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# Annual Survey of Virginia Law: Creditors' Rights

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# CREDITORS' RIGHTS

*Joseph E. Ulrich**

This article is addressed to attorneys with a general practice, as well as those familiar with the creditors' rights area. Its purpose is to alert the non-specialist to developments of the last two years—April 1986 through April 1988. Virginia cases dealing with collection matters and federal bankruptcy decisions are reviewed. Legislation enacted over the past two years is also noted.

With the exception of the *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*[1] decision involving undersecured creditors, neither the cases nor legislation appear seminal. Therefore, the reader should expect a survey of recent events and not an in-depth study. This article states the new decisions or legislation, indicates some of their ramifications, and in some instances suggests how they relate to other areas of creditors' rights.

## I. Garnishment

In Virginia, garnishment is a post-judgment proceeding to aid execution.[2] The issuance of a writ of fieri facias (execution) creates a lien on the debtor's intangible property[3] (property not subject to levy). The lien also authorizes a sheriff to levy on the debtor's tangible personal property within his bailiwick.[4] Garnishment is the primary method of enforcing the lien on intangibles. The judgment creditor, upon suggestion, institutes garnishment proceedings to enforce the lien of fieri facias on debts and chattels in the posses-

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1. 108 S. Ct. 626 (1988); *see infra* text accompanying notes 115-128.
2. *See generally* T. Boyd, E. Graves & L. Middleditch, Virginia Civil Procedure § 13.6 (1982 & Supp. 1986) [hereinafter Boyd, Graves]; D. Rendleman, Enforcement of Judgments and Liens in Virginia §§ 3.1-3.10 (1982 & Supp. 1987) [hereinafter Rendleman].
3. Va. Code Ann. § 8.01-501 (Repl. Vol. 1984).
4. *Id.* § 8.01-478; *see also id.* § 8.01-458 (judgment lien against real estate); *id.* § 8.01-501 to -505 (property not capable of levy).

sion of a third person.[5] The suggestion must be served on the garnishee, and then on the judgment debtor.[6] The garnishee must answer on or before the return date, and indicate the amount of indebtedness or the property held to which the judgment debtor is entitled.[7] Disputes over the amount of the debt will be resolved by the court.[8]

The scope of assets subject to garnishment was uncertain until the decision in *Virginia National Bank v. Blofeld.*[9] Prior to *Blofeld*, there was no decision stating whether garnishment impounds indebtedness or chattels in the garnishee's possession as of the date of service or whether it impounds indebtedness or chattels of the debtor coming into the garnishee's possession after service but before the return date. The court, interpreting sections 8.01-501, 8.01-511 and 8.01-512.3 of the Code of Virginia,[10] held that the lien covers all obligations owed, including property received by the garnishee before the return date stated on the writ.[11] Thus, the garnishee must include in the return the amount of property held as of that date.[12] Payment of an indebtedness to the debtor before the return date of an obligation which arose after service of the summons does not discharge the garnishee's liability.[13]

To discharge the obligations, the garnishee may pay the amount of his liability to the court at anytime before the return date.[14] It is unclear whether the garnishee can avoid the *Blofeld* rule by immediately denying liability and returning the summons.

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5. The suggestion commences the garnishment proceeding. VA. CODE ANN. § 8.01-511 (Cum. Supp. 1988). "In Virginia, until fairly recent times, it was the accepted practice to make the suggestion orally before the clerk." BOYD, GRAVES, *supra* note 2, § 13.6, at n.44.

6. VA. CODE ANN. § 8.01-511.

7. *Id.* § 8.01-514 (Repl. Vol. 1984).

8. *Id.* §§ 8.01-515, -519; *see* RENDLEMAN, *supra* note 2, § 3.5(A).

9. 234 Va. 395, 362 S.E.2d 692 (1987).

10. VA. CODE ANN. § 8.01-501 (Repl. Vol. 1984) provides that a writ of fieri facias creates a lien on the debtor's personal estate "to which the judgment debtor is, or may afterwards and on or before the return day of such writ become, possessed or entitled." Sections 8.01-511 and 8.01-512.3 (Repl. Vol. 1984) contain similar language.

11. *Blofeld*, 234 Va. at 399, 362 S.E.2d at 695.

12. *Id.* at 400, 362 S.E.2d at 695.

13. In *Blofeld*, the indebtedness arose from a court decree entered three days after service of the summons on the garnishee. The garnishee paid the debt to the judgment debtor and his assignee. Because the lien covered the indebtedness, the garnishee had to pay again. *Id.*

14. VA. CODE ANN. § 8.01-520 (Repl. Vol. 1984).

Two circuit courts have considered the related issue of what debts may be garnished. In *Tipco Homes, Inc. v. Woods*,[15] the court held that funds which the judgment debtor may earn in the future, but are not yet due, may not be garnished.[16] In terms of the *Blofeld* decision, if the debt remains contingent upon the debtor's performance on the return date, the garnishee may properly deny liability. Of course, if the debtor does perform, garnishment would then be proper. In *Broyhill v. Boyer Companies, Ltd.*,[17] the court held that funds deposited with county officials by the debtor to assure performance of a construction contract may not be garnished by a private party who was not an intended beneficiary of the deposit.[18]

Garnishment establishes the liability of the garnishee to the judgment creditor but does not necessarily determine the judgment creditor's priority to the debt or chattel. In *McEwen Lumber Co. v. Lipscomb Brothers Lumber Co.*,[19] a creditor recovered a default judgment against the garnishee. The garnishee moved to vacate the judgment on the ground that the judgment creditor did not have priority to the garnished indebtedness.[20] The circuit court vacated the default judgment, but the Virginia Supreme Court reversed, holding that the garnishee had failed to establish any statutory ground to upset the default judgment.[21] The supreme court emphasized that the trial court lacked jurisdiction to consider the competing priority claims because such claimants were not parties to the garnishment.[22] Thus, the judgment creditor regained its judgment, but priority to the indebtedness remained unresolved. The judgment creditor could have resolved this issue by joining the adverse claimants in the original garnishment.[23]

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15. 9 Va. Cir. 95 (Fairfax County 1987).
16. *Id.* at 95.
17. 9 Va. Cir. 550 (Fairfax County 1984). *Broyhill*, like *Tipco Homes*, appears to be a premature garnishment. *See supra* note 15.
18. *Id.* at 550.
19. 234 Va. 243, 360 S.E.2d 845 (1987).
20. *Id.* at 246, 360 S.E.2d at 847. The adverse claimants to the fund presented arguments on the motion to vacate even though they had not been joined as parties in the original garnishment proceeding. *Id.* at 246-47, 360 S.E.2d at 847-48; *cf. supra* text accompanying notes 7 & 8.
21. VA. CODE ANN. § 8.01-428(A) (Repl. Vol. 1984) provides that a default or consent judgment may be set aside for fraud on the court, a void judgment or proof of an accord and satisfaction. See *McEwen*, 234 Va. 243, 360 S.E.2d 845, for a discussion of a void judgment and proof of an accord and satisfaction.
22. 234 Va. at 247, 360 S.E.2d at 847.
23. *Id.*

*Lewis v. House*[24] almost settled the important question of whether a creditor may garnish a joint bank account. Plaintiff garnished the joint bank account of debtor and his wife. The debtor conceded that the plaintiff could reach the funds through garnishment.[25] The sole issue was whether the wife owned one-half of the funds, absent evidence as to their source.[26] The case turned on the construction of section 6.1-125.3 of the Virginia Multiple-Party Account Act which provides:

> A joint account belongs, during the lifetimes of all parties, to the parties in proportion to the net contributions by each to the sums on deposit, except that a joint account between persons married to each other shall belong to them equally, and unless, in either case, there is clear and convincing evidence of a different intent.[27]

The court read the statute as a legislative direction to treat husband and wife depositors more favorably than other joint depositors.[28] The non-debtor spouse gets one-half of the account as against creditors, unless the creditor proves the spouse's contribution was less.[29] Because the creditor in *Lewis* offered no evidence on the source of funds, the statutory presumption mandated one-half to the wife.[30]

The *Lewis* court did not answer the question of whether a judgment creditor can garnish a multiple-party account. The answer, however, must be "yes." The Multiple-Party Account Act was enacted to resolve a number of issues relating to multiple-party accounts,[31] including the right of creditors against such

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24. 232 Va. 28, 348 S.E.2d 217 (1986).

25. *Id.* at 29, 348 S.E.2d at 218.

26. *Id.* at 30, 348 S.E.2d at 218-19.

27. VA. CODE ANN. § 6.1-125.3 (Repl. Vol. 1988). This section is part of the Virginia Multiple-Party Account Act, VA. CODE ANN. §§ 6.1-125.1 to -125.16.

28. *Lewis*, 232 Va. at 31, 348 S.E.2d at 219. This liberal policy influenced a bankruptcy court decision involving an exemption claim of a spouse. *See infra* notes 62-64 and accompanying text.

29. *Id.*

30. *Id.* Presumably, the wife could prove that the entire account belonged to her. *Cf.* Fleming v. Bank of Va., 231 Va. 299, 343 S.E.2d 341 (1986) (bank could not set-off deposit against debt owed it if evidence is clear that non-debtor depositor placed all funds in account).

31. *See generally* Note, *Multiple-Party Accounts: Does Virginia's New Law Correspond with the Expectations of the Average Depositor?*, 14 U. RICH. L. REV. 851 (1980). The most litigated issue about multi-party accounts concerned the question of how to treat the account when a depositor died. Section 6.1-125.3 reverses the common law rule and provides that the funds go to the other parties to the account absent evidence of a contrary intent.

accounts.[32] Section 6.1-125.3 establishes the ownership rights of all claimants to the funds.[33] Given that a creditor is entitled to use all of the debtor's non-exempt funds to satisfy a claim, the garnishing creditor is entitled to use whatever portion of the account the debtor-depositor owned.[34] Section 6.1-125.3 provides that absent proof of contributions to the fund, the garnishing creditor is entitled to use one-half of an account in the name of spouses,[35] and the entire account in all other cases. The latter presumption is founded on the idea that the party with the best access to the necessary information has the duty of going forward with the evidence.[36]

## II. Fraudulent Conveyances

### A. *Voluntary Conveyance Section 55-81 Amended*

The voluntary conveyance statute has been amended.[37] Old section 55-81 of the Code of Virginia voided all gifts, (transfers without consideration), by an indebted person at the suit of creditors with liquidated claims[38] brought within five years of the transfer.[39] The solvency and good faith of the debtor were irrelevant.[40]

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32. Va. Code Ann. § 6.1-125.2; *see also* Rendleman, *supra* note 2, § 3.7.

33. The fact that either party may withdraw the entire account has no bearing on ownership rights. *Lewis*, 232 Va. at 30-31, 348 S.E.2d at 219 (interpreting Va. Code Ann. § 6.1-125.3).

34. This Virginia rule applies only to accounts held by spouses. The Multiple-Party Account Act assumes that garnishment is appropriate. *See, e.g.*, Va. Code Ann. § 6.1-125.3(D) (Repl. Vol. 1988) (rules stipulating notice to customers and fees financial institutions may charge when a multiple account is garnished).

35. This assumes that the spouses have not specifically stated that they hold the account as tenants by the entirety, overcoming the presumption in Va. Code Ann. §§ 55-20, -21 (Repl. Vol. 1986) that conveyances to husband and wife create a tenancy in common. Personal property may be held by spouses in this manner. Oliver v. Givens, 204 Va. 123, 129 S.E.2d 661 (1963) (citing Moore v. Glotzbach, 188 F. Supp. 267 (E.D. Va. 1960)). If the account is held by the spouses as tenants by the entireties, it is immune from the claims of all but joint creditors of husband and wife. Vasilion v. Vasilion, 192 Va. 735, 740, 66 S.E.2d 599, 602 (1951). If the account is not held in this form, the debtor spouse may claim it as exempt. *Lewis*, 232 Va. at 29, 348 S.E.2d at 218.

36. *See, e.g.*, Hayden v. Gardner, 238 Ark. 351, 354, 381 S.W.2d 752, 754 (1964) (entire account subject to garnishment, with burden on depositors to show actual ownership interests).

37. Va. Code Ann. § 55-81 (Cum. Supp. 1988).

38. *Id.* § 55-81 (Repl. Vol. 1986). A tort creditor is not liquid until the cause of action is reduced to judgment. *See* 1 Glenn, Fraudulent Conveyances & Preferences § 317 (rev. ed. 1940) [hereinafter Glenn].

39. Va. Code Ann. § 8.01-253 (Repl. Vol. 1984).

40. *See, e.g.*, Morriss v. Bronson, 170 Va. 516, 197 S.E. 479 (1938) (shows the harsh results when the statute was applied); *see infra* note 45.

The 1988 amendment brings section 55-81 more in line with similar legislation, such as section 4 of the Uniform Fraudulent Conveyance Act (Uniform Act).[41] The amendment provides that every gift "by an insolvent transferor, or by a transferor who is thereby rendered insolvent"[42] may be voided by present creditors. The plaintiff must prove three elements to state a claim under the amendment: 1) the challenged transfer was a gift;[43] 2) the debtor was either insolvent when the transfer was made or rendered insolvent by it; and 3) the creditor held a liquidated claim against the debtor when the transfer occurred.[44] The second element is new.

This change seems quite sensible, because not every gift injures creditors.[45] As long as the debtor retains assets sufficient to pay creditors, creditors have no grievance. Only those gifts which render the debtor unable to pay current obligations harm creditors.[46] Merely because the debtor once owned the property does not mean that the creditor ought to be able to satisfy claims from it.[47] Nonetheless, original section 55-81 required this result.

In contrast, where the gift leaves the debtor insufficient property to pay all debts, the creditor's complaint is apparent. The debtor's intent to hinder, delay, and defraud in such a transaction is presumed in law, based on the principle that one contemplates the

41. The Uniform Fraudulent Conveyance Act ("Uniform Act") provides that "[e]very conveyance made and every obligation incurred *by a person who is or will be thereby rendered insolvent* is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a *fair consideration.*" UNIFORM FRAUDULENT CONVEYANCE ACT § 4, 7A U.L.A. 474 (1918) (emphasis added) [hereinafter UNIFORM FRAUDULENT CONVEYANCE ACT].

42. VA. CODE ANN. § 55-81 (Cum. Supp. 1988).

43. Presumably, if the consideration is merely inadequate, § 55-81 does not apply, and the creditor must prove fraud under § 55-80. *Cf. supra* note 41. "Fair consideration" is defined in section 3 of the Uniform Act as an exchange of property of reasonably equivalent value or satisfaction of an antecedent debt. UNIFORM FRAUDULENT CONVEYANCE ACT, *supra* note 41, § 3.

44. VA. CODE ANN. § 55-81.

45. Lord Hardwicke expressed the idea underlying original § 55-81: "A man actually indebted, and conveying voluntarily, always means to be in fraud of creditors." Townshend v. Windham, 28 Eng. Rep. 1, 7 (Ch. 1750). How this concept became the Virginia rule is set forth in GLENN, *supra* note 38, §§ 268-268(a).

46. Whether a disclaimer of legacies, devises or inheritances constitutes a fraudulent conveyance has caused judicial disagreement. A disclaimer is a species of gift and arguably within the ambit of § 55-81. Disclaimers are governed by VA. CODE ANN. §§ 64.1-190 to -196 (Repl. Vol. 1987), which permits an indebted beneficiary to disclaim legacies, etc. and deprive creditors of these assets. Niklason v. Ramsey, 233 Va. 161, 353 S.E.2d 783 (1987), demonstrates how astute courts have been in finding such disclaimers ineffective as to creditors.

47. *See infra* note 54.

necessary consequences of one's own acts.[48] Amended section 55-81 applies only in this latter situation.

The debtor's insolvency can be proven by records or through evidentiary presumptions from case law. The solvency question turns on valuation of assets and liabilities when sufficient records are available. When the debtor's records are incomplete, creditors should be assisted by the evidentiary presumptions developed in cases decided under section 4 of the Uniform Act. For example, if a present creditor proves that the transfer was without consideration, the burden of proof will shift to the debtor-defendants to demonstrate the transferor's solvency.[49]

### B. *Intra-Corporate Manipulations and the Fraudulent Conveyance Laws*

The Virginia Supreme Court, like its counterparts, attempts to develop a coherent scheme for each area of the law. One of its functions is to state rules that make sense and can be easily administered. Ease of administration is often the decisive factor in choosing how to resolve a particular case.[50] Every so often, however, a court will decide a case in order to get a "good" result, and this decision becomes a stumbling block for future development. Using such perspective one can best understand the recent decision in *Cheatle v. Rudd's Swimming Pool Supply Co.*[51]

In *Cheatle*, a debtor corporation transferred all of its assets to a new corporation that had been reorganized for the purpose of operating the transferor's business. When Supply was unable to collect a judgment against the debtor, it sued to set aside the transfer as a fraudulent conveyance and pierce the corporate veil against Cheatle, a director of the debtor. Cheatle owned one-half of the stock in the debtor and one-third in the new corporation, and her husband served as a director of each. The trial judge upset the transfer to the new corporation as a fraudulent conveyance, and awarded Supply a personal judgment against Cheatle for compen-

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48. *See* GLENN, *supra* note 38, § 74.

49. *See, e.g.*, United States v. West, 299 F. Supp. 661 (D. Del. 1969); Cohen v. Benjamin, 246 App. Div. 866, 284 N.Y.S. 884 (1936) (voluntary transferror has burden of proof on questions of solvency).

50. *See* Green, *The Duty Problem in Negligence Cases*, 28 COLUM. L. REV. 1014, 1035-45 (1928).

51. 234 Va. 207, 360 S.E.2d 828 (1987).

satory and punitive damages.[52] The supreme court reversed, holding that "§ 55-80 does not authorize an in personam judgment when a fraudulent conveyance is set aside."[53] Subject to some well recognized exceptions,[54] plaintiff's remedy is to set aside the transfer and sell the property. The court also found "the evidence . . . utterly insufficient to warrant casting aside the corporate entity."[55] The decision seems so clear cut that one wonders how the trial court could have been mistaken.

The trial judge in *Cheatle* relied on the Fourth Circuit decision in *National Carloading Corp. v. Astro Van Lines*,[56] a case presenting facts similar to but not identical with *Cheatle*. In *National Carloading*, the individual defendant, Sills, purchased an insolvent corporation and then caused the insolvent to transfer the insolvent's sole asset to another corporation owned by Sills, which immediately commenced operating the transferor's business. After the transfer Sills paid off an encumbrance on the transferred asset. General creditors of the insolvent then attacked the transfer, naming the transferee and Sills as defendants. The district judge characterized the facts as a fraudulent scheme to obtain the use of the transferred asset free from the claims of the insolvent's creditors. Creditors were permitted to pierce the corporate veil and hold Sills

52. *Id.* at 211, 360 S.E.2d at 830.

53. *Id.* at 212, 360 S.E.2d at 830 (quoting Mills v. Miller Harness Co., 229 Va. 155, 158, 326 S.E.2d 665, 667 (1985)).

54. If the grantee no longer owns the property but has transferred it to another, the grantee's liability is limited to the present value of the property. For a discussion of the Virginia remedy and its difference from other states, see generally *supra* note 38, § 125. There are two exceptions to the general rule. First, where the transferee acts in bad faith, additional damages are measured by the use of the property in order that the plaintiff may receive complete relief. *See e.g.*, Tcherepnin v. Franz, 489 F. Supp. 43 (N.D. Ill. 1980); Miller v. Kaiser, 164 Colo. 206, 433 P.2d 772 (1967). Second, the limitation on personal liability does not protect the grantee if the fraudulent transfer occurred post judgment. Glenn, *supra* note 38, § 74, explains the rationale for this second exception:

> The reason why there is no tort cause of action for a fraudulent transfer that takes place before the creditor obtains judgment or attaches is that a general creditor has no property interest in his debtor's assets, and so the result of the transfer is the loss of a mere possibility of realization which is too speculative to be measured in damages. But, an exception which proves the rule, is made when the transfer takes place after the aggrieved creditor has obtained a judgment, or procured a warrant of attachment. We then have a 'rescue,' to the injury of a man who, by judgment or attachment, has acquired the rights to the subject the debtor asserts to his claims; and so in that case an action lies.

55. *Cheatle*, 234 Va. at 213, 360 S.E.2d at 831. The court emphasized that Cheatle had not benefited in the transaction, and that the transfer was a part of a reorganization in which a third party had contributed new capital. *Id.*

56. 593 F.2d 559 (4th Cir. 1979).

personally liable to the extent of their debts.[57] The Fourth Circuit affirmed, but relied on fraudulent conveyance concepts rather than accepting the trial court's rationale.[58] To Sills' defense that he (and his corporation) qualified as a bona fide purchaser by paying off a prior lien, the Fourth Circuit responded that the defendants knew that the transfer would hinder and delay the insolvent's creditors, and such guilty knowledge precluded the defendants from qualifying as bona fide purchasers.[59] The court justified the personal judgment against Sills by analyzing the transaction to a de facto merger of the seller and buyer.[60]

*National Carloading* need be examined in some detail to appreciate *Cheatle.* To start, note that the plaintiff creditors did well indeed. Before the sale of the insolvent corporation to Sills, unsecured creditors could have obtained only the equity of the encumbered asset, if any existed.[61] After Sills purchased the insolvent's stock, but before the transfer of the assets to Sills' new corporation, creditors could have gotten no more. If Sills' conduct had not been characterized as fraudulent, the most creditors could have received is the value of the asset or the consideration paid for it after the prior lien had been satisfied. The finding of fraud, however, permitted an award in excess of the amount general creditors could ordinarily expect. Characterizing the transaction as a conveyance made with actual fraudulent intent was crucial. Sills purchased the insolvent, transferred its primary asset to another of his corporations, and paid off a lien on the asset. The Fourth Circuit stated that "the obvious and inevitable effect of the transaction was to delay and hinder the plaintiffs in collecting their debts. *Because of their position,* the defendants are chargeable with that intent."[62] To support this approach the court cited *Darden v. George C. Lee Co.,*[63] which held that directors in charge of an in-

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57. *Id.* at 562.

58. *Id.* at 562-64. The district court opinion was not reported. In addition to the facts set out in the text, the district court relied on Sills' sale of other assets of the insolvent for $80,000, and his attempt to conceal that the asset was transferred to one of Sills' corporations. The district court judge apparently relied on these matters to support his characterization, but the Fourth Circuit's holding did not depend on them.

59. *Id.* at 564.

60. *Id.*

61. The Fourth Circuit carefully refrained from stating whether any equity existed.

62. *National Carloading,* 593 F.2d at 562 (emphasis added). That is, because Sills acted on both sides of the transaction, Sills knew that the insolvent's creditors would be adversely affected by the transfer.

63. 204 Va. 108, 129 S.E.2d 897 (1963).

solvent corporation commit a per se fraudulent conveyance by "grant[ing] . . . a preference or *an advantage* [to themselves] over other creditors in the payment of their claims."[64] According to the *Darden* court the evil intent inherent in such a preference, unlike others, is that it hindered and delayed creditors, and the transferee necessarily knew such hindering would ensue.

The statement of the *Darden* rationale marks it as questionable on its face. Outside of bankruptcy, preferences are permissible. Preferences necessarily hinder other creditors because such assets can no longer be used to satisfy debts. Yet, all authorities agree that payment of an antecedent debt is sufficient consideration to protect the recipient as a bona fide purchaser.[65] The fact that the recipient knows of the preference does not forfeit his status: no wrong is committed by accepting a preference. The *Darden* court never explains how the director's intent differed from that of the run of the mill preferee.[66] What intent beyond payment of the debt owed did the director have? The *Darden* court was offended by the director's use of position to gain an "*advantage*" over other general creditors, but such a rationale does not sustain a holding that the preference to the director was a fraudulent conveyance. Indeed, *Darden* has confused the law in this area.[67]

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64. *Id.* at 112, 129 S.E.2d at 900 (1963) (emphasis added). The precise facts of *Darden* are worth stating. The insolvent corporation, Ricks Company, worked out a Chapter 11 arrangement (a composition) in Bankruptcy. Darden put up $22,500 to fund the arrangement. As consideration for his advance, Darden took Ricks notes and received 50% of the common stock of Ricks. He subsequently became Ricks controlling director. *Id.* at 109, 129 S.E.2d at 898. The *Darden* case was tried on the theory that Darden was a creditor, and the issue was whether the preference should be characterized as a fraudulent conveyance under § 55-80. *Id.* at 112, 129 S.E.2d at 899-900.

Arguably, Darden was tried under the wrong theory. Darden's $22,500 should have been viewed as a contribution to capital rather than a loan. Darden made an investment in Ricks Company, buying a 50% interest. The notes were window dressing, an attempt to disguise Darden's status if the company failed. As an investor, Darden's right to corporate assets is inferior to that of general creditors, and creditors should have been entitled to all of the funds recovered from Darden. Instead, Darden used the notes to convince the court of his creditor status and shared in this fund pro rata with other creditors.

65. *See* UNIFORM FRAUDULENT CONVEYANCE ACT, *supra* note 41, § 3. Upholding preferences against a fraudulent challenge is justified on two other grounds not mentioned in the text. First, until creditors obtain a lien on an asset, creditors have no interest in it, and the debtor, as owner, may use it as he pleases. This is in the traditional justification. *See* BUMP, FRAUDULENT CONVEYANCES 179 (3rd ed. 1882); GLENN, *supra* note 38, § 74. Second, if a preference could be upset as a fraudulent conveyance, "there would be a substitution of one preference by another." Smith v. Whitman, 39 N.J. 397, 402, 189 A.2d 15, 18 (1963).

66. This point is considered at length in Ulrich, *Fraudulent Conveyances and Preference in Virginia*, 36 WASH. & LEE L. REV. 51 (1979).

67. Plaintiff in *Darden* relied on § 55-80 to upset the transfer. To sustain the judgment

*National Carloading* follows *Darden*, flaws and all. Neither court approved of the corporate manipulations. Both thought the plaintiff creditors were entitled to relief. Like *Darden*, the Fourth Circuit relied on Sills' complete knowledge of the transaction to deny him good faith purchaser status without specifying the fraud itself.[68] As in *Darden*, the murky law of fraudulent conveyances allowed the Fourth Circuit to avoid explaining why this transaction is offensive.

*National Carloading* sticks out like a sore thumb in Fourth Circuit jurisprudence. No court has done more to develop a body of law for dealing with insider preferences. Ever since *Certain-Teed v. Wallinger*[69] the Fourth Circuit has recognized that cases like *Darden* and *National Carloading* present issues crucially different from run of the mill preferential payments.[70] Such cases were viewed as attempts by the owners of failing businesses to gain an advantage over general creditors through insider maneuvers. In *Certain-Teed* and its progeny the Fourth Circuit began the difficult task of creating a theory of duties toward outside corporate creditors. The *National Carloading* panel must have assumed, however, that Virginia had rejected the *Certain-Teed* line of cases which precluded it from continuing the development.

Why didn't the Fourth Circuit rely on the District Court's position? Consideration concerning the remedy appear to have been crucial. Piercing the corporate veil apparently would have been

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below, the court was bound by its Rules of Court to consider only theories presented at trial. *See* VA. SUP. CT. R. 5:2. To obtain a good result the court stretched fraudulent conveyance concepts. *Darden* well illustrates the old saying, "the road to hell is paved with good intentions."

68. The *Darden* approach limits liability in certain cases. Under § 55-80, a bona fide purchaser retains the property despite his transferor's evil intent. The Virginia court employed this rule to protect controlling directors of an insolvent in a transaction functionally similar to Darden. In *Bank of Commerce v. Rosemary & Thyme*, 218 Va. 781, 239 S.E.2d 909 (1978), the issue was whether preferential payments made by a corporation to a third party on debts for which the directors were sureties fell within the scope of *Darden*. The court held that since the party receiving the preference qualified as a bona fide purchaser, the transaction could not be set aside under § 55-80 even though the directors possessed guilty knowledge and gained an advantage. *Id.* at 789, 239 S.E.2d at 915; *cf. Regal Ware, Inc. v. Fidelity Corp.*, 550 F.2d 934 (4th Cir. 1977); *Davis v. Woolf*, 147 F.2d 629 (4th Cir. 1945). On facts essentially identical to *Bank of Commerce*, these Fourth Circuit cases held that the creditor could recover the preference.

69. 89 F.2d 42 (4th Cir. 1937).

70. See the Fourth Circuit cases cited *supra* note 67. Ironically, *Certain-Teed* appears to be the basis for the *Darden* decision but is ignored in *Bank of Commerce*.

permissible under Virginia law.[71] Yet, approaching the case under this theory might have forced the court to consider the extent of the creditors recovery. How did Sills' manipulations harm these creditors? The manipulation deprived creditors of immediate access to the asset. Yet, as noted above, the asset may not have been of any value to creditors because it was encumbered by a prior lien. On the other hand, if the transfer involved actual fraud, the focus shifts to Sills' evil intent, and the actual value of the asset to creditors before the transfer is more easily ignored. Manipulating doctrine allowed the court to increase the creditors' recovery through the guise of finding Sills a party to the fraud, a result which demands that Sills be given no credit for paying off the prior lien and permits the award of a personal judgment for the value of the asset.[72]

With this background in mind, one can see why the *Cheatle* court distinguished *National Carloading.* Using *Darden* as the touchstone, the cases are quite different. The Cheatles, unlike Sills, were not transferees, and therefore the fraudulent conveyance laws provided no remedy.[73] To win, plaintiff needed to demonstrate another theory. Plaintiffs failed to establish a ground to pierce the corporate veil. While Sills used the corporation as a device to disguise a wrong or obscure a fraud, Supply failed to show that the Cheatles engaged in similar activity.[74]

Given that the *Cheatle* result is correct, the opinion is disappointing. *Cheatle* offered the opportunity to correct the misimpres-

71. To pierce the corporate veil, "the plaintiff must show that the corporate entity was the *alter ego*, alias, stooge, or dummy of the individuals sought to be charged personally and the corporation was a device or sham used to disguise wrongs, obscure fraud, or conceal crime." *Cheatle*, 234 Va. at 212, 360 S.E.2d at 831 (quoting Lewe's Trucking Corp. v. Commonwealth, 207 Va. 23, 31, 147 S.E.2d 747, 753 (1966)). Whether this theory would have been proper in *National Carloading* seems questionable. Such a holding would convert Sills into a surety for the insolvent's general creditors, a right not bargained. *Cf. Cheatle*, 234 Va. at 214, 360 S.E.2d at 832 (the court explains why a count sounding in deceit cannot be sustained).

72. The Fourth Circuit also affirmed a punitive damages award. Sills' fraud apparently merited a double recovery. Thus, Sills comes out far worse than Darden, although his sins may have been no worse. *Cf. supra* note 63.

73. This is true even if one assumes the Cheatles acted wrongfully and benefitted from the transfer. *See supra* note 67.

74. *Cheatle*, 234 Va. at 209, 360 S.E.2d at 830, asserts that the Fourth Circuit reached its result in *National Carloading* by "apparently pierc[ing] the corporate veil," despite its protests to the contrary. The Virginia court seems to imply that *National Carloading* could be sustained on such theory.

sions created by *Darden*.[75] Preferences by an insolvent corporation to or for the benefit of insiders present complicated issues different from standard preference situations.[76] As yet, there is no consensus on how these transactions ought to be treated outside bankruptcy.[77] It does seem clear, however, that fraudulent conveyance law should not be the primary remedy for corporate manipulations by insiders. Yet, both the lower court decision in *Cheatle* and the Fourth Circuit decision in *National Carloading* suggest that the Bench and the Bar in Virginia so regard it. Vague notions of legal fraud based on a presumed subjective intent divert attention from the issue of whether the conduct ought to be condemned. Both of these courts focused on the controlling directors' position on both sides of the transfer, and for this reason gave judgment against Darden and Sills. The real question, whether the transfers should be condemned, was not addressed.[78] *Cheatle* says only that *Darden* does not apply because the Cheatles were not transferees.

Possibly, this reads *Cheatle* too narrowly. The court does point out that despite their presumed knowledge the defendants did no wrong. This should tell trial judges that status on both sides of a transaction is insufficient, standing alone, to award a personal judgment. The court's explicit consideration of piercing the corporate veil implies that other theories are applicable. One could read *Cheatle* as suggesting that *National Carloading* was correctly decided under this theory. Read this way, *Darden* designates one situation in which insider preferences violate the law every time, and the court will consider related situations as they arise.[79]

Even if this latter reading of *Cheatle* is correct, the court should have gone further. Acceptance of the Fourth Circuit position stated in *Certain-Teed* would have been preferable. Given the confusion created by *Darden*, one has to assume the court's next opportunity to reexamine this area will soon arise.

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75. The court recently reaffirmed *Darden* in *Mills v. Miller Harness Co.*, 229 Va. 155, 326 S.E.2d 665 (1985), including the remedy.

76. *See generally* 1 Glenn, note 38, supra §§ 386-388.

77. Section 547(b)(4) voids all transfers by insiders made within one year. The maneuvering by insiders found in *Darden, National Carloading* or the cases in note 67 represent just three forms of "bankruptcy planning." See Lopucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 Wis. L. Rev. 311, 333-43.

78. What did Sills do wrong? Assuming he stood ready to pay general creditors of the insolvent the equity of the transferred asset, what complaint did they have? If Sills tried to conceal the transfer, such fraud merits punitive damages as a deterrent; whether Sills ought to be held liable for the value of the asset is unclear. *Cf. supra* note 71.

79. As noted above, the remedy for such activity should be reconsidered as well.

## III. EXEMPTIONS

The Virginia Supreme Court seldom decides cases dealing with exemption issues. Bankruptcy courts, on the other hand, decide exemption questions constantly. The Bankruptcy Code[80] provides the most important application of the Virginia exemption system. All individual debtors will claim exemptions, but the Virginia exemptions are the only ones a Virginia bankrupt may claim.[81] Bankruptcy planning often involves pushing exemption claims to the limit. For these reasons, the Virginia exemption system is continuously fashioned in the bankruptcy court.

A bankruptcy exemption may be lost if not claimed according to state provisions. Virginia law requires a voluntary bankrupt to file a homestead deed within five days after the first meeting of creditors[82] or lose the exemption.[83] Although the rule is clear, attorneys occasionally fail to comply. *In re Astin* holds that the debtor may not dismiss the case and refile in order to claim the exemption if a party in interest objects.[84] Presumably, the trustee, as the representative of general creditors, should always object.

In bankruptcy, both husband and wife may claim a homestead exemption,[85] although only one spouse could do so in a non-bankruptcy setting.[86] May the wife claim this exemption in a tax refund without regard to the extent of her contribution to the income? According to *Bass v. Hall*,[87] the answer is yes. The bankruptcy court relied heavily on Virginia's liberal policy regarding exemptions, as well as that particularly favoring spousal claims that

80. Bankruptcy Reform Act, 11 U.S.C. §§ 101-1330 (1982 & Supp. IV 1986).

81. 11 U.S.C. § 522(b)(1)(A) authorizes a state to limit its residents to local exemptions by "opting out" of the federal exemption. Virginia, along with 39 other states, has opted out. VA. CODE ANN. § 34-3.1 (Repl. Vol. 1984).

82. VA. CODE ANN. § 34-17 (Repl. Vol. 1984). When an involuntary petition is filed, § 34-17 allows the debtor to set it apart any time before the expiration of the period following adjudication within which he is required to file his schedules.

83. According to 11 U.S.C. § 2003(a) (Supp. 1982), the first creditors' meeting should take place not less than 20 or more than 40 days after the petition is filed.

84. 77 Bankr. 537 (Bankr. W.D. Va. 1987); *see In re* Wirick, 3 Bankr. 539 (Bankr. E.D. Va. 1980) (debtor may withdraw petition only if "[a]ll creditors were properly noticed and none objected"). The trustee and creditors are parties in interest. 11 U.S.C. § 1109.

85. Cheeseman v. Nachman, 656 F.2d 60, 64 (4th Cir. 1981).

86. VA. CODE ANN. § 34-1 (Repl. Vol. 1984) (definition of "householder" precludes a husband and wife living together from claiming a double exemption). For more on this anomaly, see Ulrich, *How Bankruptcy Exemptions Work: Virginia As an Illustration of Why the "Opt Out" Clause Was a Bad Idea*, 8 GEO. MASON. L. REV. 1, 8-13 (1985).

87. 79 Bankr. 653 (W.D. Va. 1987).

homestead.[88] Nonetheless, the debtor's claim of homestead cannot improve his claim of ownership. In *Barzee v. Trammel*,[89] a buyer placed funds in escrow to be paid to seller only when the seller discharged liens on the property. The seller could not assert a homestead superior to the buyer's ownership rights in the fund until the stated conditions were fulfilled.

Section 522(f) of the Bankruptcy Act permits a debtor to avoid all judicial liens and "nonpossessory, non-purchase money security interests" on designated tangible property if such lien impairs an exemption.[90] Suppose a bank perfects a non-purchase money security interest by filing, and thereafter repossesses before bankruptcy. Assuming that the goods come within the section 522(f) list, could this be a "nonpossessory" security interest? On these facts, the Bankruptcy Court for the Western District of Virginia held that a bank's repossession converted its security interest from nonpossessory to possessory, and therefore section 522(f)(2) was inapplicable.[91] The district court reversed, asserting that the proper analysis for defining the word "nonpossessory" in section 522(f) turns on how the lien initially attached and how it became enforceable against the debtor.[92] Since the bank's security interest attached and became enforceable through filing, the security interest should be classified as "nonpossessory."[93] Such analysis, which seems correct,[94] means that virtually all security interests are "nonpossessory." Thus, the problem for most debtors using section 522(f)(2) will be providing proof that the property is designated by section 522(f)(2) for special treatment *and* that the lien impairs a Virginia exemption.[95]

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88. Lewis v. House, 232 Va. 28, 348 S.E.2d 217 (1986) (discussed *supra* notes 24-36) exemplifies this policy.

89. No. 86-1264 (4th Cir. Nov. 2, 1987).

90. 11 U.S.C. § 522(f).

91. *In re* Meadows, 75 Bankr. 357, 358 (W.D. Va. 1987). The bankruptcy court opinion was not reported.

92. *Id.* at 360.

93. *Id.* at 361. Otherwise, the bank could preclude the use of § 522(f) by repossession anytime before bankruptcy.

94. The district court's distinction between perfection, which deals with the bank's right against third parties, and attachment of security interests, which deals with the bank's rights against the debtor, is in accord with the Code. *Compare* VA. CODE ANN. § 8.9-201 (Added Vol. 1965) (general validity of security agreement) *with* VA. CODE ANN. § 8.9-203 (Cum. Supp. 1988) (attachment and enforceability of security interests). For this reason the bank's initial agreement and actions control.

95. The debtor lost in *Meadows* because he could not prove he was engaged in farming

## IV. MECHANIC'S LIENS

### A. *Waiver of Liens*

The Mechanic's Lien Act[96] grants designated parties a right to a lien on real property to the extent their labor or materials have improved such property. The statute specifically permits waiver of this right.[97] Lien waivers have become increasingly common in construction agreements. The importance of lien waivers can be understood by examining the constantly recurring fact pattern from which they arise.[98]

Parties supplying labor or materials to a construction project seldom are paid in advance. Rather, they are paid as the project progresses ("progress payments"). The project's owner often finances all or part of the construction through a lender. Progress payments generally come from the lender. Before the lender advances funds to the owner for progress payments, lender will demand protection against mechanics' liens from the owner's title insurance company. The title insurance company, in turn, will condition its extension of coverage for such loans upon adequate lien waivers from the owner. When the owner delivers the required waivers, the title insurance company confirms that the requested insurance has been extended to cover the lender's proposed advance and authorizes disbursement. Once coverage is confirmed, the lender advances funds to the owner, who pays the general contractor, who in turn pays subcontractors and materialmen. The owner and the contractor anticipate that progress payments cannot occur until the lender and the title insurance company receive satisfactory lien waivers. Therefore, most prime contracts deal explicitly with lien waivers using form lien waivers.

This description sets the stage for consideration of *McMerit Construction Co. v. Knightsbridge Development Co.*[99] The essential facts peculiar to *McMerit* were not in dispute. First, the prime

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and entitled to an exemption within the meaning of VA. CODE ANN. § 34-27 (Repl. Vol. 1984).

96. VA. CODE ANN. §§ 43-1 to -23 (Repl. Vol. 1986). *See generally* J. ULRICH, VIRGINIA AND WEST VIRGINIA MECHANICS' AND MATERIALMEN'S LIENS (1985).

97. VA. CODE ANN. § 43-3(c).

98. The description in this paragraph of the paradigm fact pattern is taken from McMerit Constr. Co. v. Knightsbridge Dev. Co., 235 Va. 368, 367 S.E.2d 512 (1988), and United Masonry, Inc. v. Riggs Nat'l Bank, 233 Va. 476, 357 S.E.2d 509 (1987).

99. 235 Va. 368, 367 S.E.2d 512 (1988).

contract stated that all applications for progress payments must be accompanied by lien waivers. Second, the applications for progress payments, which the owner supplied, stated that "the CONTRACTOR acknowledges receipt from OWNER of payment of all sums due," but did not state expressly that the applications were lien waivers. Third, the applications stated that they would be submitted to the lender and the title insurance company for the purpose of obtaining progress payments.[100] Fourth, the applications provided to the subcontractors *expressly stated* that they were lien waivers.[101] Fifth, at the time the contractor submitted the application, the contractor and the owner disputed the amount owed.[102]

The Virginia Supreme Court reversed the trial court's summary judgment for the owner. The owner argued that the facts showed an express waiver or that a waiver should be implied. The owner reasoned that the phrase in the application, "CONTRACTOR acknowledges receipt from OWNER of payment of all sums due," must be equated to an express waiver, because a mechanic could not obtain a lien if no money was owed to it.[103] Furthermore, the only reason to submit the lien waiver to the lender and the title

100. The full text of the document entitled "Contractors Affidavit" provided:

> The CONTRACTOR acknowledges receipt from OWNER of payment of all sums due for work performed, labor and materials furnished or supplied to the date of the previous advance in connection with the construction of the Project. All subcontractors, contractors, suppliers, materialmen, laborers and workmen employed or engaged by the CONTRACTORS on the Project have been paid for all work previously performed for which payment has been made by or on behalf of OWNER, and all sums due for materials and supplies furnished to CONTRACTOR or for the Project have been paid for up to and including the period covered by the last preceding advance . . . .
>
> It is understood that this Affidavit and Sworn Statement together with attached contractor Application for Payment . . . will be *delivered by OWNER to TITLE INSURERS for* the purpose of *obtaining advances of money* to or for the *benefit of OWNER.*

*Id.* at 370, 367 S.E.2d at 513 (original emphasis omitted; emphasis added).

101. The form application submitted by subcontractors and materialmen was entitled "Partial Affidavit, Waiver of Lien and Release." *Id.* The document provided in pertinent part:

> The undersigned does hereby forever release and discharge the Company [Owner], the Building and the land upon which the Building is located, from any and all causes of action, suits, debts, liens, damages, claims and demands whatsoever in law or equity which the undersigned and/or its assigns ever had, now have, or ever will have against the Company, the Building, and/or the land upon which the Building is located, by reason of the delivery of materials and/or the performance of work relating to the construction of the building.

*Id.* at 371, 367 S.E.2d at 513.

102. *Id.* at 373, 367 S.E.2d at 513-14.

103. *Id.*

insurance company was to obtain progress payments.[104] The court responded that the contractor's acknowledgment in the application may not be treated as an express lien waiver as a matter of law because the owner was aware that the contractor disputed the amount owed.[105] In addition, had the parties intended to treat the applications as a waiver, they would have said so expressly, as had been done in the subcontractor's applications. Also, it was not conclusive that the application was to be submitted to the title company. Such submission could have served the purpose of having the money released by the lender to be used for progress payments and not other matters.[106]

The key issue according to the court was whether the contractor impliedly waived its lien rights. The court indicated that an implied waiver must be established by clear and convincing evidence.[107] Such a rule rests on two assumptions. First, one ordinarily does not give up a valuable right granted by statute, and second, ambiguities of meaning are resolved against the party for whose benefit the clause was inserted.[108] Having stated these principles the court simply pointed to the trial judge's characterizations of the application which demonstrated, to the courts satisfaction, that the clear and convincing evidence test had not been satisfied.[109] On remand, the contractor appears entitled to summary judgment.

While one could quibble with the court's rationale for overturn-

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104. *Id.* at 372-75, 367 S.E.2d at 515.

105. *Id.*

106. The title company has the right to know this. *Cf.* Southwood Builders, Inc. v. Peerless Ins. Co., 235 Va. 164, 366 S.E.2d 104 (1988) (general contractor's early payments to subcontractor discharged subcontractor's surety on payment bond; payments reduced subcontractor's incentive to complete job to injury of surety and payment might not be used for purposes intended).

107. *McMerit Constr. Co.*, 235 Va. at 374, 367 S.E.2d at 515-16. The court relied on VNB Mortgage Corp. v. Lone Star Indus., Inc., 215 Va. 366, 371, 209 S.E.2d 909, 914 (1974). In *VNB Mortgage*, the court apparently limited this strict rule to subcontractor's and materialmen. *McMerit* extends the rule to general contractors.

108. *See id.* at 374, 367 S.E.2d at 515-16.

109. In the instant case, the trial court said this about the contractor's affidavit:

> Given to a lawyer, he would tear his hair out and say, client, I'm going to save you some money and litigation. We're going to put in here this is a release of liens, but [it will] still get by. It bumps the channel in the bottom but it goes up the river. The trial court's own language demonstrates, and we agree, that Knightsbridge [Owner] failed to establish an implied waiver of liens by clear and convincing evidence.

*Id.* at 374-75, 367 S.E.2d at 516.

ing the trial judge as to the existence of a waiver,[110] it is difficult to quarrel with the court's desire to create "a bright line rule for lien waivers"[111] in order to avoid litigation. The decision plainly informs attorneys planning similar transactions to draft clearly. When a document is intended as a lien waiver, the attorney should state it is a "waiver of liens." If the owner had done this in *McMerit*, the court would have held for the owner.[112] Otherwise, the owner apparently loses.

There remains some question whether the clear and convincing evidence test creates a sufficiently bright line. Treating the issue as one of fact, even with an increased burden of proof, still leaves opportunity for line blurring. Read properly, *McMerit* says that the owner loses if there is any real doubt about whether the contractor waived its lien. This is a sound result, for the owner can easily comply. One wonders, however, why the court left this matter open for further litigation.[113]

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110. The court's treatment of both of the owner's arguments is troublesome. If anything short of a document entitled or stating "Express waiver of liens" amounts to an express waiver, the application submitted by the contractor is it. The prime contract required the contractor to give a lien waiver if it sought progress payments. The application says that the contractor has been paid in full for the times specified. *See supra* note 99.

In this constantly recurring situation, what else can this application be if not a lien waiver? The court relies on the admitted dispute between the parties as to the amount owed. How does the dispute bear on the question of whether the application was an express waiver? The dispute indicates that either the contractor was mistaken as to the effect of the application or that the contractor settled for early payment and subsequently changed its mind. Possibly the contractor submitted the application with an intent similar to one who accepts a check but reserves the right to dispute satisfaction later. *See* VA. CODE ANN. § 8.1-207 (Repl. Vol. 1984). However, there is no written evidence of such an intent. The owner seems to have offered clear and convincing evidence that in this setting this was understood to be an express waiver.

The court ignores the owner's stated reason for submitting the application to the title company. *See supra* text accompanying note 99. The owner sought to obtain advances for progress payments. The case seems to say that unless an owner uses the words "lien waiver" or their exact equivalent, there can be no express waiver.

A more difficult question is whether the owner offered clear and convincing evidence of an implied waiver. The court never comes to grips with the question. The court never refers to the owner's proof, rather, points to the language of the trial judge to demonstrate that he was not clearly convinced that the contractor impliedly waived the right to claim a lien. *See supra* note 108. The trial judge, however, seems to be dealing with whether the application amounted to an express waiver, not whether a waiver should be implied. Overall, it is difficult to imagine stronger proof of an implied wavier than the owner presented in *McMerit.*

111. *McMerit Constr. Co.*, 235 Va. at 374, 367 S.E.2d at 515-16.

112. *See* United Masonry, Inc. v. Riggs Nat'l Bank, 233 Va. 476, 357 S.E.2d 509 (1987) (on facts similar to *McMerit*, where the words "express waiver" are used, owner wins).

113. Presumably, the contractor did not ask for summary judgment and for this reason the court had to remand rather than enter final judgment.

### B. *Joinder of Parties in the Mechanic's Suit to Enforce*

The Virginia Supreme Court has long required that mechanics strictly comply with all formal aspects of the Mechanic's Lien Act as a condition precedent to obtaining an enforceable lien.[114] The smallest deviation from the formal requisites may cost the mechanic the lien. In *Walt Robbins, Inc. v. Damon Corp.*,[115] the court reemphasized this point.

In *Robbins*, a subcontractor who had not been paid filed a mechanic's lien and brought a suit to enforce the lien. The subcontractor named the owner and general contractors as defendants, but failed to name either the trustees or beneficiaries of a deed of trust, which had been recorded before the construction started. The trustees and beneficiaries moved to dismiss the suit to enforce on the ground that they were necessary parties.[116] The supreme court agreed.[117] Although the statute does not expressly require that such parties be named as defendants,[118] principles of due process demand that the trustees and beneficiaries of the deed of trust be made defendants.[119] The suit to enforce is the only appropriate place in the mechanic's lien process to challenge the validity of the lien. Interested parties must have notice of the suit in order to protect their interests.[120]

As often happens after reading a Virginia case dealing with mechanics' liens, the reader would like to ask the court a question or two. Why may the beneficiaries only protect their interests in

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114. The court held:

> We believe the correct rule [of construction] deducible from the language and purposes of our statute and the decisions of this court with respect to it is, that there must be a substantial compliance with the requirement of that portion of the statute which relates to the creation of the lien; but that the provisions with respect to its enforcement should be liberally construed.

H.N. Francis & Co. v. Hotel Rueger, Inc., 125 Va. 106, 121, 99 S.E. 690, 694 (1919).

115. 232 Va. 43, 348 S.E.2d 223 (1986).

116. *Id.* at 46, 348 S.E.2d at 224-25.

117. *Id.* at 46-47, 348 S.E.2d at 226.

118. VA. CODE ANN. § 43-22 (Repl. Vol. 1986).

119. *Walt Robbins, Inc.*, 232 Va. at 46-47, 348 S.E.2d at 226.

120. A mechanic's lien takes priority over a deed of trust as to the improvements, but is junior to a deed of trust to the extent of the estimated value of the land without improvements filed before the work commences. The sale proceeds may be insufficient to fully pay both lien creditors. Thus, the beneficiary of the deed of trust must be given the opportunity to challenge the perfection of the mechanic's lien in order to protect its property interest. *Id.* at 47, 348 S.E.2d at 226-27. The trustee's interest seems purely formal. *See infra* note 106.

the suit to enforce? A mechanic's lien suit is essentially a proceeding *in rem*. The sale affects only the interests of those joined in the proceeding. The buyer at this sale would not obtain good title to the property because the deed of trust had been recorded. Another suit would have been necessary to clarify the title.[121]

The supreme court held in *Monk v. Exposition Deepwater Pier Corp.*[122] that beneficiaries of an "antecedent" deed of trust disclosed by the record are not necessary parties and failure to include them as defendants does not preclude a sale. To distinguish *Monk*, a court should explain why deeds of trust recorded after the improvement commences are different from deeds of trust on record before construction began. A court should explain why the due process interests of the latter are more significant than those of the former. The *Robbins* court does not say why this difference is crucial, and no reason comes to mind. The beneficiaries in both instances have a property interest to protect.[123] The court may have wished to overrule *Monk* in order to increase the efficiency of the sale. When all parties of record are joined, the purchaser receives an unencumbered title and should be willing to pay close to full price. Whatever the court had in mind, it seems to have changed the law without admitting it has done so.

*Robbins'* impact on mechanics needs to be noted. In *Robbins*, the subcontractor was precluded from ever obtaining a mechanic's lien against the property.[124] The suit to enforce must be commenced within six months from filing of the memorandum of lien or within sixty days of completion of the project.[125] This statutory period had long run by the time the supreme court overturned the subcontractor's judgment.[126] One might ask why the subcontractor had not cured this defect by joining the trustees and beneficiaries earlier. The surprising answer is that such amendments are forbidden. Once the statutory period for filing the suit to enforce runs,

121. The concept here is essentially the same as the one the Virginia court recognized in *McEwen*. *See supra* text accompanying notes 19-21.

122. 111 Va. 121, 68 S.E. 280 (1910).

123. The creditors in *Robbins* and *Monk* hold liens inferior to the mechanic as to improvements, however, the *Robbins* creditor has priority as to the land while the *Monk* creditor does not. *See supra* note 119. This is the only distinction the court offers.

124. Since the subcontractor had no contract with the owner, he can not get a personal judgment against the owner. His sole remedy is against the general contractor.

125. VA. CODE ANN. § 43-22 (Repl. Vol. 1986).

126. *Walt Robbins, Inc.*, 232 Va. 43, 348 S.E.2d 223.

new defendants may not be added unless they claim through a party already named.[127]

Attorneys who represent contractors should not have been surprised by the result in *Robbins*. Strict compliance is required, even if the violation does not cause harm.[128] The mechanic's attorney is advised to join all parties who could possibly have an interest in the outcome and some who arguably do not, such as the trustee of the deed of trust.[129]

## V. SECURED CREDITORS IN BANKRUPTCY

### A. *Impact of Bankruptcy on Foreclosure Proceedings on an Individual Residence*

One of the most common reasons a debtor files bankruptcy is because a creditor has threatened to foreclose a deed of trust on the debtor's residence. State law offers the debtor no effective way to halt a foreclosure, however, bankruptcy does.[130] Once the bankruptcy petition is filed, the automatic stay precludes further action until the creditor can obtain relief from the stay. Bankruptcy offers the debtor a "breathing space," a time to formulate a plan to save the home. Several recent bankruptcy decisions have clarified how this matter may be approached.

To take advantage of the bankruptcy alternative, a debtor must file his petition before the sale is final under non-bankruptcy (Virginia) law.[131] The sale is not until all the formalities necessary to

127. Neff v. Garrard, 216 Va. 496, 219 S.E.2d 878 (1975).

128. The beneficiaries of the deed of trust received a windfall through the decision, because their lien was clearly junior. *See supra* note 102. Sometimes one has to wonder about the evenhandedness of the Virginia Supreme Court. *Compare* Walt Robbins, Inc. v. Damon Corp., 232 Va. 43, 348 S.E.2d 223 (1986) *with* J.I. Case Co. v. United Va. Bank, 232 Va. 210, 349 S.E.2d 120 (1986) (creditor permitted to prove no harm in fact, despite egregious violation of rules designed to prevent harm to defendant in detinue case).

129. The trustee of the deed of trust is also a necessary party because such party must be divested of legal title if the purchaser at the sale is to obtain good title. This holding seems to support the idea that the court wishes to increase the efficiency of the process, yet, the trustee's interest is purely formal. The trustee loses nothing. Why create this additional snare for the unwary?

130. *See generally* Zaretsky, *Some Limits on Mortgagees' Rights in Chapter 13*, 50 BROOKLYN L. REV. 433 (1984) [hereinafter Zaretsky].

131. The debtor's interest in the property is extinguished if the foreclosure sale has been completed before the petition is filed. The property is no longer a part of the debtor's estate and the automatic stay granted by 11 U.S.C. § 362(a) (1982 & Supp. IV 1986) does not prevent creditor action unless the sale process is deficient. *See, e.g.*, Abdelhaq v. Pflug, 82 Bankr. 807 (Bankr. E.D. Va. 1988).

pass title to the purchaser have been completed. Thus, the sale is not complete until the trustee of the deed of trust has prepared and signed the memorandum of sale or has recorded the deed evidencing the sale. As long as the sale is not final, the residence remains a part of the debtor's estate. In effect, filing the bankruptcy petition permits the debtor to block the sale.[132]

After the petition is filed, what can the debtor do about saving the residence? Chapter 7 of the Bankruptcy Code contains no explicit rehabilitative provisions dealing with real property. Nonetheless, the bankruptcy filing may aid the debtor in working out a reaffirmation agreement with the creditor holding a deed of trust.[133] Of course, the creditor does not have to reaffirm, but often the creditor will find that the reaffirmation agreement is better than a sale.

In many cases the debtor's residence is encumbered by two liens, and the pressure that leads to bankruptcy comes from a junior lienor's efforts to foreclose. The debtor may be able to work out a reaffirmation agreement with the senior lienor and continue payments under the senior deed of trust. Yet, this arrangement will be fruitless for the debtor if such payments inure solely to the benefit of a junior lienor. For example, suppose the residence is appraised at $28,000; the first lien secures a $24,000 debt, and the second lien secures a $16,000 debt. In this situation, each payment reduces the amount owed to first lienor while increasing the value of the junior lien.[134]

*In re Crouch*[135] offers the debtor a way out. The debtor was permitted to use section 506(d) of the Bankruptcy Code to "strip down" the junior lien to the amount available to pay the second debt, determined as of the date of petition.[136] Using the above hypothetical to illustrate the *Crouch* approach, assume that the resi-

132. *See, e.g.*, Bradley v. United States, 75 Bankr. 198 (Bankr. W.D. Va. 1987) and cases cited therein.

133. 11 U.S.C. §§ 524(c)(6)(B) and 524(d)(2) (1982 & Supp. IV 1986), except home mortgages from the stringent rules concerning reaffirmations. Congress, therefore, must have recognized that this tactic was common.

134. In the hypothetical, the first lien is a fully secured claim, while the second lien is partially secured. *See* 11 U.S.C. § 506(a) (1982 & Supp. IV 1986). In the hypothetical, the debtor's payment of $1,000 to the first lienor reduces that debt but increases the value of the second lien on the property by $1,000 (first lien reduced to $23,000, but second lien now worth $5,000).

135. 80 Bankr. 364 (Bankr. W.D. Va. 1987).

136. *Id.* at 367.

dence is worth $28,000. The court should "strip down" any lien to the extent it is not fully secured. Thus, the first lien of $24,000 is fully secured. The second lien is secured only to the extent of $4,000. The court should bifurcate the second lien into a $4,000 secured claim and a $12,000 unsecured claim. Section 506(d) voids the unsecured part of this lien. The court should then order the trustee to abandon the property and leave the parties to their state law remedies.[137]

In contrast to Chapter 7, Chapter 13 of the Bankruptcy Code provides special treatment for home mortgages in section 1322(b)(2). The debtor may cure defaults over the course of his plan while making regular payments.[138] Chapter 13 could be comparatively expensive if the debtor has to pay the trustee's commission of 10% on these payments. Some courts have held that a Chapter 13 debtor must pay the commission to the trustee on mortgage payments.[139] A recent Virginia bankruptcy decision[140] holds that payments to satisfy liens on a residence may be made outside the plan and are not subject to the trustee's commission.[141] Of course, the debtor may use the *Crouch* technique to "strip down" liens in a Chapter 13 action.

### B. United Savings Association v. Timbers of Inwood Forest

An article on recent developments in creditors' rights would be incomplete without noting the United States Supreme Court's decision in *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*[142] Much ink, both by judges and scholars, has been consumed dealing with the issue *Timbers* raises.[143] Much

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137. In effect, *Crouch*, permits the debtor to redeem the residence. *Cf.* 11 U.S.C. § 722 (1982 & Supp. IV 1986) (permits a debtor to redeem personal property by paying its value to the secured creditor). Some courts refuse to employ 11 U.S.C. § 506(d), as a method to redeem real property, as the *Crouch* court did. Other courts view 11 U.S.C. § 506(d) as a method to foster a debtor's fresh start and void the entire second lien. Neither of these extremes seem appropriate. The matter is fully discussed in Note, *Can A Debtor Avoid A Real Property Lien that Exceeds the Value of the Collateral: An Interpretation of Section 506(d) of the Bankruptcy Code*, 45 WASH. & LEE L. REV. ___ (1988).

138. *See generally* 5 COLLIER ON BANKRUPTCY ¶ 1302.06-.09 (15th ed. 1986); Zaretsky, *supra* note 129.

139. *See, e.g.*, Foster v. Heitkamp, 670 F.2d 478 (5th Cir. 1982).

140. *In re* Wright, 82 Bankr. 422 (Bankr. W.D. Va. 1988).

141. *Wright* grants the trustee a commission on payments to secured creditors for debts paid in full under the plan. *Id.* at 424.

142. 108 S. Ct. 626 (1988).

143. The leading article is Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and*

more will be used in debating the result. Only an effort to give the reader a speaking acquaintance with *Timbers* will be attempted here.

*Timbers* holds that an undersecured creditor is *not* entitled to compensation for the delay of its right to foreclose on its collateral caused by the automatic stay.[144] The *Timbers* rule governs a common occurrence. Assume that a creditor loans a debtor $2,000,000. The creditor takes a mortgage on real property worth $1,500,000 as security for the loan. The creditor is undersecured. Outside bankruptcy, the creditor could foreclose upon default, sell the property and reinvest the $1,500,000. In bankruptcy, the automatic stay precludes the creditor's foreclosure. The creditor must file a complaint for relief from or modification of the stay. Before *Timbers*, the creditor would seek either the return of the property or "adequate protection" of her interest in the collateral via monthly payments equal to her lost opportunity costs, that is the prospective return from reinvestment of the liquidation value of the collateral.

The Supreme Court denied the creditor's relief in *Timbers*, resolving a conflict among the circuits.[145] Based on its "holistic"[146] reading of the Bankruptcy Code, the Court unanimously concluded that the undersecured creditor's state law right to immediate foreclosure was not protected under the concept of "adequate protection." Therefore, the creditor was not entitled to interest payments on the value of the collateral.[147] Rather, the creditor was entitled to be protected only against a decline in the value of its collateral, and where the collateral was not declining in value, no payments

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*the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

144. *Timbers*, 108 S. Ct. at 635.

145. Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985), and Crocker Nat'l Bank v. American Mariner Indus., Inc., 734 F.2d 426 (9th Cir. 1984) were overruled. The Court affirmed the *en banc* decision of the Fifth Circuit in United States Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd., 808 F.2d 363 (5th Cir. 1987).

146. 108 S. Ct. at 630-31. The primary issue in *Timbers* was the proper construction of the phrase "interest in property" in 11 U.S.C. § 362(d)(1). The undersecured creditor argued that the state law right to foreclose was an interest in property and was entitled to adequate protection. 108 S. Ct. at 630. The Court responded that the creditor's position was plausible only if 11 U.S.C. § 362(d)(1) was read in isolation. *Id.* at 630. "Statutory construction, however, is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme—because the same terminology is used elsewhere in a context that makes its meaning clear . . . ." *Id.* at 630. The Court asserted that reading the related sections of the Bankruptcy Code compelled rejection of the creditor's position. *Id.* at 630-32.

147. *Id.* at 635.

need be made.[148] Such a result, the Court asserted, was necessary to properly balance the interests of secured and general creditors.[149]

The impact of *Timbers* upon undersecured creditors is apparent. Before *Timbers*, the undersecured creditor had a strong bargaining position against the reorganizing debtor. If the debtor in possession desired to use the creditor's collateral, the debtor had to pay for this right. Under *Timbers*, the debtor may retain the collateral without payments if it is necessary to the debtor's reorganization. According to the Court, the undersecured creditor's position has not been greatly eroded. Once the undersecured creditor proves its status, the debtor must demonstrate that there exists "a reasonable possibility of a successful reorganization within a reasonable time."[150] If no such prospect exists, the collateral must be released to the secured creditor.[151] Secured creditors, on the other hand, probably view *Timbers* as further evidence of the demise of security interests.

## VI. RECENT LEGISLATION

### A. *Domestication of Foreign Judgments*

In 1988, the Virginia General Assembly enacted the Uniform Enforcement of Foreign Judgments Act (Foreign Judgments Act).[152] The Foreign Judgments Act represents a major change. Before the adoption of the Foreign Judgments Act, a foreign judgment had to be converted ("domesticated")[153] into a Virginia judgment. This process involved two steps:

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148. *Id.* at 629-30.

149. *Id.* A detailed account of the Court's rationale is beyond the scope of this article.

150. *Id.* at 632 (citing United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd., 808 F.2d 363, 370-71 (5th Cir. 1987)).

151. "The cases are numerous in which § 362(d)(2) relief has been provided within less than a year from the filing of the bankruptcy petition." 108 S. Ct. at 632. For this reason undersecured creditors' fear of "inordinate or extortionate" delay are unfounded. *Id.*

152. VA. CODE ANN. §§ 8.01-465.1 to -465.5 (Cum. Supp. 1988).

153. Judgments of sister states . . . have no force in effect as judgments outside of the territorial limits of the states . . . in which they are rendered, and, consequently, cannot be docketed and do not constitute liens in another jurisdiction where the land is situated. They may be the foundation of actions upon which judgments may be rendered, and full faith and credit will be given to the records of sister states of the Union as provided by the Constitution, but that does not mean that they constitute liens outside of the state in which they are rendered, or can be enforced by execution or other process until the domestic judgment has been obtained on the foreign judgment.

> First, the judgment creditor must obtain an authenticated copy of the foreign judgment, and the authentication must comply with the requirements of the Virginia Statute with respect to the admission in evidence of the records of the courts of foreign countries or sister states; and second, the judgment creditor must institute an action by motion for judgment or other proceedings appropriate to the case based upon the foreign judgment and obtain service of process on the judgment debtor in accordance with Virginia Law.[154]

This method was not only time consuming and expensive, but also unsatisfactory, for it failed to give the judgment debt priority over subsequently obtained local claims.

The Foreign Judgments Act adopts in substance the practice employed by the federal courts. The Act provides a comparatively speedy and economical method of enforcing out-of-state judgments.[155] The major changes from prior procedure may be summarized as follows:

i. Once a foreign judgment has been filed in the clerk's office, it must be treated and enforced in the same manner as a Virginia judgment;[156]

ii. The creditor must give the clerk an affidavit setting forth the last known address of the debtor. The clerk is obligated to promptly notify the debtor that the foreign judgment has been filed;[157]

iii. Enforcement of the foreign judgment may be stayed only by proof that an appeal is pending in the foreign state, or proof of any ground for staying enforcement of a Virginia (domestic) judgment.[158]

iv. The traditional method of enforcing a foreign judgment may be used rather than proceeding under the Foreign Judgments Act.[159]

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BURKS, PLEADING AND PRACTICE § 351 (4th ed. 1952).

154. BOYD, GRAVES, *supra* note 2, at § 12.6.

155. UNIFORM ENFORCEMENT OF FOREIGN JUDGMENTS ACT prefatory note, 13 U.L.A. 150 (1964). The treatment of federal judgments in Virginia is described well by RENDLEMAN, *supra* note 2, § 8.7.

156. VA. CODE ANN. § 8.01-465.2 (Cum. Supp. 1988).

157. *Id.*

158. *Id.* §§ 55-66.3, -66.7.

159. *See supra* text accompanying note 153.

Once the foreign judgment is filed, the creditor may employ all remedies available to a Virginia creditor to satisfy her claim, e.g., levy execution, garnish the debtor's debtor, and docket and enforce her judgment lien.[160] Thus, the creditor will be able to retain the relative priority of the claim.

### B. *Lis Pendens*

The filing of a lis pendens gives constructive notice to the world that title to the described property is the subject matter of a lawsuit. One who acquires an interest in such property from a party-litigant, while the suit is pending, takes the property subject to the outcome of the lawsuit. Technically, a lis pendens creates no lien, but the effect is essentially the same since the property is tied up until the pending litigation is resolved.[161]

Most Virginia attorneys have long assumed that a lis pendens may only be filed in connection with a suit in which title to property is at issue. This assumption is questioned in dictum found in *In re Hart*.[162] In *Hart*, Judge Bostetter upheld the validity of an attachment, suggesting that a lis pendens could be filed against real property in connection with an ordinary law suit seeking a money judgment.[163] Lis pendens would be proper because the plaintiff might obtain a judgment lien on the defendants interest in real property.[164] Thus, "any suit in which the defendant is an individual has the potential to affect the title to real estate."[165] In a subsequent case, *Green Hill Corp. v. Kim*,[166] a divided Fourth Circuit affirmed a Judge Bostetter decision, holding that a lis pendens could not be filed in Virginia except in connection with a suit which brought the title to the property in question.[167]

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160. Virginia courts are not bound by decrees in divorce cases, especially those involving child custody and support. Osborne v. Osborne, 215 Va. 205, 207 S.E.2d 875 (1974). *See generally* BRINIG & WHITE, VIRGINIA DOMESTIC RELATIONS HANDBOOK §§ 21-20 to -30 (1985). Virginia courts are not bound by an out-of-state judgment concerning Virginia real estate. *See* Annotation, *Res Judicata or Collateral Estoppel Effect, in State Where Real Property is Located, of Foreign Decree Dealing with Such Property*, 32 A.L.R.3d 1330 (1970).

161. Preston's Drive Inn Restaurant, Inc. v. Convery, 207 Va. 1013, 1016, 154 S.E.2d 160, 162 (1967).

162. 24 Bankr. 821 (Bankr. E.D. Va. 1982).

163. *Id.* at 824.

164. *Id.*

165. *Id.*

166. 842 F.2d 742 (4th Cir. 1988) (Hall, J., dissenting).

167. *Id.* at 744; *see also* Palmore, *Commercial Law*, C.L.E. Seminar II-30, 31 (1988).

The *Hart* decision and the existence of Judge Hall's dissent in *Green Hill* convinced the legislature of the need to clarify this matter. Thus, section 8.01-268(B) of the Code of Virginia was amended to state: "No memorandum of lis pendens shall be filed unless the action on which the lis pendens is based seeks to establish an interest by the filing party in the real property described in the Memorandum."[168]

One may file a lis pendens against real property as an incident of an attachment even though the attaching party does not claim an interest in the property. In fact, section 8.01-268 expressly authorizes[169] such a filing in attachment to suit, permitting the attaching creditor to protect against sales to a bona fide purchaser during the litigation.[170] Unlike a pure lis pendens, a creditor may obtain an attachment only if he or she proves the required grounds.[171] If the attachment fails for any reason, the creditor is automatically liable for wrongful attachment.[172]

### C. *Other Legislative Changes*

Section 8.01-66.2 of the Code of Virginia grants a lien in favor of hospitals and medical personnel on the claim the injured party has against the person who caused the injury.[173] In 1988 the legislature increased the lien from $500 to $1500 for hospitals and from $100 to $300 for medical personnel.[174]

Owner of hangers who service and store aircraft are granted statutory liens pursuant to sections 43-32 and 43-33 of the Code of Virginia.[175]

Creditors whose liens have been paid have a duty to record the release of such liens quickly. Section 55-66.3 of the Code of Vir-

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168. VA. CODE ANN. § 8.01-268(B) (Cum. Supp. 1988). A lis pendens may be filed against personal property under § 8.01-268. Whether such a filing in an ordinary lawsuit violates the statute is unclear.

169. Section 8.01-268 speaks of "lis pendens or attachment."

170. *Id.* § 8.01-268; *see* Breeden v. Peale, 106 Va. 39, 55 S.E. 2 (1906).

171. *See* VA. CODE ANN. § 8.01-534 (Repl. Vol. 1984); *see generally* RENDLEMAN, *supra* note 2, § 1.2.

172. VA. CODE ANN. § 8.01-568 (Repl. Vol. 1984).

173. *Id.* § 8.01-66.2 (Cum. Supp. 1988). An injured party's assignment of his negligence claim to the hospital has been upheld even though causes of action for personal injury may neither be transferred or levied upon. *See In re* Duty, 78 Bankr. 111 (Bankr. E.D. Va. 1987) (assignment void to extent it involved attorney's fees for collection); *see also supra* note 62.

174. VA. CODE ANN. § 8.01-66.2.

175. *Id.* § 55-66.3 (must record within 90 days).

ginia puts pressure on the lienors to act quickly through imposition of costs. A release in the margin, if customarily employed, is sufficient.[176]

176. *Id.* §§ 55-66.3, -.7 (a marginal release shall be all that is required for a release if such a release is customarily employed in the clerk's office).