, there had not been a release making that defense available.

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The bank contends that the comments to this section clearly indicate that this defense is available only to "any party" who is an accommodation maker or surety.³ However, in order for us to reach the bank's conclusion, we would have to violate the ordinary rules of statutory construction.

It is well-settled law that in ascertaining the meaning of the statute, we must look to the express language of the law irrespective of what may have been intended. *State ex rel. Degraffenreid v. Keet*, 619 SW2d 873, 876 (Mo App 1981). We cannot alter the plain, ordinary and natural meaning of words used in a statute and we must determine the meaning of the words by applying the plain and natural meaning of the language. *Bethel v. Sunlight Janitor Service*, 551 SW2d 616, 619 (Mo banc 1977). An unambiguous statute should be taken to mean what it says, for the General Assembly is presumed to have intended what the law states directly, and courts have no leave to impose another meaning. *State ex rel. Degraffenreid v. Keet*, supra. We hold that the term "any party" as used in § 400.3-606 means any party to the instrument, including comakers. See *Rushton v. U.M. & M. Credit Corp.*, 245 Ark 703, 434 SW2d 81, 83 [5 UCC Rep 1078] (1968); *Deese v. Mobley*, 392 So2d 364, 368 [30 UCC Rep 1314] (Fla Dist Ct App 1981); *Southwest Florida Production Credit Association v. Schirow*, 388 So 2d 338, 339-40 [30 UCC Rep 268] (Fla Dist Ct App 1980); *Beneficial Finance Co. of New York, Inc. v. Husner*, 82 Misc 2d 550, 369 NYS2d 975, 977-78 [17 UCC Rep 477] (Sup Ct Wayne County 1975); *W. Hawkland*, *Commercial Paper* 99, 121 (1959); *White & Summers*, *Uniform Commercial Code*, 434 n 121, § 13-14 (1972).⁴ Not only is

³ § 400.3-606, VAMS, Missouri Code Comment says that "[t]he words 'any party to the instrument' are used to make it clear that the suretyship defenses provided herein are available to any party who is in the position of a surety and not just to parties secondarily liable."

§ 400.3-606, VAMS, Uniform Commercial Code Comment 1 states that:

"The words 'any party to the instrument' remove an uncertainty arising under the original section. The suretyship defenses here provided are not limited to parties who are 'secondarily liable,' but are available to any party who is in the position of a surety, having a right of recourse either on the instrument or dehors it, including an accommodation maker or acceptor known to the holder to be so."

⁴ We recognize the cases cited by the bank for the position that a comaker is not included as "any party" under UCC 3-606, but those cases ignore the plain, unambiguous meaning of the statute and proceed to look at the UCC Comments. See *United States v. Unum, Inc.*, 658 F2d 300, 304 [32 UCC Rep 646] (5th Cir 1981); *Wohlhuter v. St. Charles Lumber & Fuel Co.*, 62 Ill 2d

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this result mandated by a plain reading of this unambiguous section, but there are also two other good supporting reasons.

First, this definition is consonant with the definition of "party" listed in the code. See § 400.1-201(29). Second, adopting the bank's construction would result in a different meaning being applied to "any party" in § 400.3-606 compared to the term "any party" used in the remaining discharge sections of 400.3-601 through 400.3-605. We refuse to adopt this incongruity which would result from following the bank's approach.

A final argument raised by the bank under this issue is that even if § 400.3-606 applies to the Bishops as comakers, the Bishops are still liable on the note under § 431.150.⁵ We find, however, that while § 431.150 was not expressly repealed by § 400.3-606, the § 400.3-606 requirements must be met in a case such as this. Since the bank failed to obtain consent or expressly reserve its rights, it cannot claim any benefit of § 431.150.

The bank's last issue on appeal is that the trial court erred in totally releasing the Bishops as comakers since it failed to place a value on either the Bishops' impaired right of recourse or impaired collateral. The trial court's judgment does not expressly state why it totally released the Bishops. Apparently, the trial court believed that under § 400.3-606(1)(a) the Bishops were totally released from obligation on the note since the bank totally discharged the Mohrs from liability on the note without the consent of the Bishops and without expressly reserving its rights against the Bishops. If this was the trial court's belief, it was wrong.

One co-maker's right of contribution from the other comaker is a right of recourse within the meaning of § 400.3-606. See *Beneficial Finance Co. of New York, Inc. v. Husner*, supra, 369 NYS2d at 978; 3 *Anderson*, Uniform Commercial Code 128, § 3-606:5 (2d ed

16, 338 NE2d 179, 181 [18 UCC Rep 174] (1975); *Farmers State Bank of Oakley v. Cooper*, 227 Kan 547, 608 P2d 929, 933-34 [28 UCC Rep 733] (1980); *Peoples Bank of Point Pleasant v. Pied Piper Retreat, Inc.*, — W Va —, 209 SE2d 573, 578 [14 UCC Rep 1398] (1974); *Hooper v. Ryan*, 581 SW2d 237, 238-39 [26 UCC Rep 982] (Tex Civ App 1979).

⁵ "It shall be lawful for every creditor of two or more debtors, joint or several, to compound with any and every one or more of his debtors for such sum as he may see fit, and to release him or them from all further liability to him for such indebtedness, without impairing his right to demand and collect the balance of such indebtedness from the other debtor or debtors thereof, and not so released; provided, that no such release shall impair the right of any debtor of such indebtedness, not so released, to have contribution from his co-debtors, as is by law now secured to him." § 431.150.

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1971 & Cum Supp 1982). The release of one comaker under § 400.3-606(1)(a) discharges the other comaker to the extent of only one-half the liability on the note since one comaker would have the right of recourse against the other comaker for only one-half the note. *Deese v. Mobley*, supra; *Provident Bank v. Gast*, 57 Ohio St 2d 102, 368 NE2d 1357, 1360-61 n 4 [26 UCC Rep 114] (1979); *White & Summers*, supra. This result is in accord with our case law which recognizes that comakers of a promissory note are equally liable. *Wright v. Wright*, 567 SW2d 371, 374 (Mo App 1978). Also, when a release is executed on an instrument covered by the Uniform Commercial Code and that release has the consent of the other comaker or contains an express reservation of rights against the other comaker, §§ 400.3-606(1)(a), (2)(c) and 431.150 operate to preserve the right of the other comaker for payment from the released comaker of any sum paid by the other comaker which exceeds his one-half liability on the note. But when such a release is executed without consent or express reservation of rights, as in the case at bar, §§ 400.3-606(1)(a) and 431.150 operate to discharge the other co-maker's liability to the extent of one-half the note since that was the amount of recourse against the discharged comaker that the other comaker had if consent had been obtained or rights had been expressly reserved. See §§ 400.3-606(1)(a), 431.150. We hold that that part of the trial court's judgment which totally released the Bishops from liability on the note under § 400.3-606(1)(a) was an erroneous declaration and application of the law and we therefore reverse it.

We need not address the valuation problem raised by the bank under § 400.3-606(1)(b) in great detail now since the trial court failed to expressly grant its judgment on that ground and since it failed to place a value on any impaired collateral. It suffices to say that the Bishops, being only half liable on the note under § 400.3-606(1)(a), are also entitled to be discharged from their remaining liability on the note to the extent of the value of any impaired collateral under § 400.3-606(1)(b). We remand the case for a determination by the trial court of the value of any impaired collateral, and a determination of the Bishops' remaining liability, if any, on the note once the value of one-half the note and of any impaired collateral are subtracted from the amount due on the note.

That part of the judgment which found the Bishops, as comakers, to be totally discharged under § 400.3-606(1)(a) from liability on the note is reversed, and the cause is remanded for the trial court

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to determine the Bishops' liability on the note for one-half the note minus the value of any impaired collateral as found by the trial court on remand. We recognize that this will involve the trial court hearing additional testimony. In all other respects, the judgment of the trial court is affirmed.

TITUS and CROW, JJ., concur.

FLANIGAN, P.J., recused.

FIRST ARLINGTON NATIONAL BANK v. STATHIS

Illinois Appellate Court, First District, Fifth Division, May 27, 1983
115 Ill App 3d 402, 450 NE2d 833

[¶ 5114.2(3)] Letters of credit—duty to honor draft complying with terms of credit.

In providing exceptions to an issuer's duty to honor a demand on a letter of credit, UCC § 5-114(2)(b) does not include within its scope warranties other than those specifically mentioned in the subsection (warranties under §§ 7-507 and 8-306). Therefore, the trial court did not err in holding that § 5-114(2)(b) did not permit issuer of letter of credit to refuse to honor a demand which complied on its face with the terms of the letter of credit and to which the warranties specifically mentioned in § 5-114(2)(b) did not apply.

[¶ 5111, ¶ 5114.2(4)] Letters of credit—distinguished from guaranty.

A letter of credit is to be distinguished from a guaranty, since a guaranty, as a secondary obligation, is based on the rights and obligations of the parties to the underlying contract, while a letter of credit, as a primary obligation, is independent of the underlying transaction. Therefore, an agreement between the beneficiary (seller of real estate) and the buyers, releasing one buyer, did not affect the beneficiary's right to demand payment on the irrevocable letter of credit. The basic warranties under UCC § 5-111(1) are that the documents comply on their face with the terms of the letter of credit, and that none of the exceptions set forth in UCC § 5-114(2)(b) are present.

[¶ 3417.1, ¶ 5111] Warranties on presentment and transfer—applicability to letters of credit.

Although UCC § 3-417 warranties are applicable to any person who transfers an instrument and receives consideration, the obligations of a bank which had issued a letter of credit were unrelated to the underlying note, and alleged breach of warranties applicable to the note did not affect the issuer's obligation to pay on the draft presented under the letter of credit. If § 3-417 was applicable at all, it was applicable to the draft, not to the underlying note, and the issuer did not allege any breach of warranty related to the presentment of the draft under the letter of credit.

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[¶ 3606.2] Effect of right

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contends that the April 11 and July 19 agreements constituted a novation of the original note without his consent, absolving him of liability on the note. See *Williams v. Crusader Disc. Corp.*, 75 Nev 67, 334 P2d 843 (1959).

The April 11 agreement states that Hi-Tide, Inc. "has assumed an obligation to repay to Lowden . . ." The use of the word "assumed" could be construed as a release, suspension, or novation of Lowden's rights as against O'Rayeh. Lowden argues that he intended the later agreements only to add a second guarantor for the original obligation. Where, as here, the crucial factual dispute concerns characterization of a party's conduct, which in turn involves elusive questions of intent and motive, summary judgment is inappropriate. *Feminist Women's Health Center, Inc. v. Mohammad*, 586 F2d 530, 548 (5th Cir 1978), cert denied, 444 US 924 (1979). See *Poller v. Columbia Broadcasting System, Inc.*, 368 US 464, 473 (1962). See also *Admiralty Funds v. Tabor*, 677 F2d 1297, 1298-99 (9th Cir 1982); *Prochaska v. Marcoux*, 632 F2d 848, 851 (10th Cir 1980), cert denied, 451 US 984 (1981). On the record in the case at bar, summary judgment was not proper on the issues concerning the effect of the April 11 and July 19 agreements on Servaites' contract of guaranty.

As the district court erred in granting summary judgment and holding that Servaites was barred from contesting the bankruptcy court's findings, we reverse and remand for a full trial on the merits.

BISHOP v. UNITED MISSOURI BANK OF CARTHAGE

Missouri Court of Appeals, Southern District, February 17, 1983
647 SW2d 625

[¶ 1201.29, ¶ 3606.4(1)] "Any party"—co-maker's right to claim discharge.

The term "any party" as used in § 3-606 means any party to the instrument, including co-makers. That definition not only encompasses the plain meaning of the words of the statute, but is consonant with the definition of "party" at § 1-201(29). If "any party" were interpreted as being only an accommodation maker or surety for purposes of § 3-606, this would result in a different meaning being applied to § 3-606 than to the other discharge sections of the UCC §§ 3-601 through 3-605, which would create an unacceptable incongruity. Thus, § 3-606 was available as a defense to co-makers of a note.

[¶ 3606.4(5)] Extent of co-maker's discharge.

One co-maker's right of contribution with the other co-maker is a right of recourse within the meaning of § 3-606. The release of one co-maker under

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UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
PIKEVILLE

CIVIL ACTION NO. 80-95

RODNEY E. TAYLOR,
TRI STATES LAND CORPORATION,
LONG BRANCH COAL CORPORATION

AND

FIRST MARYLAND LEASECORP

VS:

MAPCO, INC.

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) Motion of Plaintiff for
) directed verdict at con-
) clusion of trial on
) May 14, 1982.
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MR. FOWLER: Your Honor, I want to state at the outset to be sure it is clear to the Court although we have made a motion for directed verdict here that in the stipulation it is set forth that the proof of our third amended complaint was asked for higher rate of interest as either consequence of damages or proper interest at the discretion of the Court would be the proof of First Maryland in the trial of their case on the equipment lease. And that's been stipulated so, of course, unless the Court sustained our motions there is no reason for that proof or if the Court sustained their motion there would be no reason for the proof.

It simply goes to the amount of recovery. But we have reserved that by stipulation. Your Honor, we really view this case and we recognize Mr. Vish's statement of legal principles here. It is really a fact. Unless the facts support these

legal theories they have no part in it. In our trial brief we have answered him, his legal arguments which were related to the facts of this case. But I would like to concentrate on the highlights only of the facts as we see them.

Your Honor, of course Your Honor listened very intently and I am certain the Court is aware of the facts of the case. We simply want to highlight.

Obviously, Your Honor, in the fall of 1977 the proof shows that Mr. Taylor was in distress from a capitalized standpoint. Mr. Wilson in his report to the board indicated that he was a shoestring operation, had constant cash flow trouble. He made a deal with Mapco whereby he had the opportunity--in July he made that contract where he had the opportunity if he could finish his railroad and his tippie to do extra mining and get a better price for his coal by selling clean coal or unwashed coal with Mapco with their big sales force acting as his agent. An opportunity to get himself a great deal better shape in that operation.

It went on that fall and became impossible. Building a railroad is a big job. He spent almost a million I think it was testified to at that point and it took a lot more. He couldn't do it without capitalization. Then he realized the strike was coming up and that would be the end of it.

The Court will recall that he went to Mapco, he and Mr. Mills went to Tulsa with the idea in mind, "Look, give us a long-term loan, give us some capitalization, and we will make it." "No. We are not a bank." "All right, let's joint venture. That way

you can get capital in it and have some part of it and I can stay in the game."

Now, is that the picture of a man that wants to unload a property? He wanted to go on and operate it, but he couldn't. His last resort was he would have to sell it. And they wanted to buy it.

Those negotiations have been testified to in detail. The Court will recall that according to both Mr. Taylor and Mr. Mills that there was no discussion of tonnage. At no time did they discuss the Hill report. At no time was any of the tonnage or the recoverability any issue whatsoever.

All the other factors--and there were many--were discussed in detail. Then at the end of the time the lawyers get together to make all these papers that have been introduced here, the closing documents. And right toward the end its customary, Your Honor, that anything that has been furnished to a buyer, that in the contract of sale, or the purchase contract they call it, he will say, "Let's warrant these. Now, here is your income statement, here is your leases, here is so and so which we want to represent they are true. Here is the Hill report." "Wait just a minute."

You recall the testimony. Mr. Taylor adamantly "I can't warrant or represent any tonnage. No coal man can do that. No one who knows anything about the coal business can do that." He said, "I won't do it." It came up then with 3.6 in the contract "The report entitled 'Long Branch Coal Company Information Relating to Mine No. 1, Martin County, Kentucky,' prepared by

Hill Engineering Company and Seller, and delivered to MAPCO herewith"--There has been a lot of talk about penciled notes, Your Honor. There were no penciled notes on any Hill report or twenty-three page report that Mr. Taylor delivered. And that is what the reference is to in that Section 3.6--"and contains no material misstatement of fact, (including, to the best of the knowledge and belief of Seller and Tri-States, the statement therein as to total in-place tons of coal)."

Now, Your Honor, when you say you believe something--we have got a good Kentucky case on that--the very condition of a belief is that you don't know the fact. He says, "I believe it but I don't know it."

Now, when we start talking about in-place tonnage, then we have to be talking about the factors that go into the in-place tonnage. You don't get in-place tonnage without saying there is a seam here of a certain height, a seam here of a certain height, there is so many acres of such and such a density. You multiply it out and you get the tonnage. If you don't know the tonnage then you don't know those exact figures that was used in the two-page Hill report.

Plus the fact that Mr. Taylor knew what the Hill report was and to this day to the best of his knowledge with the data Hill had, the limited data he had, was to fully outline the coal. It was a good report.

Now, in the background of this, Your Honor, is Bruce Wilson. He is an experienced mining engineer. Mr. Taylor is a miner, but he is certainly not an engineer. He hasn't been educated. He

simply has known how to mine. He had been at it ten years as I recall. But between those two, you give Mr. Wilson a two-page report that is simply narrative, a conclusion, and say, "Well, we thought it was right."

Well, Mr. Wilson himself said it was no good in the sense that it did not define. You couldn't verify it in any way even by reading it, there were no maps, there were no charts, there were no tables, you simply couldn't depend on it.

We think that this disclaimer "best of knowledge and belief" in Section 3.6 just simply qualifies the whole matter. And yet this whole case, Mapco's whole position, rests solely on the fact that they bought, their proof, their damage proof, "We bought twelve million eight hundred thousand tons of coal from you, Mr. Taylor, and for every lump that is not there you have got to pay it so we have got to deduct it from the purchase price." Yet he disclaimed it and they knew it.

THE COURT: What about that part there, Mr. Fowler, where I think they stated they hadn't given any contrary information to the Hill report? There wasn't anything said in this trial about that.

MR. FOWLER: I am sorry?

THE COURT: I said I don't recall any evidence regarding that one sentence at all in this trial.

MR. FOWLER: "All the information provided by Seller and Tri-States to Hill Engineering Company in connection with the preparation of the report was true, correct and complete."

THE COURT: Right.

MR. FOWLER: Mr. Taylor testified all the information he had and turned over to Hill. Hill was doing his permit report.

THE COURT: Yes, sir, I recall that. But I don't recall anyone testifying as to the reason that was in there.

MR. FOWLER: I don't either, Your Honor, exactly that it was in there for any specific purpose other than what it says. I think Mr. Taylor's proof is clear that Hill had all the knowledge Mr. Taylor could have given him or did give him. There wasn't any more.

THE COURT: I just don't recall the purpose was stated as to why that was put in that qualification.

MR. FOWLER: There is no proof on that. I think Your Honor is correct.

They try, Your Honor, to take Section 10.6, I believe it is-- that's not right--10.3, which is indemnification. It is a general indemnification. It does mention misrepresentations of any report and so forth. They try in some way to make it a general statement, bring the limited or qualified special statement of 3.6 up to this standard as if it wasn't there, and I don't think it can be done.

I really think, Your Honor, that as we move on through the year 1978 after Mapco bought the property Your Honor will recall it's been called to the Court's attention on several occasions that the stipulations as stipulated that prior to receipt of the information of the John T. Boyd Company in late 1979 Mapco was unaware of any alleged deficiency of the coal reserves of the leasehold properties conveyed by Taylor.

They say in their proof and insinuate here because Taylor mined the property between the time of the Hill report and the sale of--October of '76 I think until say February of '78, that somehow or another he must have known something and didn't tell us. Mapco mined it from February of '78 till November of '79 and they didn't find anything wrong.

It wasn't until this telephone conversation with Boyd, they say. I don't know how they could say Taylor should have known something and at the same time we didn't, and they mined it almost the same length of time just about between those two periods.

In addition to that, Your Honor, all through this case there has been quite a battle certainly of discovery over job site 2, the roof of the coalberg mining on the Ruth McCoy property. They brought Mr. Vanhooose and Mr. Crider in here and they testified maybe five feet. Mr. Taylor--or Mr. Taylor didn't particularly contradict them. It was a seam of coal that was mineable. He testified they got thirty-seven thousand clean washed product tons out of the coalberg at that job site.

But more important, Your Honor, and uncontradicted, that right there on that red, which is the coalberg on job site 2, Ruth McCoy, Mapco's representatives on June 1, 1977, came to that property, measured uncovered coalberg, measured its height, measured it in order to estimate the tonnage of the uncovered coal. That's right at sixteen thousand.

As far as we know Mapco's representatives are the only people that measured it. Crider and Vanhooose didn't. Mr. Taylor didn't.

They measured it. Yet they say, "Why didn't he tell us about that?" They knew more about it than he did. And the record shows it's clean.

Pencil notes that Mr. Wilson put on the contract. And they did get into the closing papers, Your Honor. How we don't know. But those weren't there when they were delivered. Neither Mr. Taylor or Mr. Mills ever saw them. A copy somehow that had those notes on them and when it got to making copies got all those papers apparently in there. Those pencil notes are not initialed. They are in no way authenticated as part of the contract.

3.6 of the contract does not refer to anything other than the Hill report as furnished by Mr. Taylor. When we get up to--

In the meantime, Your Honor, although this has been brought to the Court's attention, speaking of Mapco's experience in mining between the time of the sale and the report from Boyd in November of '79, it is stipulated, a report is stipulated was made by Mr. Cuzzort, chief engineer of Mapco, of Martiki. And in I believe it was February of '79, Your Honor, some time right after the first of the year of '79, after they had been mining a year, Mapco on Toptiki, Long Branch, Mr. Cuzzort made a reserve study. He went out--and the report is in with the stipulations, Your Honor. The report showed detailed measurements of all seams. I think probably five random measurements of all the random seams all the way, all four seams. And taking those together and making an estimate of what was left on the property in place, he came up with close to ten million tons. I think nine million some-odd. I

forget the figure. And a great deal had already been mined. So here they are, Mapco, in 1979, a year after the sale. They have been mining. Their engineer made a study that came right close to the Hill report. So Mapco didn't have any reason to question the Hill report.

We get up to November 21. As I recall, Your Honor, that in October of 1979 Mapco laid off at Toptiki mine half of the work force. They explained in the newspaper--there were two newspaper articles: one in Martin County, one in Huntington, West Virginia, and in Huntington Mr. Wilson himself was quoted--general market conditions, the market was bad, it was soft, reclamation, OSM had come in and was heavy and it was affected, for that reason we laid them off.

If you will recall a letter that was written soon after the--this incident is actually dated January 3, 1980, in connection with a problem with the Office of Surface Mining, the federal people, Mr. Wendell Keller, the general superintendent of Mapco, wrote to the official and said, "As you know the Federal Surface Mining Control and Reclamation Act of 1977 has had a profound impact on mining operations of this type. The act has caused many operators to change methods of operation. Due to this fact and general market conditions, approximately one-half the Toptiki force was laid off October 27, 1979."

Now we lead directly from that to Mr. Wilson's letter of November 21 to Mr. Taylor informing him that he is going to cease monthly payments on the note. The Court will recall with this background of general market conditions, difficulties they

were having with the surface mining act, the limitations it was placing on them, they restricted the operation.

The Court will recall also that John T. Boyd was in the process of making an engineering report on all of the properties. He says Mr. Wilson called him in November and says, "Give me something on Toptiki." Then Mr. Lewis says, "I called Mr. Wilson on November 21 and told him it looked like we had made some little runs and it looked like there was a discrepancy."

Mr. Wilson had to confer with his attorney and officials there at Mapco, "What are we going to do about it?" and they made the decision according to them in that one day and drafted this letter. And one of the striking things about this letter is it says, "Hill Engineering report"-- Excuse me. "Although we have only received a preliminary estimate from John T. Boyd Company, it is obvious there is a substantial discrepancy between in-place reserve figures shown in the Hill Engineering report and the actual in-place reserves as determined by the Boyd Company with the Hill Engineering report indicating in-place reserves considerably greater than are present." All he said.

And Mr. Vish talked about recoverability and I don't know what. But Mr. Wilson said, "The in-place tonnage is wrong in Hill and we are going to quit paying you." Of course, the Court can draw its own conclusions as to why, but the circumstances are there to indicate just this, Your Honor: that the market got bad, OSM was running up the costs, limiting their recovery there by surface mining methods, they were paying Taylor seventy-eight thousand dollars a month on that note, there was no interest,

no good cause for interest, "Let's quit paying him. He will just sue us." The Court can from the proof draw that conclusion.

"We need an excuse. Call Boyd."

Your Honor, the way this case is presented by Mapco is this. Here is the Hill report. It says twelve million eight hundred tons. Now we have got to find in 1981 they get the final Boyd report that was some nine months after this action was filed. Now we have got this report. And all we do is compare them. Twelve million eight, six million what. And, Your Honor, to take a two-page narrative report with no data, no data shown on it, vague references to outside property and so forth, and this report does with twelve diamond drill holes plus other points of exploration in there that were used, sophisticated engineering techniques, it's obvious by looking at it, the tremendous number of charts and tables, and say, "Compare these." You see.

Your Honor, we characterize it as trying to add oranges and apples. They won't compare. The testimony certainly of Mr. Gales and we think Mr. Lewis would indicate completely you cannot compare those reports. If you can't compare them, Your Honor, then what are we talking about? What does it prove? What does the Boyd report prove about the Hill report other than that the result they get from each report is different? That's all.

The fact here is to say, "Mr. Taylor, we got you to make a statement in the contract, 3.6." That statement says true and correct and no material misrepresentations. That statement has no relation to the report itself. Mr. Taylor says, "I think it was true and correct for what it was, and I still do." But, no, that brings his statement, brings it up to perfection. His

statement can't make the Hill report any more than what the Hill report is. It can't increase it. It can't increase its reliability.

Mr. Boyd will tell you or Mr. Lewis that "Look, after all of this tremendous job we have done to make a measured report,"--that is disputed to some degree it is measured by Mr. Gales, but measured report. "What is the reliability of it, Mr. Lewis?" "Plus or minus 20 percent." What is the reliability of the Hill report according to Lewis, Gales? Zero. You can't. It's speculating.

But what are they saying? "It's true this measured report we want you to consider as data with the Hill report is plus or minus 20 percent, but because of what Mr. Taylor said the Hill report is perfect. If there is a lump of coal missing or short of that twelve million tons you owe us for it." It has to be a hundred percent reliable to use it that way.

Now, when Mr. Taylor said it was true and correct but he would not represent that the tonnage was true and correct, surely he had a plus or minus 20 percent leeway. If you take 20 percent off of them, there is no problem. And Mapco never thought there was any problem until after their troubles in the fall of 1979.

Your Honor, really we started out by thinking that the case, that was the case about what I have outlined here, but out of caution we asked Mr. Gales of Gates Engineering Company to take a look at these two reports and give us some notion and when we got his preliminaries we went on to have him make a study with the

thought in mind if somehow we are wrong here let's show that if you do compare the Boyd and the Hill report there's not that difference. He has done it. He comes up with ten million six hundred thousand against twelve eight, and even counting the Hill report as a measured report, taking 20 percent plus or minus, and you are down to exactly Mr. Gales' testimony of the amount of recoverable in-place tonnage on that property.

According to Mr. Gales there is no contradiction tonnage-wise within those perimeters between the Boyd report and the Hill report. So if we are wrong at first here we have shown the Court that the difference isn't there that they say is, Your Honor, that they said in their November letter based on a telephone conversation, "We think there is a discrepancy."

We have shown on top the fact the two reports can't be compared the fact that Mr. Taylor's statement, particularly with the tonnage disclaimer, cannot make the Hill report something it isn't and certainly an experienced engineer, Mr. Wilson, knew it couldn't be. And in addition to that, we have shown that you could take the Boyd data and Mr. Gales said the coal was there. So what are we fighting about, Your Honor? Thank you for your attention, sir.

THE COURT: Thank you, sir.

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
PIKEVILLE

CIVIL ACTION NO. 80-95

RODNEY E. TAYLOR,	)	
TRI STATES LAND CORPORATION,	)	Motion of MAPCO, Inc. for
LONG BRANCH COAL CORPORATION	)	
AND	)	directed verdict at con-
	)	
FIRST MARYLAND LEASECORP	)	clusion of trial on
	)	
VS:	)	May 14, 1982.
	)	
MAPCO, INC.	)	

MR. VISH: Your Honor, Mapco began this case as a plaintiff in the United States District Court at Roanoke. Later Mr. Taylor sued to enforce his note in Pikeville and we agreed to assert our claims as counterclaims in this action. This is not a defensive move, Your Honor, to finesse any obligations. If Mapco intended to finesse Mr. Taylor in 1978 it wouldn't have purchased his mining property. It would have waited until he had to sell on a desperation basis, dealt directly with the land owner and that would have been a way to finesse.

Mapco is here, Your Honor, because it doesn't believe it should pay for something it didn't get. Its legal theories are based in contract and in tort and in equity. The contract theories come from the purchase contract itself. We believe there has been a failure of consideration under 2.1 of the contract. We

believe there has been a breach of warranty under 3.6 of the contract. And we believe that the obligations of the indemnity have been triggered under 10.3 of the contract.

In order to rule upon Mapco's case Your Honor would have to decide whether coal reserves was part of the consideration for 2.1, whether coal reserves was the object of the indemnity of 10.3, and whether the language of 3.6 directed to the Hill report was in fact a warranty or representation and whether it was breached.

In tort Mapco has a series of theories. On the one extreme side of the spectrum is fraud, not in the sense of criminal fraud, Your Honor, not in the sense of fraud that Mr. Taylor has a black heart and a cluttered conscience, but in the sense of more relaxed standard of securities fraud which the believe the parties agreed to in 3.14 of the contract.

Now, over on the other side of the tort spectrum is innocent misrepresentation. In the equity part we are relying on mutual mistake of fact and the old Kentucky 10 percent rule which is a variation of consideration. I think it well fits in this case.

Prior to 1826, Your Honor, Kentucky courts wouldn't listen to anything on the amount of land described in a deed because they didn't believe the technology was available to measure how many acres were in a deed. It was after 1826 that the Kentucky 10 percent rule was developed that if the amount of property conveyed varies by more than 10 percent, then equity will adjust the purchase price.

There was probably a later period in judicial development when courts had to wonder whether you could rely upon accounting testimony. Maybe those were estimates and maybe the courts couldn't rely on those. Then later opinions, opinions of people like lawyers. And today coal reserves, Your Honor, whether they can be measured with sufficient specificity to enable people to rely on that type of report.

The 1975 Hill report properly qualified and cautioned the reader on any reservations that the reader should be aware of as to the coal in place. Mr. Sparr testified that he had available to him the full lexicon of qualifying language and the 1975 Hill report shows that he used it.

After the prospecting cut was taken in job site 3, Mr. Hill correctly removed coal reserves from that area. And we have contended and introduced, in addition to some expert testimony, some eyewitnesses who mined coal at job site 2, who picked it up and brushed it off and carried it away.

If that information had been available to Mr. Hill prior to the 1978 closing with Mapco, we think the amount of reserves would have been adjusted.

Now, on the comparability of the reports, Your Honor, we think that Mapco is obligated to and has proved there is a deficiency. Whether the methodology is the same I don't think is critical. But we have to prove that the reserves were part of the contract, were material and that there has been a breach or a failure to deliver the things in that quantity.

I think both experts have proved that, although the extent of the deficiency is subject to conflicting testimony which we believe Your Honor can reconcile in the coalberg underground reserves.

There is some testimony that you can't warrant coal reserves at any time. Well, we introduced testimony, written documentation, that in his course of dealing with Mapco Mr. Taylor had indeed represented coal reserves on prior occasions and that the Hill report was the basis for that representation.

Much has been said about whether we were entitled to rely on it, the confidence factors, which Mr. Gales would like to see in the four corners of the report. Well, Your Honor, in addition to relying on paper, Mapco relies on people and they dealt with John Hill over a period of time and they had confidence that just because every assumption, every bit of investigation was not within the four corners of that report didn't mean that it couldn't be relied upon, and they did rely on it.

Your Honor, they actually included that report in their filing with the Securities and Exchange Commission. The 10-Ks went into evidence. The Federal Government requires mining companies, mineral resource companies, to report this information to the Securities and Exchange Commission to disseminate it to its stockholders and to have that information on file. The fact that Mapco used those numbers in that report demonstrates the amount of confidence and reliance they had in those numbers.

Subsequent 10-K reports demonstrate that they did have to adjust that number downward after Mr. Lewis' report was delivered to them in 1980.

We think there are a number of other statements in the Hill report that were significant and material to the transaction and which were relied upon by Mapco. The biggest of which is the extent of the unmineable coalberg zone depicted on Mapco Exhibits 5 and 8.

While Mr. Taylor may have defined his warranty and representation as to in-place reserves in terms of the knowledge and believe he had, we don't believe that limitation applied to other material statements in the Hill report such as the extent of the unmineable coalberg zone.

In addition, Your Honor, we have to prove injury. That has been proved to the extent of six and a half million dollars by Mr. Weddington and Mr. Base. Your Honor, even though the Hill report was dated in October of 1976, the warranties and representations of the contract made that report speak at the time of closing, which was February, 1978.

We argue that we have proved a prima facie case of failure of consideration, a prima facie case of breach of warranty, a prima facie case on indemnity, on innocent misrepresentation, on the securities fraud standard, no intent to deceive, mutual mistake of fact in the Kentucky 10 percent rule, and we do not believe that case has been rebutted so we ask for a verdict for Mapco in the amount of six and a half million dollars, Your Honor.

THE COURT: Thank you, sir.

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
PIKEVILLE

CIVIL ACTION NO. 80-95

RODNEY E. TAYLOR,	)	
TRI STATES LAND CORPORATION,	)	Court's Findings at conclusion
LONG BRANCH COAL CORPORATION	)	
	)	of trial on May 14, 1982.
AND	)	
	)	
FIRST MARYLAND LEASECORP	)	
	)	
VS:	)	
	)	
MAPCO, INC.	)	

THE COURT: Gentlemen, the Court was impressed in this case by the testimony of all the experts, which would be Mr. Lewis, Mr. Gales and also Mr. Sparr. Well, I think the Court feels, as did Mr. Gales, Mr. Lewis' report was top class. I am quite sure Mr. Lewis would say the same thing about Mr. Gales. Primarily their differences are the interpretation of the data and I think all of us will agree that is a matter about which experts will differ. That is an accepted fact.

The Court is of the opinion that the Hill report was intended to be and is an engineering report of maximum in-place coal acreage and tonnage. This was a minimal data-high risk report of which Mapco was aware.

The evidence will reflect that I believe Mr. Taylor stated he had a B.S. in mathematics. I believe he operated heavy equipment for a while and then became a salesman. Along about the time the coal boom came into effect, of course he was selling heavy equipment, he realized easy money in the coal business and he got into mining and shifted back and forth between Virginia, West Virginia and into Kentucky. And he got into the Long Branch business, at which time he became acquainted with Bruce Wilson.

Bruce Wilson was a mining engineer. The Court was impressed by Mr. Wilson. In fact, the Court's heart kindly went out for him because Mr. Clark came into the court well prepared. And I want to compliment you, Mr. Clark. You did your groundwork very well and you diligently stayed right with it. And he cross-examined him very thoroughly. But Mr. Wilson I would say is a true expert. He bore up very well.

But the negotiations were conducted primarily between Mr. Taylor, Mr. Mills--well, primarily first between Mr. Taylor and Mr. Wilson. They had been in business here two years together on this stip of property and considering the knowledge and experience of Mr. Wilson, the Court is of the opinion that Mr. Wilson knew more about the property than Mr. Taylor.

But, anyway, the Court is I guess of the opinion that when they went to Tulsa Mr. Taylor realized perhaps he might be getting over his head so he got Mr. Mills to go with him. I think first Mr. Taylor and Mr. Mills and Bruce Wilson primarily did some negotiation and then it came on to the attorney, Mr. Holden.

Now the Court wants to digress back to its notes, but I think Mr. Holden made them aware of the SEC requirements and, of course, this comes into the Hill report, and I think it was stated that, "Well, we have got to do something to satisfy SEC." Mr. Taylor I think said, no, he wasn't going to guarantee the Hill report.

And this was confirmed by Mr. Wilson's testimony. Mr. Wilson says that Mr. Taylor said he wasn't going to guarantee it and this thing in 3.6 was a compromise. But, anyway, it appears from reading the instrument and the testimony of Mr. Mills and Mr. Taylor and also Mr. Wilson the Court is of the opinion that the Hill report was not a guarantee nor a representation by Mr. Taylor but that they hadn't given any false information upon which the report was based and that the report was the report of Hill and insofar as Taylor knew it was true and correct insofar as his knowledge and belief.

The Court feels that that was sufficient for Mr. Wilson because he felt like he was acquainted with the property and he was acquainted with Hill so he could rely on it and he didn't need any guarantee. Of course, they were feeling like I think possibly the primary purpose was to try to get this matter by the SEC.

The Court does not feel that this was a misrepresentation of a fact contained within the indemnity section. The Court doesn't feel there was any fraud, any misrepresentation because the Court doesn't feel like there was reliance upon it by Mr. Wilson.

Who needed to get
by SEC? Not
to vent to SEC? Not
to not see it that he
after the audit - certainly
the SEC.

The Court feels that this is a high risk matter. I think it was Mark Twain, The Prince and the Pauper. We have all in the coal fields seen paupers made overnight. We have seen princes made out of paupers and paupers made out of princes in the coal fields.

The Court is going to sustain the motion of the plaintiff, deny the motion of the defendant. The Court reserves the right to edit and supplement its findings of fact upon the issues of liability, which will be done by the Court and mailed to the parties.

The parties will be given thirty days from the time they receive the memorandum within which to submit to the Court a memorandum stating why this memorandum should not be entered as the Court's memorandum.

Is there any questions on my-- I am sure you object to my ruling, and that's understandable. But here is what I am doing is this: I will take the record and this will be within two or three weeks, gentlemen, you will get my finding of fact which I am making today and you will have thirty days from that time to submit to the Court a memorandum. You will have read my memorandum and you can point out to me and give me citations why I should not enter that in the record.

MR. FOWLER: That would be concurrent, Your Honor, thirty days?

THE COURT: Yes, sir, that is concurrent. That's right. Let's do this: Thirty days concurrent. Then I will give each of you fifteen days thereafter to respond to the other. And if I

am convinced, gentlemen, I am erroneous I will set it aside. But if I have to fall off the log right now, which I am, that's my ruling.

Now, are we ready to proceed? Let's have about ten minutes, gentlemen. Then we will proceed on the other issues.
