LEGAL FOUNDATIONS

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Secured Lending in North Carolina

By: Cody R. Loughridge

Generally speaking, secured lending is defined as a loan or extension of credit in which the borrower pledges an asset as collateral for the loan. A secured loan or transaction generally involves a two document system: an acknowledgment of the debt/pledging of the collateral and an instrument which evidences the creditor's encumbrance on the collateral. For example: a debtor\borrower may agree to pledge his motor vehicle as collateral for a loan. In such a case, the debtor would execute 2 documents: 1) A promissory note acknowledging the debt and agreeing to pledge the motor vehicle and 2) an MVR-6, which creates a lien on the vehicle. There are many types of secured transactions in North Carolina, including but certainly not limited to: UCC Financing Statements, Deeds of Trust, Confessions of Judgment, MVR-6, etc. We will look at each of these, individually:

Deeds of Trust: Perhaps an arrangement with which most are familiar, this type of secured transaction involves the pledging of real property to secure a debt. This is commonly seen in a typical mortgage situation where the real property is pledged to secure the debt owed to the bank. A deed of trust is actually a three party document wherein the debtor/purchaser conveys interest in the real property to a trustee, to be held for the benefit of the lender/creditor until the underlying debt is paid. A deed of trust should be immediately filed in the Office of the Register of Deeds in the county where the property is located. Once the debt has been paid in full, the creditor causes a satisfaction of deed of trust to be filed, thereby removing the encumbrance on the real property.

Confession of Judgment: A confession of judgment is a document wherein the debtor agrees to let the creditor enter a judgment against him/her in the event of non-payment of the underlying debt. A confession of judgment is accompanied by a promissory note which lays out the terms of repayment and grants the confession of judgment as security/collateral. Generally, the creditor holds the executed confession of judgment during the repayment period. Should the debtor default, the promissory note grants the creditor the authority to file the confession of judgment with the Clerk of Court and thereby obtain a judgment against the debtor for the outstanding balance owed to the lender\creditor.

MVR-6: As mentioned above, a MVR-6 is used in situations where the debtor\borrower seeks to pledge a motor vehicle as collateral for the repayment of a loan or debt. -Continued on Page 3-

In This Issue

Contractual Attorneys' Fees: What Are They and How Do I Get Them?

By: Nan E. Hannah

The questions set out in the title of this article would seem on their face to be self-explanatory, but that is far from the truth of the situation. Most lawyers will tell you that in contract-based litigation, judges are disinclined to award attorneys' fees unless the end result shows that one side clearly should have resolved this matter without taking it through the trial phase.

The first requirement for a party to have any chance of recovering some part of its attorney's fees is that the underlying contract must provide for the recovery of attorney's fees. N.C. Gen. Stat. § 6-21.2 states that "[o]bligations to pay attorneys' fees upon any note, conditional sales contract or other evidence of indebtedness. . . . shall be valid and enforceable up to but not in excess of fifteen percent (15%) of said 'outstanding balance' owing on [the evidence of indebtedness]."

Many have asked, "Why 15%"? It is an arbitrary number which will be found to vary from state-to-state. The concept of awarding attorneys' fees in contract cases is not to make the prevailing party whole, but rather to reduce the burden of going to court to resolve a dispute between two parties who at some point agreed, in the form of the contract, and subsequently faced a dispute. In some cases, 15% becomes far less than the prevailing party paid its attorney to get a favorable outcome. In other cases, it far exceeds the actual cost of litigation. Therefore, it becomes an element for a party to consider before initiating litigation and throughout settlement discussions.

Another element which should be considered is the actual language of the attorneys' fees provision of a contract or note. Some provide attorneys' fees to the "prevailing party;" other clauses indicate that if a party initiates collection that is sufficient to merit recovery; and still others provide for "actual" attorneys' fees. It is important to note that in North Carolina, the latter will generally still get you 15% as that is the maximum recoverable in an action governed by § 6-21.2.

Consider two scenarios: (1) You have your attorney initiate an action to collect $100,000.00. A complaint is filed and the summons served, but the defendant chooses not to respond, so your counsel obtains a default judgment which includes the awarding of $15,000.00 in attorneys' fees pursuant to the contract. Your legal fees may be in the $1,500 - $2,000 range, so if you are able to collect on the full judgment inclusive of interest and attorneys' fees you will experience a windfall. (2) You have your attorney initiate an action to collect $20,000.00, but this time, the defendants answer and fight you through a trial. The potential exists for you to spend close to the amount you are seeking and yet, the attorneys' fees award would be capped at $3,000.00. This is a strategic element you must consider.

And, the final word of caution in depending upon attorneys' fees is that at the end of the day they are discretionary for the judge. If the term in the contract provides that attorneys' fees become due upon your filing an action to collect on a note or account, there is a stronger argument that the fees are not discretionary. However, if a judge denies attorneys' fees, the cost of appealing that decision is most likely cost-prohibitive. In the "prevailing party" situation, there is usually an "unreasonable refusal to settle" provision as well and therefore, a judge who finds that there was a close question may elect to not award either side the fees. And, the ultimate word of caution, if the language for attorney's fees includes the word "prevailing party," then recognize that if the judge finds for the opposing party, you could find yourself paying the other side's attorneys' fees.

The moral of this story is to not assume that you will recover what you spend on your attorney in every case. If you are a supplier who on occasion needs to file actions to recover on an account, expect the 15% figure to balance out over time, but understand its purpose is to alleviate some of your pain, but not to cure you.

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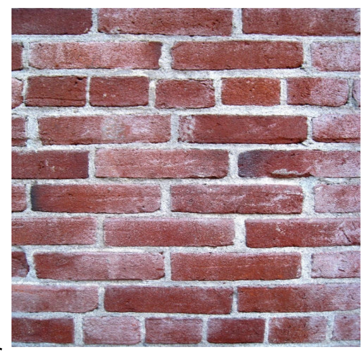
You can register by e-mail at administrator@hslc-law.com or by phone at 919-859-6840.

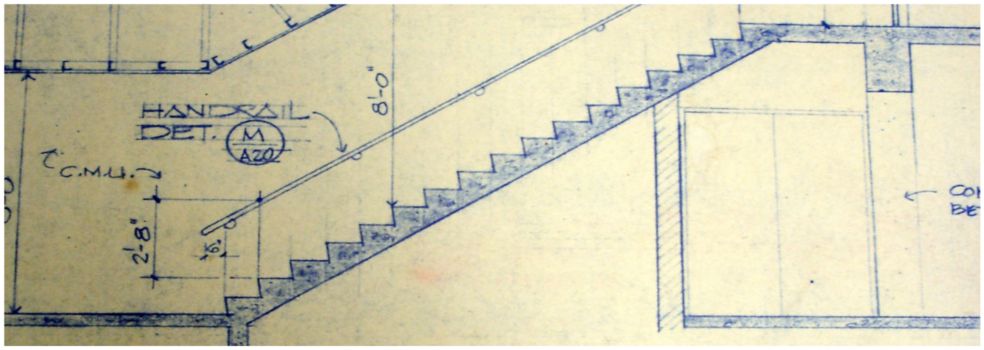


Secured Lending in North Carolina Cont.

In this scenario, the debtor executes a promissory note which sets forth the terms of repayment and pledges the vehicle as collateral. The MVR-6 is the document which is filed with the North Carolina Division of Motor Vehicles and creates the creditor's interest in the collateral. Specifically, the creditor's name is shown as a lien on the vehicle's title. Once the debtor has remitted full payment, the creditor must cancel the title encumbrance. Only then could the debtor convey the motor vehicle, free and clear.

<u>UCC Financing Statements</u>: UCC secured transactions are situations where the lender takes a security interest in an asset of the debtor and that security interest is perfected by a filed UCC Financing Statement. UCC Financing Statements are often utilized in situations where the asset or assets pledged as collateral are not necessary tangible or may not be titled. For example, assets such as accounts receivable, inventory, equipment or even after-acquired property can be encumbered by a UCC Financing Statement. Similar to a Deed of Trust or an MVR-6, the purpose of the UCC Financing Statement is to provide notice to the public-at-large that the secured party/ lender has an interest in the property pledged as collateral. Once the UCC financing statement is filed with the North Carolina Secretary of State, a lien is created and the debtor cannot dispose of the asset to a third party unless the debt is paid and the lender's interest is extinguished.

If you have additional questions regarding methods of secured lending or secured transactions, please contact our office.



Construction Law

It's Not My Fault: I Built It According to the Plans!

By: Paul A. Sheridan

A project is complete and everyone is happy, until a latent structural defect is suddenly noticed. The owner calls on the general contractor to fix it. The general contractor calls on the subcontractor to address the problem. Everyone points fingers, but disclaims responsibility. "But I built it according to the plans and specifications that were given to me". "Flawed design", a phrase that strikes fear into the heart of any architect, engineer, or owner that bid the project out using the plans. This article discusses the obligations of each party on a project relating to design errors, as well as burden shifting contract clauses that are sometimes invoked to shift responsibility.

Engineers and architects have an obligation to design in accordance with a reasonable standard of care, in the time and place of the project. But we all recognize the complexity of today's structures. Even with CAD programs, often there are inconsistencies, omissions, or ambiguities within a set of plans and specifications. Plans and specifications are rarely perfect.

An owner also impliedly warrants the adequacy of the plans and specifications. This is sometimes known as the "Spearin Doctrine," after the seminal Supreme Court case, *US. v. Spearin*, 248 U.S. 132 (1918). The Spearin Doctrine has been faithfully followed in the North Carolina courts for nearly a century. One state court held that it is simply unfair to bar recovery to contractors who are mislead by inaccurate plans and submit bids lower than they might otherwise have submitted. This responsibility of the owner is not overcome by clauses requiring builders to visit the site, to check the plans, and to inform themselves of the requirements of the work. Courts have held the duty to check plans does not impose the obligation to pass upon their adequacy.

That is not to say the contractor or subcontractor holds no duties relating to proper construction techniques and code compliance. While the contractor is not responsible for design errors, he does have a duty to report any design errors or omissions which he discovers during his review of the plans. If he discovers any design errors, he must timely report them to the owner.

Clever owners and architects have devised burden shifting clauses that can successfully shift the burden downstream in the contractual chain. Through the use of disclaimers, which deny responsibility for the constructability of all design, owners and professional designers are passing the buck. Disclaimers might deal with a specific aspect of the design or site conditions, or they might apply to the entire design, as in a general disclaimer that the plans and specifications may not comply with local building codes.

Aside from burden shifting clauses, the architect or engineer is ultimately responsible for design errors. All parties play a role in identifying and minimizing the effect of such errors through prompt notification. Pay particular attention to the terms of the contract before the project begins, as construction defect claims are one of the fastest growing areas of construction litigation and potentially crippling liability for contractors.

The Basics of Pass-Thru-Entities

By: Chad J. Cochran

Business Law

Some businesses must pay income taxes. Some need not. Some businesses must file annual federal tax returns. Some need not. During tax season, these issues obviously take on added importance. We have recently fielded dozens of related questions and formed several new business entities. Given the volume of interest in these topics, we hope a primer on pass-thru-entities proves useful for our clients.

To start, a business entity (e.g., Corp, LLC, LLP, etc.) is typically formed to provide business owners with the protections of the “corporate veil”. This legal theory means that business owners are shielded from personal liability for acts of the business. Imagine you own a restaurant and a customer suddenly sues for medical bills associated with food poisoning caused by a sloppy restaurant cook. First, check your menu. Second, check your business’s legal papers. If you have properly formed and maintained a business entity, such as an LLC, the corporate veil should protect you from personal liability. The business entity is still on the hook.

The IRS defines a “pass–thru-entity” as a business entity which “passes its income, loss, deductions, or credits to its owners.” Owners must be “partners, shareholders, beneficiaries, or investors.” In simple terms, a pass-thru-entity generally pays zero income tax to the IRS. Instead, company profit is carried forward onto the owners’ tax returns by way of a K-1 statement. For instance, imagine an LLP with two 50/50 owners. If the LLP enjoys a $100,000 profit in a given year, then each of the owners has incurred a $50,000 taxable income increase on their individual taxes. The corporate veil might protect you from food poisoning, but it will not protect you from the IRS.

Partnerships, joint ventures, and limited liability companies with two or more owners/members are considered pass-thru-entities by default. Corporations have an election to make. The business can form as a C corporation (meaning that the business itself will pay income taxes) or as a S corporation (meaning that it constitutes a pass-thru-entity). These businesses generally file a tax return setting forth: (i) the amount of tax liability for the business itself (businesses treated as C corporations) or (ii) the amount of tax liability which carries over onto the business owners’ tax returns (businesses treated as a pass-thru-entity). Limited liability companies with only one owner march to the beat of a similar drummer with one key difference. Unless it elects treatment as a C corporation, single member LLCs are generally considered a separate entity for liability purposes but a disregarded entity for tax purposes. In this case, the single member LLC files no business tax return, as LLC business activity is reflected only on the owner’s tax return.

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