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Practical Advice During The Residential Real Estate Crisis

June 3, 2008 | by

It is difficult to pick up a newspaper anywhere in the United States and not find an article on the economy, the downturn in the residential real estate market, and the prospect of the economy sliding into recession. "U.S. Housing market is currently suffering one of the worst downturns in history." "The outlook is bleak with new home sales projected to fall 13 percent in 2008..." No sector of the U.S. economy is immune from the impact of the fall in the residential real estate market. Particularly hard hit has been the residential construction market.

As the slowdown in the housing market has starved builders of needed operating cash, many large homebuilders from all corners of the United States have shut their doors, slashed their workforce, filed for bankruptcy protection, or at a minimum slashed prices of their inventory. Since August 2006, many large homebuilders from throughout the United States have succumbed to the downturn and have filed for bankruptcy relief, including such notables as Meyer-Sutton Homes, Inc. (GA), Neuman Homes (IL), Levitt and Sons (FL), and Technical Olympic USA (Tousa), Inc. (FL). In North Carolina, Den-Mark Construction, Inc. of Youngsville, North Carolina filed for Chapter 11 protection in April 2008. Others are likely to follow as market indicators and economic prognosticators indicate there may be no end soon in sight. The impact on homebuilders has created a trickle-down effect on construction lenders, contractors, subcontractors, and suppliers. A break in any link in the construction industry chain creates a challenge to keep cash flowing throughout these interconnected segments.

Practical Advice for Those Who Extend Credit

One pervasive impact of the real estate downturn is the tightening credit markets. Buyers and builders are finding loan approvals more difficult to obtain as lenders raise their credit standards to protect against the perceived higher risk. The resulting overall reduction in construction volume hurts subcontractors and suppliers who have become dependent on the previous cash flow levels of higher construction spending. For those who extend credit to these sectors, the following offers some practical advice to keep in mind, particularly during this period of economic downturn.

- Maintain high credit standards. Now is not the time to lessen your standards for extending credit.
- Thoroughly document every transaction. Make sure all contracts are properly executed, legible and, if possible, witnessed and/or notarized. If collateral is involved, obtain the proofs of delivery and acceptance. File UCC-1 Financing Statements if you have a security interest in your customer's assets.
- Take extra efforts to verify the customer's income and ability to repay the debt. Ensuring that specific, adequate procedures are in place (and consistently applied) can save companies tens of thousands of dollars in write-offs no matter the economic climate.
- Periodically check your customers' credit and trade references.
- If collateral is involved, confirm its location, know who is in possession, and make periodic visual inspections to determine its present condition and value.
- Monitor even slight fluctuations in payments and immediately act on delinquencies.
- Understand your company's collection procedures, and be familiar with your in-house and outside counsel.

Pre-Bankruptcy Protections

There are several steps that lenders, contractors, subcontractors, and suppliers can take to protect their rights when a customer defaults, provided that the customer has not filed for bankruptcy relief. First, wherever possible, obtain personal guarantees. Make sure the personal guaranty contains an original, legible signature and, if possible, have the signature witnessed and/or notarized. Also, check that the person signing the personal guaranty signed in a personal capacity, not as an officer of a corporation.

Second, if collateral is involved, have the contract provide for possession upon default. Prior to a default, periodically investigate the condition and location of the collateral. If a default occurs, act quickly on recovering the collateral. Develop and foster relationships with recovery vendors so if a default occurs, you can act quickly to recover your collateral.

Third, consider reclaiming goods sold to an insolvent buyer. Reclamation is a legal remedy allowing the seller to recover (i.e., "reclaim") goods that it sold to a buyer whom it discovers is insolvent. The right of reclamation by the seller upon discovery of a buyer's insolvency is provided in Article 2 of Uniform Commercial Code, Section 2-702. The Uniform Commercial Code allows the seller to reclaim its goods under certain circumstances, but demand must be made within ten (10) days after the buyer receives the goods. Generally speaking, a buyer is insolvent if it has either ceased to pay its debts in the ordinary course of its business, is unable to pay its debts as they become due, or is insolvent within the meaning of federal bankruptcy law (entity's debts exceed the value of assets at a fair evaluation).

Finally, attempt to secure payment of a debt through the use of mechanics' and materialmen's liens. As a general rule, any person who performs or furnishes labor or materials pursuant to a contract with the owner of real property shall be entitled to a lien on the real property to secure payment of all debts owed for the labor or materials

provided. Generally, contractors have liens on land while subcontractors have liens on money that is owed up the chain of contract. The purpose of lien statutes is to protect the interests of the supplier in the materials it supplies. The materialman, rather than the owner, should have the benefit of the materials that go into the property and give it value. The basic requirements for perfecting and enforcing lien rights include timely filing a claim of lien in the clerk or recorder's office in the county in which the real property is located. In North Carolina, a Claim of Lien on Real Property must be filed within 120 days after the date of last furnishing of labor or materials to the job site. In order to enforce a claim of lien in North Carolina, the contractor must file suit within 180 days of the last date of furnishing. The requirements for establishing and enforcing lien rights are very detailed and time sensitive. Failure to proceed within the statutory requirements can quickly lead to the loss of liens rights and you should consult with an attorney with knowledge in this area of the law prior to proceeding.

Post-Bankruptcy Protections

All is not lost when a customer files bankruptcy. Once notified that a customer has filed for bankruptcy protection, the best business practice is to stop everything and contact your attorney. Mechanic's and materialmen's liens and reclamation may provide a way to protect your rights following a customer's bankruptcy.

Mechanic's Liens and the Automatic Stay. Upon the filing of the debtor's bankruptcy petition, an "automatic stay" is simultaneously put into effect that, for the most part, precludes creditors from taking any actions against the debtor without prior bankruptcy court approval. The automatic stay stops creditors' continued collection efforts, foreclosures, and the continuation and commencement of any actions against the debtor. The automatic stay prohibits any act to create, perfect, or enforce liens against the property of the debtor's estate. The Bankruptcy Code broadly defines a lien and includes security interests, statutory liens, and judicial liens, as well as inchoate charges against property.

The Bankruptcy Code provides exceptions to the application of the automatic stay, one of which is the filing of a claim of lien. It is not a violation of the automatic stay to file a claim of lien after the debtor filed its bankruptcy petition if the lien rights relate back to a date prior to the bankruptcy. In North Carolina, a claimant's lien rights relate back to the first date it furnished materials to the project. Generally, the trustee appointed in the debtor's bankruptcy may invalidate a transfer of property that occurs after the commencement of the bankruptcy case, and which is not authorized by the Bankruptcy Code or the Bankruptcy court. However, the trustee is prohibited from invalidating the perfection of a mechanic's and materialman's lien that by statute relates back to a time prior to the debtor's bankruptcy filing.

To the extent that a creditor wishes to proceed to perfect such a lien claim by filing suit against the debtor, the creditor must seek relief from the automatic stay. While it is not a violation of the automatic stay to file the claim of lien after the bankruptcy has been filed, a creditor must obtain relief from the automatic stay in order to file a state court action against the debtor to enforce and foreclose on the lien.

Reclamation. As noted above, reclamation is a legal remedy allowing the seller to recover goods that it sold to a buyer whom it discovers is insolvent. Reclamation is also available after bankruptcy is filed. In October 2005, revisions to the Bankruptcy Code expanded a seller's right to reclaim goods sold to an insolvent buyer. The seller may demand reclamation of the goods that the debtor received within 45 days before the debtor's bankruptcy petition was filed. Demand must be made in writing not later than 45 days after the debtor received the goods. If this 45 day time period expires after the date that the bankruptcy was filed, then the seller's reclamation demand must be made within 20 days of the date the bankruptcy petition was filed. If the seller fails to make the proper reclamation demand or is unable to recover the goods, the revised Bankruptcy Code provides seller with an Administrative Priority Claim for the value of the goods that debtor received 20 days before the bankruptcy filing if the goods were sold to the debtor in the ordinary course of the debtor's business. Such administrative claims are paid before general unsecured claims, improving the creditor's collection position.

The above practical advice is relevant not only to those impacted by the recent real estate market woes but to anyone who extends credit, especially during an economic downturn. We encourage you to contact legal counsel when confronted with situations involving liens, general collections or a customer's bankruptcy.

ⁱ Julie Haviv (2008, February 20), Home Loan Demand Plunges as Interest Rates Soar, Reuters, visited February 20, 2008

ⁱⁱ Dan Levy and Brian Louis (2007, November 30), Housing Slump's Third Year to be 'Deepest' Since WWII., Bloomberg.com, visited February 20, 2008

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