

Commonwealth Of Kentucky
Court of Appeals

NO. 2004-CA-001094-MR

CONSOLIDATED MORTGAGE, INC.

APPELLANT

v. APPEAL FROM FRANKLIN CIRCUIT COURT
HONORABLE WILLIAM L. GRAHAM, JUDGE
ACTION NO. 03-CI-01515

DEPARTMENT OF FINANCIAL
INSTITUTIONS

APPELLEE

OPINION
AFFIRMING

** ** * * *

BEFORE: GUIDUGLI, McANULTY, AND MINTON, JUDGES.

GUIDUGLI, JUDGE: Consolidated Mortgage, Inc. (hereinafter "Consolidated") has appealed from the Franklin Circuit Court's Opinion and Order affirming the final order of the Department of Financial Institutions (hereinafter "the Department"), which revoked its mortgage broker licenses and imposed a \$15,000 fine for violations of KRS Chapter 294. The sole issue on appeal is the validity of an *ex parte* administrative subpoena the Department issued and served on a third party financial

institution in order to access Consolidated's bank account records. We affirm.¹

For our recitation of the facts of this case, we shall rely upon the Hearing Officer's findings of fact, which were adopted by the Commissioner in the Department's final order:

1. The Department of Financial Institutions is an administrative agency in the Commonwealth of Kentucky which regulates state-chartered banks, savings and loan institutions, credit unions, consumer loan companies, mortgage lenders, mortgage companies and mortgage loan brokers in the Commonwealth of Kentucky.
2. The Respondent, Consolidated Mortgage, Inc., has operated a mortgage loan brokering business under license number 501-B since May 22, 1991. The current location of the business and its registered address is 2401 Regency Road, Suite 202, Lexington, Kentucky 40503. Consolidated's agent for service of process is Donald A. Clark, whose address is the same.
3. On December 15, 1993, the Department granted Consolidated a license to operate a branch office at 1717 Dixie Highway, Suite 100, Fort Wright, Kentucky 41011, and assigned license number 559-B to this mortgage brokering business.

¹ We take judicial notice of our unpublished opinion in Consolidated Mortgage, Inc. v. Department of Financial Institutions, appeal No. 2003-CA-002122-MR, rendered December 10, 2004. In that case, a different three-judge panel affirmed the revocation of Consolidated's mortgage broker licenses by a default order. Following the events in this case, two of Consolidated's officers opened another escrow account in a different bank, and then failed to pay off prior creditors in five loan closings. Although not yet final, at the time of this writing no further review of that opinion has been sought in the Supreme Court and the time has expired to do so. Therefore, Consolidated's mortgage broker licenses shall remain revoked regardless of our ruling in the present appeal.

4. James C. Clay, Esq., is a real estate attorney who practices in Lexington, Kentucky. Mr. Clay's practice includes closings for residential mortgage loans, and he has performed residential mortgage loan closings for Consolidated since 1999. In these closings, Mr. Clay received the loan proceeds, deposited the proceeds [in]to his firm's escrow account, then issued a check in the amount of the loan proceeds to Consolidated. In turn, Consolidated, not Mr. Clay, was expected to disburse the proceeds to the payees listed in the HUD-1 Settlement Statement. This arrangement was unique among the various mortgage brokers serviced by Mr. Clay in his mortgage loan practice, and it was initiated at Consolidated's behest in 1999.
5. Mortgage loan proceeds typically are disbursed by the lender of the loan proceeds or its closing agent.
6. Mr. Clay always attempted to deliver the loan proceeds to Consolidated as promptly as possible after the closing, even hand delivering the check at times rather than mail delivery. Payment needed to be made as promptly as possible to cut off accrued interest, which was normally paid by the person refinancing their (sic) mortgage loan.
7. In March or April of 2002, Mr. Clay met with representatives of the FBI concerning allegations that certain mortgage holders had not been paid in a timely manner or had not been paid at all.
8. Mr. Clay ceased to close loans for Consolidated on or about April 1, 2002. Shortly thereafter, and based on information provided by Mr. Clay, the Department initiated an investigation

into Consolidated's business practices at its Lexington and Fort Wright offices.

9. E. Martin Bryan has served as a Certified Financial Institutions Examiner with the Department for over five (5) years. Prior to joining the Department, Mr. Bryan served as a bank examiner, a commercial loan broker and a residential mortgage loan broker.
10. Mr. Bryan conducted three (3) examinations of Consolidated. Approximately two (2) to three (3) weeks prior to this first meeting on May 10, 2002, Consolidated was served with a Department "Examination Request List." The List asks the company to have available and provide to the Department at the examination, among other information, "all accounts maintained by the licensee for the past twelve (12) months, together with all canceled and voided checks." Mr. Bryan's examination was intended to address allegations that Consolidated was maintaining an escrow account into which it deposited loan proceeds and paid from this account prior liens and expenses of closing. By this point, the Department was also investigating allegations that Consolidated was delaying the payoff of prior mortgages.
11. Suspecting that the funds which Consolidated should have used to discharge liens were being used to operate Consolidated's business or were being used for personal purposes by Consolidated's officers, Mr. Bryan and Mr. Shelby Merritt, the Department's Compliance Director, met with Consolidated's representatives on May 10, 2002, and requested that these representatives produce records of its operating account, #10245618 Central Bank, Lexington, Kentucky, and its

escrow account, #10277011 Central Bank, Lexington, Kentucky. Ms. Brenda F. Gentry, Consolidated's Secretary/Treasurer, informed Consolidated's representatives that the records were with the company's accountant, who was out of the country. This information was false.

12. Mr. Bryan returned to Consolidated's offices on May 15, 2002, to retrieve canceled checks and bank statements. The checks were supplied to Mr. Bryan, but Ms. Gentry informed Bryan that no bank statements were available since the company accountant had shredded them. This information was false.
13. On May 22, 2002, Mr. Bryan telephoned Ms. Gentry and reported that he had spoken with the company's accountant at his office in Lexington, Kentucky; thus he was not out of the country. Mr. Bryan further reported to Ms. Gentry that the accountant represented he only dealt with Consolidated's payroll account and he never had any records on its operating or escrow account. When confronted with this information, Ms. Gentry informed Mr. Bryan that she had spoken with Ms. Barber Clark, an owner of Consolidated and a company Vice-President, and the requested records would be forthcoming.
14. The review of the canceled checks supplied by Consolidated on its escrow account revealed to the Department officials alterations of the dates of the checks themselves. Similarly, the bank statements supplied by Consolidated for its operating and escrow accounts contain numerous alternations.
15. After its preliminary review of these checks and bank statements, the

Department sought to compare these documents with the bank records on both Consolidated's operating and escrow accounts from Central Bank in Lexington, Kentucky. The Department obtained Central Bank's records pursuant to subpoena.

16. After comparing the documents provided by Central Bank with those provided by Consolidated, Mr. Bryan quickly concluded that the original check was dated accurately, but the "original" as supplied by Consolidated had the date changed to coincide with the date when funds were received from Mr. Clay and deposited into Consolidated's account.

17. From Mr. Bryan's testimony, coupled with the Hearing Officer's review of the bank's records, the Hearing Officer finds that over 100 of the checks and statements had been altered when Consolidated finally provided the Department the requested canceled checks and bank statements for its escrow and operating accounts. For example, there are approximately 115 different transactions which evidence deposits made into Consolidated's escrow account on a date certain. However, the date for the check written by Consolidated to pay off the prior mortgage from its escrow account has been altered to reflect that it was written simultaneously with the deposit. In fact, the check would not clear the bank until two (2) to four (4) weeks thereafter.

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22. Based upon the testimony presented by Mr. Merritt, coupled with the financial records themselves, the Hearing Officer finds that Consolidated's activities resulted in a financial situation where it would have to wait on the next closing to pay the loans from a prior closing. Mr. Merritt, a thirteen (13) year veteran of the Department, characterized Consolidated's conduct during the Department's investigation as "the most egregious case I have ever encountered in trying to conceal from the Department what the actual situation was."
23. Based on testimony presented by Ms. Gentry on the second day of the administrative hearing, it is clear that Consolidated's officers either personally altered the subject checks and bank statements, or knew of and reviewed the alterations when they were being made.
24. Consolidated's officers repeatedly failed to disclose to Mr. Bryan or other Department officials the existence of Consolidated's escrow account #10277011 used to disburse loan proceeds, which is the subject of this administrative action.
25. Had Department officials known of the existence of Consolidated's escrow account used to disburse loan proceeds, it would have at least asked Consolidated to cease using it for such purpose or would have required Consolidated to post a higher surety bond, as it was performing the functions of a mortgage loan company (i.e., raise the bond principal amount from the \$50,000.00 required of mortgage brokers to the \$100,000.00 required of mortgage loan companies).

26. When Department officials learned of the existence of Consolidated's escrow account #10277011 and requested of Consolidated records on that account, Consolidated's officers deliberately misled the Department concerning the location of bank statements for the account.
27. Consolidated's purpose in altering bank statements was, in part, to hide the existence of insufficient funds checks written by Consolidated. Consolidated's purpose in altering the checks was to make it appear checks were mailed out to pay off creditors on mortgage loan closings simultaneously with the date when funds were deposited to cover such payments. The evidence discloses that these altered checks did not actually clear the bank for periods of time up to four (4) weeks after deposit of the funds from the loan closing.
28. All transactions complained of in this administrative action occurred in the Commonwealth of Kentucky.
29. The Department filed an Administrative Complaint against Consolidated on July 11, 2002. The Department alleged that Consolidated committed three (3) separate categories of violations of KRS Chapter 294; to wit, that Consolidated concealed an escrow account used for deposits of loan closing funds, that it failed to supply documents when requested by the Department, and that it supplied numerous altered checks and bank statements to the Department during its investigation.

Ultimately, Consolidated's mortgage broker licenses were revoked and a \$15,000 fine was imposed.

At the beginning of the administrative hearing, Consolidated moved the Hearing Officer to strike all of the documentary evidence obtained pursuant to the subpoena. Consolidated's position was that the agency did not have investigative subpoena power under KRS 294.180 unless the subpoena was served with the same notice as under a hearing subpoena. Furthermore, Consolidated argued that the statute was arbitrary and capricious, and therefore unconstitutional, because it did not provide a procedure to challenge the subpoena. After considering the parties' arguments, the Hearing Officer stated that he interpreted KRS 294.180 to encompass third parties, that he knew that other agencies had *ex parte* investigative subpoena power, and that he was not convinced that the agency's investigative subpoena power in this case should be quashed.

After the Commissioner entered a Final Order adopting the Hearing Officer's findings of fact, conclusions of law and recommended order, Consolidated filed a Petition for Review in the Franklin Circuit Court. In its petition and other filings, Consolidated argued that the *ex parte* subpoena caused a denial of its due process rights, that KRS 294.180 is arbitrary and capricious, that the attorney-client privilege attached to

protect communications between attorney Clay and its representatives, and that the findings of fact were not supported by substantial evidence. The circuit court entered an Opinion and Order on May 24, 2004, affirming the Final Order. Regarding the propriety of the investigative subpoena at issue before this Court, the circuit court held as follows:

The law does not support [Consolidated's] argument [that the Department violated [its] federal and state constitutional rights]. In SEC v. Jerry T. O'Brien, 467 U.S. 735 (1984), the Court declared that an agency's authority to issue a subpoena to a third-party without notice to the targeted party does not violate the United States Constitution. At least one state, Colorado, interprets its constitution to require notice to targets for subpoenas issued for the target's bank records. See Colorado v. Lamb, 732 P.2d 1216 (Colo. 1987)(finding that customers have a reasonable expectation of privacy in their bank records). This Court refuses to similarly read Kentucky's constitution. Unlike the Colorado courts, the Kentucky Supreme Court indicated in Deemer v. Commonwealth, Ky., 920 S.W.2d 48 (1996), that customers do not have a reasonable expectation of privacy in their bank records. Although Deemer ruled that a defendant had no expectation of privacy in film negatives delivered to a developer, the Court based its ruling on the holding in United States v. Miller, 425 U.S. 435, 443 (1976), that customers do not have a reasonable expectation of privacy in their bank records under the United States Constitution. Deemer, 920 S.W.2d at 50. [Consolidated] also cites Geary v. Schoering, 979 S.W.2d 134 (1994), but that case is inapplicable because it involved subpoenas for a pending civil action, not

subpoenas for investigative purposes by an administrative agency.

Similarly, the circuit court found no merit in Consolidated's attorney-client privilege or substantial evidence arguments. This appeal followed.

On appeal to this Court, Consolidated limits its arguments to the propriety of the investigative subpoena. Rather than continuing its previous argument that KRS 294.180 is unconstitutional, Consolidated asserts that the Department's use of that statute was unauthorized because of lack of notice. In a related argument, Consolidated argues that Central Bank is expressly exempt from all provisions of KRS Chapter 294.

As did the Department, we shall address Consolidated's second argument first. Consolidated argues that KRS 294.020(1)(a) specifically exempts Central Bank from the investigative subpoena power conferred by KRS 294.180. We agree with the Department that Consolidated is precluded from raising this issue for the first time on appeal to this Court. Even if we were to consider this argument, it is clear that it has no merit; banks are regulated under a different chapter of Kentucky Revised Statutes, so there would be no need for them to be regulated under KRS Chapter 294.

We shall next address Consolidated's argument that the Department's use of the *ex parte* investigative subpoena denied its due process rights. Again, we disagree.

KRS 294.180 provides, in relevant part, as follows:

- (1) In the conduct of any examination, investigation, or hearing, the commissioner or an officer designated by him may compel the attendance of any person or obtain any documents by subpoena; administer oaths or affirmations in the examination of the directors, officers, agents, employees of any mortgage loan company, or mortgage loan broker or any other person concerning the business and conduct of affairs or any person subject to the provisions of this chapter, and in connection therewith may require and compel the production of any books, records, papers, or other documents relevant to the inquiry.
- (2) In the contumacy by, or refusal to obey a subpoena issued to, any person, Franklin Circuit Court, upon application by the commissioner, may issue to the person an order requiring him to appear before the commissioner, or the officer designated by him, there to produce documentary evidence if so ordered or to give evidence touching the matter under investigation or in question. Failure to obey the order of the court may be punished by the court as a contempt of court.

Under the authority of KRS 294.180(1), the Commissioner signed a subpoena ordering Central Bank to produce documents on an attached list. These documents included copies of checking account statements for Consolidated's escrow and operating

accounts from December 31, 2000, through April 30, 2002, as well as front and back copies of approximately 100 tendered original checks. Pursuant to the testimony at the hearing, the Department sought these documents to compare to the documents supplied by Consolidated's officers.

Consolidated relies primarily on this Court's opinion in Geary v. Schoering,² which concerned a defendant's attempt to obtain an unrestricted medical authorization from the plaintiff in a pending civil action. While the case turned on the use of the Civil Rules of Procedure as a means of obtaining discovery, the Court likened an executed medical authorization to an *ex parte* subpoena: "It would allow Grant and Welding to obtain medical information without any notice to Geary and without any means for Geary to protect her legitimate privacy interests."³ However, in relation to this case, it does not appear that Consolidated has any privacy interest in the bank records produced pursuant to the subpoena, and there was no action pending at the time it was issued.

In United States v. Miller,⁴ the United States Supreme Court addressed the propriety of subpoenas issued for bank records that were served without notice to the account holder under investigation. After stating that the documents

² 979 S.W.2d 134 (Ky.App. 1998).

³ *Id.* at 136.

⁴ 425 U.S. 435, 96 S.Ct. 1619, 48 L.Ed.2d 71 (1976).

subpoenaed were not Miller's private papers, but were rather the banks' business records, the Supreme Court indicated that it could "perceive no legitimate 'expectation of privacy' in their contents."⁵ The Supreme Court went on to state, "[a]ll of the documents obtained, including financial statements and deposit slips, contain only information voluntarily conveyed to the banks and exposed to their employees in the ordinary course of business."⁶ Finally, the Supreme Court made it clear that "[t]he depositor takes the risk, in revealing his affairs to another, that the information will be conveyed by that person to the Government."⁷ The Supreme Court of Kentucky adopted this reasoning in Deemer v. Commonwealth,⁸ holding that the criminal defendant lost any expectation of privacy he might have had in undeveloped film when he delivered it to Walgreens for processing.

In the present case, Consolidated clearly had no legitimate privacy interest in Central Bank's bank records. In opening accounts with Central Bank and using those accounts to conduct its business, Consolidated gave up its right to any privacy as to those bank documents. It is also notable that the documents obtained pursuant to the subpoena were not used for the information the documents themselves contained, but rather

⁵ Id. at 441-42.

⁶ Id. at 442.

⁷ Id.

⁸ 920 S.W.2d 48 (Ky. 1996).

were used merely to compare to the suspected altered documents provided by Consolidated. Furthermore, Consolidated's officers had to know that the Department would attempt to verify the accuracy of the checks and bank statements they provided when they had obviously been altered. As an aside, we note that although the subpoenaed records verified the Department's suspicions that the documents had been altered, those same records could have supported Consolidated's claims that they had not been altered, other than to clarify the printing or handwriting. Because Consolidated did not have a legitimate privacy interest in the subpoenaed bank records, it could not have been deprived of its due process rights by not receiving notice of the investigative subpoena. The circuit court properly upheld the administrative ruling denying Consolidated's motion to strike those records.

For the foregoing reasons, the Opinion and Order of the Franklin Circuit Court is affirmed.

ALL CONCUR.

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