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THE LEGAL PAD

A Newsletter of Current Business and Legal Matters

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Bankruptcy Court Shift Changes Law

- By Nan Hannah

In This Issue:

A recent decision handed down in the Eastern District of North Carolina has turned the practice of Construction Law in the Bankruptcy Court on its ear. In the decision, In re Shearin Family Investments, LLC, the court addressed the issue of a Notice of Claim of Lien on Funds being served post-petition and determined that since the Notice does not relate back in time, it does not fall within the exception to the automatic stay which permits the perfection of a lien post-petition. As the law currently stands, it appears that those creditors who have a direct Claim of Lien on Real Property (dealt directly with the property owner who subsequently filed bankruptcy) may still file their liens post-petition, but first, second or third-tier lien claimants may not do so without leave of court and there is no indication whether the court would grant such relief.

A bit of history: Until the decision in Shearin, it had long been understood by all who participated in the bankruptcy/lien process that if a debtor filed a bankruptcy petition and you had lien rights, you could move forward and file your lien relying upon section 362(b)(3) of the Bankruptcy Code which provides that the automatic stay does not serve to stay “any act to perfect, or to maintain or continue the perfection of, an interest in property . . . .” There had been debate in recent years as to whether you could do the same with a Notice of Claim of Lien on Funds where you did not retain rights to a lien on the real property. While, until Shearin there had been no definitive answer, the general consensus was that a non-subrogated lien on funds might not fly since it does not clearly relate back. However, there is a great argument that the lien right exists from the moment you extend credit or perform work until the funds are paid and no longer subject to a claim and that the serving of the document is “an act to perfect . . . an interest in property.”

What does all this legalese mean to the average credit manager or subcontractor? It means that, for the time being, if a subcontractor (or contractor working for an owner) utters the word “bankruptcy,” you need to at the very least serve a Notice of Claim of Lien on Funds immediately. If a bankruptcy crops up on a project in which you are involved, get the matter to your attorney ASAP because the attorney may have to jump through some hoops in an effort to get permission from the court to file a lien and will need as much time as you can give them to beat deadlines.

There are two cases moving almost in tandem towards hearings which will permit the court to address the issue in the context of a subrogated lien, so it may be that by the time this article reaches your desk we will have additional news and guidance. In the meantime, the best advice is vigilance.

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A Construction Divorce – Avoiding the "3C's" of a Separation: Confusion, Cost, and Conflict. - *Part 2* -

- By Paul Sheridan

Termination for Convenience

Indeed, the AIA's A201 contract provides that the owner may, at any time, terminate the contract for the owner's convenience and without cause. In this instance, you must cease operations and follow the owners requests to protect and preserve the work completed to date. Furthermore, you need to terminate existing subcontractors and purchase orders except those directed to be performed before the effective termination date. And, naturally, you may not initiate any new subcontracts or purchase orders.

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. Indeed, the AIA's A201 contract provides that the owner may, at any time, terminate the contract for the owner's convenience and without cause. In this instance, you must cease operations and follow the owner's requests to protect and preserve the work completed to date. Furthermore, you need to terminate existing subcontracts and purchase orders except those directed to be performed before the effective termination date. And, naturally, you may not initiate any new subcontracts or purchase orders.

Termination for convenience clauses are intended to provide the owner with the option to terminate the remaining balance of the contracted work for a reason other than the contractor's default. For example, if the owner cannot obtain additional financing to complete the work, the owner can terminate the balance of the work for convenience so long as there is a termination for convenience clause in the contract. Sometimes, weather delays, design issues, changing tenant/purchaser markets, governmental intervention, or other slowdowns drag a job so far off schedule that its owner just gives up. Of course, if the owner can convincingly blame the contractor for the delay, the contractor may find itself fighting termination with cause. However, if the contract does not contain a termination for convenience clause, and the owner/general contractor terminates the contract before the work is complete, then the contractor/subcontractor would be entitled to the value of the work completed plus profit that he or she would have earned on the balance of the contract.

Typically, a termination for convenience clause states:

> *"Owner may at any time and for any reason terminate Contractor's services and work at Owner's convenience. Upon receipt of such notice, Contractor shall, unless the notice directs otherwise, immediately discontinue the work and placing of orders for materials, facilities and supplies in connection with the performance of this Agreement.*
>
> *Upon such termination, Contractor shall be entitled to payment only as follows: (1) the actual cost of the work completed in conformity with this Agreement; plus, (2) such other costs actually incurred by Contractor as are permitted by the prime contract and approved by Owner; (3) plus ten percent (10%) of the cost of the work referred to in subparagraph (1) above for overhead and profit. There shall be deducted from such sums as provided in this subparagraph the amount of any payments made to Contractor prior to the date of the termination of this Agreement. Contractor shall not be entitled to any claim or claim of lien against Owner for any additional compensation or damages in the event of such termination and payment."*

From a contractor's point of view, the owner's exercise of a termination for convenience clause can impact the contractor's contract profit. Simply stated, if the contract is terminated for convenience, the contractor will not earn the profit that was anticipated when the contract was executed. If the contract is terminated, the amount paid to the contractor may not recapture the contractor's home office overhead that was allocated to the contract.

There is a Price for "Convenience"

Not surprisingly, termination for convenience does not grant owners the substantial rights and control of termination with cause. For starters, owners may not take control of your subcontracts. Thus, they risk falling into lien battles with unpaid subcontractors, which they're often unlikely to win. Also, owners may not backcharge for the amount that the final completed contract cost exceeds the original contract. And they must pay for the labor completed, though they can offset this amount by deducting for improper work, termination costs and reasonable overhead on the project's remaining phases. Often these issues turn a termination-for-convenience situation into a termination-for-cause dispute, bringing along the latter's legal baggage. Nevertheless, many owners terminate for convenience anyway, because these cases narrower scopes and diminished value tend to curtail their duration and expense.

In the best of all possible worlds, people would respect each other's best interests when getting divorced. And, similarly, owners/general contractors would do the same when terminating a contract with a builder or subcontractor/supplier that's been working hard to finish a job. Sadly, in the real world of construction, neither circumstance usually occurs. That's why you need to know your options should the rug be pulled out from underneath you on one of your projects.

Improving the Odds of Recovery: How to Ensure Your Judgment Attaches to Assets

- By Richard Prosser

Much of a judgment's value depends on the creditor's ability to locate assets and take prompt action. As many of our clients know from experience, a delay or misstep can prove the difference between collecting a debt and having to write one off. One thing that can inhibit a creditor's post-judgment collection efforts is whether the judgment has been "transcribed" or located to the appropriate places. The concept is simple, but if the necessary steps are not timely taken, significant rights may be lost and opportunities passed by.

"Transcription" refers to the process used in North Carolina to have a judgment recognized in a county other than the county of origin – in other words, the process of moving a judgment between counties. Often a judgment is obtained in the county where the plaintiff conducts its business operations. The defendant-debtor, however, may reside or conduct business elsewhere. If you have encountered this situation previously, you were likely advised of the need to transcribe the judgment between counties before seeking a Writ of Execution to levy on assets.

Without further explanation, one might think that the purpose of moving the judgment is to follow the debtor; the true purpose, however, is to follow the debtor's assets. Because the most likely location of the debtor's assets is where he resides, the judgment is often transcribed here first as a matter of course. But it is important to understand that the location of the assets is the true aim, not the location of the debtor.

Why Does It Matter?

In North Carolina, a judgment extends only to property located in the counties where the judgment is "docketed" or formally indexed by the Clerk of Court. Simply put, only property in the counties where the judgment is docketed can be seized to satisfy the debt.

The ability to actually seize the property, however, is only part of the issue. Until a judgment is transcribed and indexed in the appropriate county, a judgment debtor can transfer real property (i.e., real estate) free and clear of an outstanding judgment. And in the case of personal property (e.g., vehicles, personal property, etc.), property can be transferred until the Sheriff physically seizes it or "levies" on it.

> ***One thing that can inhibit a creditor's post-judgment collection efforts is whether the judgment has been "transcribed" or located to the appropriate places.***

So, if you have information regarding the location of a debtor's assets, you can see why there is strong incentive to immediately transcribe the judgment to the corresponding county. Otherwise, the property is not only outside your reach, but can be transferred without consequence.

Now, you are likely thinking, "This doesn't make any sense. I know the debtor owned the property post-judgment, and if he owned the property, it should go toward satisfying my judgment." Unfortunately, the law prefers someone else's interest over yours. "Who?" you might ask. It's the innocent purchaser. Before your judgment is entered on the docket, no one else is on notice of the property owner's debt. Thus, the policy behind the procedure is to protect the unwitting purchaser from unknown creditors – at least until the creditor provides public notice of the debt.

How Can I Put this Information to Work for Me?

Up until now, you may have operated under the assumption that the time for asset analysis was after the judgment was obtained by your attorney. But, as you can see, by the time the judgment is obtained, property that could have been captured to satisfy the debt may be long gone. Further, if you do not act with haste to transcribe the judgment to the necessary locations, the debtor retains the ability to transfer property from your grasp and without recourse.

For these reasons, it is important to carefully consider your options at the outset – when you first sense the matter is headed toward litigation. Perform your due diligence, and if you have the opportunity to seek out information, seize it. If your debtor has means, and you can target certain assets from the start, we can work with you to formulate a strategy that will provide the best shot at making you whole.

Joyful News at Vann & Sheridan

On Thursday, May 21, 2009 Luke Cameron Waters was born to Andrea and Jason Waters. Luke will be the baby brother of Caleb Waters who is three years old. Caleb lovingly calls him Baby Brother. Andrea is a paralegal with Vann & Sheridan and we share in her joy the birth of her son. We wish Andrea, Jason, Caleb and Luke much happiness, joy and love.

Can Security Really Protect Me?

- By Cody Loughridge

What is a Security Interest?

Generally speaking, a "security interest" is an interest in the property of another created by agreement (or sometimes by law) over assets to secure the performance of an obligation, usually the payment of a debt. The party who receives the security interest is often referred to as the "secured party" or "secured creditor". The party who owns the subject matter of the security interest (often referred to as the "collateral") and seeks to give the secured party an interest in the collateral is often referred to as the "debtor". The security interest allows the secured party to enforce its rights against the collateral in case the debtor defaults on its obligations to the secured party. It most cases, it gives the secured party the benefit of seizing, and usually selling, the property of another to discharge the debt that the security interest secures. North Carolina security interests are governed by the Revised Article 9 of the Uniform Commercial Code, which have been adopted by the North Carolina General Assembly and codified in Chapter 25 of the North Carolina General Statutes.

How is a Security Interest Created?

In North Carolina, there are typically three elements in creating a security interest. First, the parties must have an agreement that the security interest attaches to the collateral. Most frequently this is accomplished by a written security agreement, signed and acknowledged by the secured party and debtor. Secondly, the secured party must give value to the debtor in exchange for the security interest. Often, this is in the form of an extension of credit by the secured party to the debtor. Third and finally, the debtor must have rights in the collateral. Generally speaking, a debtor cannot grant a security interest to a secured party unless the debtor has some type of ownership interest or right to the collateral.

How Do I Enforce the Security Interest?

As mentioned previously, a security interest is frequently given by the debtor to the secured party to ensure the performance of an obligation of the debtor; often repayment of a debt. But what happens when the debtor defaults on the obligation? First, it is extremely important that the agreement clearly articulates what constitutes a default of the debtor's obligation, thus avoiding further confusion when it comes time for the secured party to exercise his rights against the collateral. Generally, upon the clear default of the debtor, the secured party will have the right to take possession of and sell the collateral. The North Carolina General Statutes allow for the secured party to take possession of the collateral, without judicial process, if the secured party can do so "*without a breach of the peace*". Once the secured party has recovered the collateral, either by self-help or judicial process, he may sell, lease, or license the collateral to satisfy the debtor's debt. Said sale may be accomplished by public action or private sale. It is worth noting that the General Statutes require that the sale of the collateral by the secured creditor must be "*commercially reasonable*". In short, "commercially reasonable" refers to the time, manner, place and terms of the sale. Once the sale of the collateral is complete, the proceeds from the sale are first applied to the expenses of the repossession and sale; then to the satisfaction of the debt; then to any other secured parties who held a junior security interest in the collateral. To the extent the sale of the collateral does not satisfy the debt obligation of the debtor, the secured party then becomes an "unsecured creditor" of the debtor and he can pursue the debtor through other available judicial means.

V&S Website and Business Law Blog

We are excited to announce that we are updating our website. Our updated website will include new features which we hope will be helpful and be a source of information. We are adding a business law blog to our site which will provide a running commentary of information on business law issues. We will also be adding video clips regarding law related topics in the near future.

We hope you will enjoy the new website and hope it will serve as a portal of information for you. Our website address is www.vannattorneys.com