In Brief

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The Implied Covenant of Good Faith and Fair Dealing

With debtors becoming increasingly litigious in what most bankers would consider ordinary collection cases, one of the most common counterclaims or defenses asserted is a breach of the implied covenant of good faith and fair dealing. This begs the question, what is the covenant of good faith and fair dealing? What must banks do to ensure they act in accordance with it?

It is a well settled principle in Kentucky that "in every contract there is an implied covenant of fair dealing." *Rainer v. Mt. Sterling Nat'l Bank,* 812 S.W.2d 154, 156 (Ky. 1991). However, that implied covenant is not defined by statute. Even more importantly, it is not defined as to what duties it entails or what actions a bank must take to comply with the covenant in everything from originating new loans to special asset workouts. Fortunately, the Kentucky Court of Appeals was afforded the opportunity to provide bankers, lawyers and borrowers alike an explanation of what the implied covenant of good faith and fair dealing means in *Harvest Homebuilders, LLC v. Commonwealth Bank and Trust Company,* 310 S.W.3d 218 (Ky. App. 2010).

In *Harvest Homebuilders*, the debtors, Harvest Homebuilders and Barbara Jeter, appealed the judgment of the Oldham Circuit Court awarding the bank a deficiency balance for the remaining amount owed on the loan following the foreclosure sale of the property, which was the subject of the action. In their appeal, Harvest Homebuilders and Barbara Jeter argued the bank breached the implied covenant of good faith and fair dealing by continuing with the foreclosure sale when there was a contingent, purchase option agreement with a third party.

The Court of Appeals denied Harvest Homebuilders' and Barbara Jeter's arguments on the basis that the bank did not enter into a contract with the third party to sell the property and any attempt by the bank to enter into such a contract was "insufficient

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alone to constitute a breach of the covenant." The Court of Appeals also found that Harvest Homebuilders' and Barbara Jeter's demands they be released from any deficiency balance were without merit. Ultimately, the Court of Appeals determined "[t]he implied covenant of good faith and fair dealing simply imposes on the parties a duty to do everything necessary to carry out the contract" and that the bank had met that standard.

The decision of the Court of Appeals in *Harvest Homebuilders* is crucial for several reasons. First, it leaves banks with a clearer standard in conducting business with borrowers—do everything necessary to carry out the contract. As long as banks act in accordance with the terms of their account agreements, notes, security agreements, mortgages and any other documents governing their agreements with borrowers, they should be found to have satisfied the covenant of good faith and fair dealing. Secondly, and just as importantly, in ordinary collection cases where the borrower is unhappy because of a deficiency balance, the claim of a breach of the covenant of good faith and fair dealing, absent additional facts, should not be successful.

It is important to note that this decision is in conformity with the Kentucky Court of Appeals decision in *Arie de Jong v. Leitchfield Deposit Bank,* 254 S.W.3d 817 (Ky. App. 2008), which held that "[b]anks do not generally have fiduciary relationships with their debtors. This flows from the nature of the creditor-debtor relationship. As a matter of business, banks seek to maximize their earnings by charging interest rates or fees as high as the market will allow. Banks seek as much security for their loans as they can obtain. In contrast, debtors hope to pay the lowest possible interest rate and fee charges and give as little security as possible. Without a great deal more, a mere confidence that a bank will act fairly does not create a fiduciary relationship obligating the bank to act in the borrower's interest ahead of its own interest…" Consequently, it is clear the Kentucky Court of Appeals is not asking banks to forego their own interests with borrowers, but rather is only asking banks to act in conformity with the terms of their loan documents in dealing with problem credits.

While debtors in default may continue to utilize breach of the implied covenant of good faith and fair dealing as a defense to collection actions, such defense should be readily terminated in summary judgment proceedings where the bank has acted in accordance with the terms of the loan documents. To the extent that banks live up to their end of the bargain, there is no breach of the implied covenant of good faith and fair dealing.

Timothy A. Schenk
Senior Associate

Did you know?

Beginning January 1, 2011, a new disclosure is required by Kentucky law to be made by the seller of a condominium unit.

The disclosure is required by KRS 381.9203, which was enacted in 2010 when Kentucky substantially revised its condominium laws. In general, the seller is required to provide the purchaser with copies of the condominium regime declarations, bylaws, rules or regulations, and a certificate about the condominium complex containing information on 12 different subjects. The seller can request the condominium association provide the certificate and the other information, and the seller is not liable for any errors in the information the association supplies. The statute also provides that "the sales contract is voidable by the purchaser until the certificate has been provided and for five (5) days thereafter or until conveyance, whichever first occurs."

Our lender clients should be aware that KRS 381.9201(2) expressly states that a certificate is required in the case of "a disposition pursuant to court order" or "by foreclosure or deed in lieu of foreclosure."

There is a possible exception for units in a condominium complex in which all units are restricted to nonresidential use. In such cases, KRS 381.9201(1) provides that the certificate requirement may be waived by agreement of the purchaser.

For more information, please contact Thurman Senn.

Changes to Kentucky Secretary of State's web site

With assistance from M&P, the Kentucky Secretary of State has modified its UCC Online Search system. The system will now return the secured party's name as an additional column on the search result, if the search returns 200 rows or less. This is a useful and efficient change for parties who regularly conduct UCC searches online.

M&P Obtains Published Opinion from Kentucky Supreme Court Enforcing Arbitration Agreements in Motor Vehicle Sales Disputes

When Velessa Hathaway found some records in a used car she purchased showing that a wheel speed sensor and a power steering pump had been replaced in the past, she tried to sue on all types of theories – fraud, conversion, breach of warranty, violation of Kentucky's consumer protection and motor vehicle sales laws, and violation of the federal Truth In Lending Act. The seller of the used car, Commonwealth Dodge, LLC, disputed her claims, and it also insisted that she arbitrate all of her claims under a written arbitration agreement Ms. Hathaway had signed at the time of the sale. Ms. Hathaway refused, but both the Kentucky Circuit Court and the Court of Appeals ordered her to arbitration.

When Ms. Hathaway appealed to the Kentucky Supreme Court, M&P was tasked with explaining why Commonwealth Dodge's arbitration agreement should be enforced. On March 24, 2011, in the case of *Hathaway v. Commonwealth Dodge, LLC,* No. 2010-SC-000457-MR, the Kentucky Supreme Court unanimously ruled that "all of the claims [Ms. Hathaway] raises against Commonwealth Dodge… are covered by the arbitration clause" which is binding against her.

The case addresses a number of key points that regularly arise in disputes over arbitration. First, the Supreme Court ruled that parties may, by contract, specify that the arbitration clause will be governed by the federal Arbitration Act (9 U.S.C. §1, et seq.). Second, the Supreme Court reminded contracting parties that when the Kentucky Arbitration Act (KRS Chapter 417) applies, the arbitration clause must expressly specify a location in Kentucky for the location of the arbitration or the agreement is not enforceable. Third, the Supreme Court rejected all of Ms. Hathaway's arguments that the arbitration clause was "unconscionable" even though it was on a preprinted form and allowed Commonwealth Dodge to use court procedures to enforce its security interest in the vehicle if necessary to repossess it. Fourth, the Supreme Court emphasized that Ms. Hathaway had the obligation to read the contract she signed and that Commonwealth Dodge was not required to verbally warn her about its contents. Fifth, the Supreme Court enforced in a common sense way the "broad" scope of the types of disputes the agreement required to be arbitrated.

M&P is pleased to have helped Commonwealth Dodge obtain a published opinion from Kentucky's highest court enforcing its contractual arbitration agreement.

> "Thurman knew the importance of this appellate brief to our company and understood the repercussions that it would have for all businesses utilizing arbitration clauses. And, because of that, Thurman put tremendous effort and focus into preparing a quality and well-thought out brief. His convincing arguments are what ultimately won the day. We are beyond pleased with this outcome."
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> ***Ray Duran, Jr., CFO, Hays Automotive Group***

Firm News

M&P is pleased to announce:

John T. McGarvey has been inducted into the 2011 class of the University of Kentucky College of Law Hall of Fame.

Thomas R. Coffey, formerly with the Commonwealth Attorney's office, has joined the firm as a Senior Associate. Coffey is a 2006 graduate of the Notre Dame Law School. Coffey's practice will be concentrated in the areas of commercial litigation, business disputes and criminal defense. Coffey is located in M&P's Louisville office and can be reached at 502-560-6742 or trc@morganandpottinger.com.

Tim Schenk was recently named a Senior Associate.

Deane Stewart was named to the 2011 class of Leadership Kentucky.

Mindy Sunderland was named to the 2011 class of the Louisville Bar Association's Leadership Academy.

If you would like to receive future editions of M&P InBrief electronically, please e-mail us at newsletter@morganandpottinger.com.

In other news:

John McGarvey was named the co-chair of the Enactment Task Force for the 2010 Amendments to Article 9.

Mindy Sunderland was the chair and moderator of the University of Kentucky College of Law Collection Law Conference held on May 19, 2011. Both John McGarvey and Molly Rose were presenters.

Tim Schenk was named to the Louisville Downtown Development Corporation's Young Advisory Group.

M&P has become a Top Investor of Greater Louisville, Inc. (GLI).

John McGarvey appeared on a panel titled Difficult Debtor Names at the ABA Business Law Section Spring Meeting to discuss perfection of security interests.

Mindy Sunderland and **Tim Schenk** recently participated in Focus Louisville through the Leadership Louisville Center.

Garret Hannegan has joined One Southern Indiana on behalf of M&P.

Mindy Sunderland has joined GLI's Small and Independent Business Committee and serves on the Inc.Credible Awards sub-committee.

In May, **John McGarvey** presented on the 2010 Amendments to Article 9 at the Hudson-Cook Housing and Auto Finance Workshop in Baltimore.

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