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Pre-Judgment Attachment: An Extraordinary Remedy for Dealing with Unscrupulous Debtors

- By Richard Prosser

In a day and age where debtors are increasingly skilled at hiding or "secreting" away assets, creditors are learning that if you do not act fast, you can miss out on what may be your only opportunity to collect. Attachment is a simple concept at its core. In essence, if someone owes you money, and you know they are about to flee to avoid service or dispose of assets to avoid collection, you can have the Sheriff seize known assets and hold on to them until a judgment can be obtained and the matter formally resolved. What makes attachment so extraordinary is that the debtor's property can be seized not only without a judgment, but without so much as notice or a hearing on the matter.

The lack of notice makes attachment particularly appealing because you can sneak up on a debtor who you know is up to no good. If you have information that the debtor is about to dispose of valuable assets, you can have the Sheriff show up at his door unannounced; thus, preventing the debtor the opportunity to act on his intentions.

When is attachment available?

Attachment is governed by §§ 1-440.1 through 1-440.6 of the North Carolina General Statutes. Under these provisions, out-of-state debtors or "non-residents" are treated differently than local or in-state debtors. Because of this treatment, we will address the two categories separately in turn.

A. Non-resident Debtors

Non-resident debtors are treated differently than local debtors because they are perceived as posing a greater risk to North Carolina residents. At least generally, non-residents are in a better position to avoid process and also to move assets without the creditor's knowledge. As a consequence, attachment is more freely allowed with respect to non-resident debtors than those native to North Carolina.

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Nan Hannah Elected President-Elect

We are proud to announce that Nan Hannah was recently elected as President-Elect of the Wake County Bar Association and Tenth Judicial District. The Wake County Bar Association consists of almost 3000 Attorneys and the Tenth Judicial District is comprised of approximately 4000 Attorneys. As President-Elect, Nan has the opportunity to schedule and introduce speakers at the monthly luncheons of the Association as well as assist with the numerous committees of the Association. Nan will assist in continuing the good work of the Wake County Bar Association and Tenth Judicial District.

Being chosen by her peers to serve in such an honorable role is clear evidence of Nan's commitment to her community and her leadership. Please help us in congratulating Nan.

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N.C. Gen. Stat. § 1-440.3 subdivides "non-residents" into three separate categories: (1) foreign individuals; (2) foreign corporations; and (3) domestic corporations whose primary officers cannot be located in North Carolina after due diligence. Debtors falling within any of these three categories meet the first criterion for pre-judgment attachment. In fact, a plain reading of the statute would suggest that non-residency is all that is required; however, because of the extraordinary nature of the attachment remedy, the courts have held that due process demands a second showing.

Seeking attachment without proper grounds or unfounded claims can lead to liability, including civil penalties for malicious prosecution

In addition to non-residency, so called "exigent circumstances" must exist to validate attachment. *See Mitland Raleigh-Durham v. Mudie*, 122 N.C. App. 168, 468 S.E.2d 275 (1996). The most commonly recognized example of exigent circumstances is the debtor's refusal to accept service or "evasion of the judicial system." *Id.*

With respect to non-resident debtors, it is important to keep in mind that attachment only permits seizure of assets located in North Carolina. For property located outside North Carolina's borders, attachment is unavailable. Logically, this makes sense. Consider the execution analogy, if attachment is the pre-judgment equivalent of execution against the debtor's property, it would make sense that you can only seize property located in North Carolina under a North Carolina attachment order, just as you can only execute on property located in North Carolina under a North Carolina judgment.

B. Resident Debtors

Resident debtors present somewhat different concerns than their non-resident counterparts. The obvious distinction being that it is more difficult for a resident to evade service or avoid jurisdiction. Because of this difference, there are only two limited grounds for attachment with respect to North Carolina residents, both of which require evidence that the debtor's actions are specifically aimed at defrauding creditors.

First, attachment is available where a resident debtor has left the State or is keeping himself concealed therein for the purpose of defrauding creditors or avoiding service. You are likely more familiar with this type of debtor than you would prefer. This is the spendthrift debtor who requires significant amounts of time, effort and money just to serve with your lawsuit. During which time, of course, he is out spending with reckless abandon, ultimately, leaving you holding the bag on the credit you extended or money you loaned.

Second, attachment is available where a resident individual or corporation has or is about to remove property from the State, or has or is about to "assign, dispose of, or secrete, property" with the intent to defraud creditors. Basically, hiding or transferring property to avoid collection efforts. You are familiar with this sly debtor as the one convinced he can make himself "judgment proof" by shifting around or stashing away assets. Although there are measures to avoid any fraudulent conveyances, you will almost certainly spend more to undo the debtor's fraudulent transfers, than to attach the assets at the outset. Thus, you can see the benefit of attachment when available.

Remember, when considering attachment against resident debtors, there must be evidence of the debtor's intent to defraud creditors by his actions, be it avoiding service or transferring and/or hiding assets.

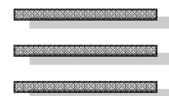
What are the requirements for attachment?

The requirements for attachment are minimal in light of the remedy allowed. The party seeking attachment must submit an affidavit or verified complaint noticing the court that it has commenced an action or is about to do so for the purpose of which is, at least in part, to secure a monetary judgment. The affidavit must set out the amount of money sought, as well as, the precise grounds for attachment. If the attachment concerns a resident debtor, the affidavit must include the specific facts which form the basis for the claimant's belief that the debtor's actions are taken with the intent to defraud his creditors.

Additionally, a bond must be posted with the court before an order of attachment will be issued. The court has some leeway in setting the bond amount; however, the court is directed to require a sum "sufficient to afford the debtor reasonable protection." The minimum bond amount is $200.00.

Conclusion

Pre-judgment attachment is a useful tool, but it is not available in every circumstance. It is considered exceptional relief; thus, its use is carefully guarded by the courts, and its misuse is not taken lightly. Seeking attachment without proper grounds or unfounded claims can lead to liability, including civil penalties for malicious prosecution. That said, do not let yourself fall victim to a debtor's tricks and deception. If you have reliable information which leads you to believe your debtor is not playing by the rules, please feel free to consult us for advice. We will gladly assist you in considering your options, and help you to determine whether attachment is an appropriate remedy.



A Construction Divorce – Avoiding the "3C's" of a Separation: Confusion, Cost, and Conflict. - *Part 1* -

- By Paul Sheridan

Construction contracts can be analogous to a marriage. The Owner and General Contractor or, alternatively, the General Contractor and Subcontractor, exchange legal vows to build something worthwhile and beautiful, and the process can seem as exciting as it does uncertain. There are dreams of a successful union which results in a great project, with everyone richer and happier for the experience. However, unlike most marriages, parties to a construction contract usually intend to part ways long before their respective deaths.

But what happens if an owner or general contractor wants to end the blessed union before the project has been completed? Such a circumstance gives new meaning to the phrase the honeymoon's over. The resulting litigation can be just as lengthy and expensive as the most tumultuous divorce. Fortunately, under the law, owners/contractors may break a construction contract for only two reasons: "with cause" or "for convenience". In today's market of turnkey projects these concepts can also be very important to that supplier who has agreed to perform in the role of a subcontractor. Let's take a closer look at these two important concepts.

Termination for Cause

Most construction contracts include provisions for termination of the contractor's remaining work on a project under certain pre-defined conditions. These clauses typically are included to define the particular events that will allow the owner to eject the contractor from the project and prevent the contractor from completion of his or her scope of work. Termination under these provisions constitutes termination for cause. Such termination for clause provisions will define what constitutes a default that constitutes sufficient cause for the owner/general contractor to terminate the contract and enumerates the rights the contractor has under the contract to cure such a default. Generally, sufficient cause includes:

- Incompetence. Owners may understandably ask for an annulment if a contractor fails to provide the materials and skilled labor force the contract specifies, causes significant progress delays, or displays poor workmanship. Such criticisms may particularly hold weight if job failures continue after the owner/contractor provides notice.
- Illegal activities. Another rather obvious cause for termination is a contractor who fails to follow building codes, ordinances or regulations, or who otherwise disregards federal, state or local laws. Often, these violations arise from ignorance or inability due to lack of experience
- Subcontractor neglect. Sometimes general contractors neglect payment agreements with subcontractors. For example, a financially strapped general contractor may divert cash from one job to a more troubled one instead of paying the first job's subcontractors. Often, this leads to those subcontractors filing liens on the project, creating legal and financial troubles for everyone.

To judge whether cause for termination really exists, owner inquiries frequently begin with the professional responsible for drafting the project's specifications, the architect. Typically, an owner asks an architect to certify that cause exists and to state the specific reasons behind it. He or she will generally comply when circumstances are clear. But if substantial doubt clouds whether termination with cause would hold up in court, many architects will hesitate to enter into an undoubtedly lengthy litigation.

The Consequences of Cause…

If able to establish termination with cause, an owner secures great power and leverage, as a successful case may grant the owner/general contractor the right to:

- Assess a backcharge for the amount that the final completed contract cost exceeds the original contract, assuming the revised job incurs the same number and type of change orders you would have faced had you finished the project (this amount can be difficult and quite contentious to determine),
- Take control of your subcontractor agreements and require these companies to complete their contracts under the original terms doing so may remove their lien rights on work they started with you.
- Seize on-site materials, equipment and tools to complete the contract. This generally leads to a more acrimonious dispute because of the obvious hardships it places on the "removed" parties, and,
- Complete the contract as expeditiously as possible (leading to the backcharges mentioned above) and stop any remaining payments due until the project is finished.

As you can see, termination with cause usually hits quite hard. Recognizing this, most contracts require a grace period for the parties to resolve the dispute. It further complicates the owner/general contractor's decision and may allow both parties enough time to cool off and reach a solution.

Termination for Convenience

Historically, termination with cause was the only reason an owner could break a construction contract. Many modern construction contracts also include a clause that allows the owner or general contractor to terminate the contractor's remaining work on the project at the owner's convenience. Such a termination is not due to any fault on the part of the contractor. Termination for convenience clauses first were included in federal government procurement contracts. Under these, the government could terminate without cause as long as it did so in good faith. The construction company involved could still recover some lost profit, though not nearly the amount they would have for breach of contract. Eventually, termination for convenience became accepted in private contracts as well.

To be continued in our June Newsletter.

Preferential Transfers in Bankruptcy: How to Minimize the Preference Risk

- By Richard Prosser and James Vann

For suppliers of goods and services, nothing may be more unsettling than discovering that a customer has filed bankruptcy. To add insult to injury, there is a risk that any recently received payment or settlement might be recaptured by the bankruptcy trustee as a preferential transfer or "preference."

Fortunately, there are defenses that can be raised against preference claims. Creditors should be aware that there are certain contexts where payment can be accepted without fear of having to return the money to the bankruptcy trustee at some future date. Below is a basic overview of the criteria that give rise to preference claims, and also some common defenses available to creditors in preference actions.

What is a "preference" payment?

Section 547 of the Bankruptcy Code provides that a trustee or debtor-in-possession may recover – as "preferences" – any payments or other transfers of assets by a debtor to a creditor within ninety (90) days of the debtor's bankruptcy filing. There are two main purposes for this policy: (1) to prevent debtors from favoring any one of its general unsecured creditors over the others; and (2) to discourage creditors from storming the debtor to collect their debts upon hearing of the possibility of bankruptcy.

The elements of a preference claim are: (1) the debtor transferred property to or for the benefit of the creditor (i.e., made a payment); (2) the transfer was made on account of the debtor's pre-existing debt to the creditor; (3) the debtor was insolvent at the time of the transfer; (4) the transfer was made within 90 days of the debtor's bankruptcy filing; and (5) the creditor obtained a larger sum from the transfer than they would have in a Chapter 7 liquidation had the transfer not occurred. Note that payments to a fully secured creditor fail to meet these criteria.

Common Preference Defenses

The Bankruptcy Code provides a series of defenses that creditors can assert to evade preference treatment. These defenses are primarily aimed at encouraging creditors to continue doing business with financially troubled companies. The defenses most frequently asserted are: (1) contemporaneous exchange for new value; (2) ordinary course of business; and (3) small transfers. If a creditor is to routinely avoid preference claims, a working knowledge of these defenses is imperative.

1. The Contemporaneous Exchange for New Value Defense

It excuses any payment or other transfer that the debtor and creditor intend as a contemporaneous exchange for new value and that is in fact a substantially contemporaneous exchange. In other words, if a creditor provides new goods and/or services and receives payment at substantially the same time, the payment will not receive preference treatment.

An example of such a contemporaneous exchange is payment received on C.O.D. basis. Another example – this one specific to the construction context – is the exchange of lien waivers for payment. Outside the Eastern District of North Carolina, a lien waiver exchanged for payment is generally considered the sort of contemporary exchange which insulates from a preference claim. In the Eastern District, however, a lien waiver only offers protection if the lien has been previously filed and/or served.

2. The Ordinary Course of Business Defense

Payments received in the ordinary course of business on debts incurred in the ordinary course of business are excepted from preference treatment. A creditor may utilize the ordinary course defense in either of the following contexts: (1) where payment is received in its ordinary course of business with the debtor, or (2) where payment is received according to the ordinary course of business in that industry.

In the first context, the court's basic inquiry involves a subjective evaluation of the debtor/creditor relationship. This generally takes the form of a consideration of the length of time the parties have had a business relationship, and whether the amount or form of payment at issue differed from past business practices between the parties. The key is the ability to demonstrate that the payment activities of the creditor and the debtor in the 90-day period look the same as those in the year or two years before that period.

In the second context, a more objective inquiry is utilized. The supplier must establish that the terms by which it extended credit to the debtor were "ordinary" within industry standards. This does not mean that all invoices are required to be paid within the invoice terms. The creditor needs to show that payments made by this debtor are similar in time with payments routinely made in the particular industry involved, or at least in a manner and form consistent with the payment practice being challenged.

The Small Transfer Defense

The small transfer defense is another product of the 2005 Act. The exception bars preference claims in the case of primarily consumer debt for payments of up to $600.00, and in the case of primarily non-consumer debt, for payments up to $5,475.00. The amounts are cumulative over the 90-day period immediately preceding filing, so in a situation where bankruptcy appears imminent, one strategy is to keep the cumulative payments over any 90-period below these amounts.

Conclusion

Often, bankruptcy trustees will file preference claims against all creditors who received payment from the debtor in the 90-days immediately prior to a bankruptcy filing. The strategy is to file the claims upfront, and then sort out the merits later in the process. A basic understanding of preferences can help creditors avoid making a reflexive and unnecessary refund payment. However, as demonstrated by this cursory outline, these matters are often complex and best addressed with the assistance of a lawyer specializing in bankruptcy law.