

***Bouncing Your Last Check: Does Death Really Put an End to Your Debts?***

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**INTRODUCTION**

Death does not automatically spell the end to the decedent's debts.<sup>1</sup> Rather the claims of the decedent's creditors live on and become part of the estate that is sorted out during probate. This process varies from state to state, but this memo will focus on the procedure for dealing with creditor's claims in North Carolina. This memo will break down the interaction of creditors and the decedent's estate into four parts: I. Claims of creditors against a decedent's estate; II. Classes of creditors; III. Sale of assets (both personal property and real property) by the executor; and IV. Fiduciary liability for the decedent's debts. The memo will conclude with an overall summary of North Carolina's process for handling claims against a decedent's estate.

I. Claims of Creditors Against a Decedent's Estate.

In order to discuss the process of handling claims of the decedent's creditors, it is necessary to understand how North Carolina defines "claims" and the statutory procedures that the executor of the decedent's estate must follow. This section will breakdown those topics into five categories: A) What constitutes a claim? B) Notice to potential creditors; C) Presentment of claims by creditors; D) Permanent bar to claims; and E) Notable exceptions.

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<sup>1</sup> Note, *Suicide or Bankruptcy?*, 5 STAN. L. REV. 74, 74 (1952).

## A. What Constitutes a Claim?

Unfortunately, North Carolina does not provide a statutory definition of what constitutes a "claim," rather it provides several specific exceptions that tell us what is not a claim. These exceptions are discussed in more detail in paragraph E below. North Carolina General Statute § 28A-19-3 provides the basis for determining the definition of a claim. The statute is extraordinarily broad and provides that a claim can be "due or to become due, absolute or contingent, liquidated or unliquidated, secured or unsecured, founded on contract, tort, or [any] other legal basis . . . ." <sup>2</sup> So practically speaking what does this include? Well typical claims would include debts owed by the decedent, liens on the decedent's property, judgments against the decedent, potential lawsuits against the decedent, etc.

However, the statute is broad enough that it arguably includes rights that may have arisen as a result of the decedent's death. Take for example the triggering of a purchase option to the remaining shareholders in a closely held corporation, or the buyout of a member's interest in an LLC. These examples are arguably "claims" as they are contingent on some event, i.e. the decedent's death, and are founded on a contract, i.e. an operating agreement, buy/sell agreement, or shareholder agreement. At first glance it seems unlikely that these purchase options are the types of claims that the legislature had in mind when the statute was drafted, as the vast majority of claims deal with money owed by the decedent. However, courts in other states, with similar statutes, have taken the position that a purchase option is a claim. <sup>3</sup> At present, North Carolina has no case on point that clarifies whether a purchase option constitutes a claim, but this is a good reminder that because the definition of a claim is so broad, the potential universe of

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<sup>2</sup> N.C. GEN. STAT. ANN. § 28A-19-3(a).

<sup>3</sup> See *Steen & Berg Co. v. Berg*, 713 N.W.2d 87 (N.D. Apr. 25, 2006).

creditors can be quite large. Therefore it is important to understand the procedure for dealing with the decedent's creditors.

### **B. Notice to Potential Creditors**

The first step in that process is to provide notice to all potential creditors. North Carolina requires every executor to notify all persons, firms, or corporations that have claims against the decedent's estate by publishing a notice in a newspaper once a week for four consecutive weeks.<sup>4</sup> The creditors must then notify the executor of any claims prior to the date posted in the notification, or within three months of the first publication date of the notice.<sup>5</sup> Additionally, the executor must mail (or personally deliver) a copy of the notice directly to any creditors of the decedent's estate that are actually known to the executor or can be reasonably ascertained by the executor within seventy-five (75) days of being appointed.<sup>6</sup> Once notice has been given, the executor must file a copy of the notice with the clerk of court to satisfy the probate court that proper notice has been given.<sup>7</sup> The executor's failure to comply with the notice provisions can have serious consequences to the decedent's estate. As discussed further in paragraph D below, the filing of notice is a prerequisite to the executor's justification for barring a creditor's claim as being untimely.

### **C. Presentment of Claims by Creditors**

After notice has been given, creditors must submit all claims against the decedent's estate in "writing and state the amount or item claimed, . . . the basis for the claim, and the name and address of the claimant."<sup>8</sup> The claim must be delivered in person or by mail to the executor, or

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<sup>4</sup> N.C. GEN. STAT. ANN. § 28A-14-1(a).

<sup>5</sup> N.C. GEN. STAT. ANN. § 28A-14-1(a).

<sup>6</sup> N.C. GEN. STAT. ANN. § 28A-14-1(b).

<sup>7</sup> N.C. GEN. STAT. ANN. § 28A-14-2.

<sup>8</sup> N.C. GEN. STAT. ANN. § 28A-19-1(a).

delivered to the clerk of court in the county where the estate is pending.<sup>9</sup> Failure to comply with this requirement can result in the creditor being permanently barred from bringing their claim against the decedent's estate.<sup>10</sup> But what happens when no estate file has been opened or no executor has been appointed?

To avoid the risk of the creditor's claim being barred, the creditor has several options. The simplest and most straight forward option is to mail the claim directly to the clerk of court where the decedent was a resident.<sup>11</sup> If an estate file is opened later, then the clerk already has a record of the creditor's claim. However, this approach only works if an estate file is actually opened. In many instances an estate file may never be opened because the decedent did not have a probate estate. Thus the creditor's other option, is to petition the clerk of court in the county where the decedent was a resident to appoint himself as the executor.<sup>12</sup> Once appointed, the creditor can now serve himself with the claim. Applying to become the executor may not be practical in many cases, but if a creditor has a large enough claim against the decedent, then applying to be the executor may be a worthwhile option to avoid the risk of the creditor's claim being barred. In ascertaining whether or not the creditor's claim is barred, it must be determined whether the claim arose before or after the decedent's death.

#### **D. Permanent Bar to Claims**

The primary purpose of requiring the executor to notify creditors and likewise requiring creditors to present their claims to the executor within certain time frames is to make the administration of the decedent's estate more efficient. Thus N.C.G.S. § 28A-19-3 equips the executor with both a sword and a shield as a way to ward off the decedent's creditors. If the

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<sup>9</sup> N.C. GEN. STAT. ANN. § 28A-19-1(a).

<sup>10</sup> N.C. GEN. STAT. ANN. § 28A-19-3.

<sup>11</sup> N.C. GEN. STAT. ANN. § 28A-19-1(a).

<sup>12</sup> See N.C. GEN. STAT. ANN. § 28A-6-1 and N.C. GEN. STAT. ANN. § 28A-4-2.

creditor's claim existed *prior* to the decedent's death, then the creditor must submit his claim before the date set forth in the general notice to creditors.<sup>13</sup> Similarly, if the executor was required to mail a copy of the general notice directly to the creditor—because the executor knew the creditor's claim existed prior to the decedent's death—then the creditor must submit his claim within ninety days of the mailing date of the notice.<sup>14</sup> In either of these situations, the creditor's failure to timely present his claim to the executor will result in his claim being permanently barred.<sup>15</sup> Thus, the executor can use N.C.G.S. § 28A-19-3(a) like a sword to actively ward off creditors.

As mentioned above in paragraph B, the executor must comply with the notice requirements before the executor can use the time limitations set forth in N.C.G.S. § 28A-19-3(a) to permanently bar a creditor's claim. Therefore, if the executor fails to give notice (either by publication or by mail), or if the notice given is defective, the executor can no longer rely on the time limitations set forth in N.C.G.S. § 28A-19-3(a) as a bar to the creditor's claim.<sup>16</sup> Instead, the creditor now must bring his claim within three years of the decedent's death.<sup>17</sup> Likewise, if no executor has been appointed, and thus no notice given, the creditor has three years from the date of the decedent's death to bring his claim.<sup>18</sup> Furthermore, to prevent executors from trying to game the system and delay being appointed until after the limitations period has run, the courts have made it clear that the time limitations in N.C.G.S. § 28A-19-3(a) are extended and become effective once the executor qualifies.<sup>19</sup> Thus, the executor's failure to comply with the

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<sup>13</sup> N.C. GEN. STAT. ANN. § 28A-19-3(a).

<sup>14</sup> N.C. GEN. STAT. ANN. § 28A-19-3(a).

<sup>15</sup> N.C. GEN. STAT. ANN. § 28A-19-3(a).

<sup>16</sup> *Anderson v. Gooding*, 300 N.C. 667 (1994).

<sup>17</sup> N.C. GEN. STAT. ANN. § 28A-19-3(f).

<sup>18</sup> N.C. GEN. STAT. ANN. § 28A-19-3(f).

<sup>19</sup> *Ragan v. Hill*, 337 N.C. 667 (1994); *Wright v. Smith*, 151 N.C. App. 121 (2002).

notice requirements gives the decedent's creditors a much longer time period to present their claims.

On the other hand, for claims that arise *at or after* the decedent's death, the creditor must present his claim to the executor within six months from the date the claim arose, or his claim will be permanently barred.<sup>20</sup> This acts like a shield and gives the executor the ability to rely on the statute to bar certain claims. Take for example the purchase options discussed in paragraph A above. Let's say that pursuant to the terms of a valid shareholder agreement between Shareholder A and Shareholder B, at Shareholder A's death Shareholder B has the option to buy A's stock. The agreement further provides that Shareholder B has one year to exercise his purchase option. If we assume that the purchase option is a claim, then Shareholder B is a creditor of Shareholder A's estate and must comply with the time limitations discussed above. Since Shareholder B's purchase option was triggered at Shareholder A's death, then arguably Shareholder B only has six months from the date of A's death to exercise his purchase option despite the fact that the shareholder agreement gives Shareholder B one year. If Shareholder B does not exercise his option within six months, then B risks losing his purchase option. Keep in mind this has not been specifically addressed by the courts in North Carolina, but it is something to think about when advising clients who may be in a similar situation.

#### **E. Notable Exceptions**

As mentioned in paragraph A above, there are several specific exceptions that define what is not a claim. Thus, if the creditor can fit his claim into one of the exceptions, then the time limitations discussed above do not apply and there is no absolute bar for failing to timely present his claim to the executor. Keep in mind, the three year statute of limitations period from

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<sup>20</sup> N.C. GEN. STAT. ANN. § 28A-19-3(b).

the date of the decedent's death still applies even though the creditor's claim falls within an exception. Those exceptions include:

1. All claims of the United States;<sup>21</sup>
2. Claims of the North Carolina Department of Revenue (Note all other state claims are subject to the limitations discussed above);<sup>22</sup>
3. Claims by heirs or devisees, to their respective shares in the decedent's estate;<sup>23</sup>
4. Contingent claims based on any warranty made in connection with the conveyance of real estate;<sup>24</sup>
5. Any action to enforce a mortgage, deed of trust, pledge, lien, or other security interest upon the decedent's property (Note deficiency judgments must comply with the presentment requirements or risk being barred); and<sup>25</sup>
6. Claims against the decedent that are covered by insurance (Note the decedent must be the insured).<sup>26</sup>

Once all claims have been presented to the executor, the executor must classify the creditors in order to determine the order in which the claims are paid.<sup>27</sup>

## II. Classes of Creditors

North Carolina General Statute § 28A-19-4 provides that the executor may pay all claims and charges against the estate as the executor “deems [is] in the best interest of the estate” if there are sufficient assets to make the payments. Additionally, the statutes provide the executor

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<sup>21</sup> N.C. GEN. STAT. ANN. § 28A-19-3(a).

<sup>22</sup> N.C. GEN. STAT. ANN. § 28A-19-3(a).

<sup>23</sup> N.C. GEN. STAT. ANN. § 28A-19-3(h).

<sup>24</sup> N.C. GEN. STAT. ANN. § 28A-19-3(a).

<sup>25</sup> N.C. GEN. STAT. ANN. § 28A-19-3(g).

<sup>26</sup> N.C. GEN. STAT. ANN. § 28A-19-3(i); *Brace v. Strother*, 90 N.C. App. 357 (1988).

<sup>27</sup> *See* N.C. GEN. STAT. ANN. § 28A-19-6.

with a specific order in which to make the payments based on the class of the creditor.<sup>28</sup> This section will break the discussion into three parts: A) The nine creditor classes; B) Priority of payment; and C) Contingent and unliquidated claims.

### **A. The Nine Creditor Classes**

In general, there are nine classes of creditors: 1) Claims to a specific lien on property in an amount not exceeding the value of the property; 2) Funeral expenses in an amount not to exceed \$3,500; 3) Burial expenses, such as cost of a gravestone and cost of a burial plot, in an amount not to exceed \$1,500; 4) All taxes and claims payable to the United States; 5) All taxes and claims payable to the State of North Carolina; 6) Any judgment of a court with in the state; 7) Wages owed to an employee of the decedent for a period not to exceed twelve months; 8) All claims for equitable distribution; and 9) All other claims.<sup>29</sup> Once each creditor has been classified, payment is made based on each class's priority.

### **B. Priority of Payment**

Typically the creditors are paid in the same priority as that of their respective class.<sup>30</sup> In other words, class one is paid first and class nine is paid last.<sup>31</sup> However, North Carolina's statute states that all of the classes of claims listed above are secondary to the general administrative expenses of the estate.<sup>32</sup> For example, the executor is entitled to be paid for administering the estate prior to paying any creditors of the estate.<sup>33</sup> However, this amount is limited if it would cause the estate to be unable to pay the creditors.<sup>34</sup> More importantly though,

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<sup>28</sup> N.C. GEN. STAT. ANN. § 28A-19-6(a).

<sup>29</sup> N.C. GEN. STAT. ANN. § 28A-19-6(a).

<sup>30</sup> N.C. GEN. STAT. ANN. § 28A-19-6(a).

<sup>31</sup> N.C. GEN. STAT. ANN. § 28A-19-6(a).

<sup>32</sup> N.C. GEN. STAT. ANN. § 28A-19-6(a).

<sup>33</sup> N.C. GEN. STAT. ANN. § 28A-19-6(b).

<sup>34</sup> N.C. GEN. STAT. ANN. § 28A-19-6(b).

the spousal allowance of up to \$30,000,<sup>35</sup> and the child allowance of \$5,000 per minor child,<sup>36</sup> are both paid prior to any creditors receiving their payment.<sup>37</sup> Additionally, the spousal allowance is exempted from any lien that may be associated with the property being transferred to satisfy the allowance.<sup>38</sup> Thus in an estate with very little assets passing under the will, it is highly likely that many of the decedent's creditors will not be paid as a result of the spousal and children's share having priority.

### **C. Contingent and Unliquidated Claims**

The process described above is generally how most claims of a decedent's estate are handled. In some situations, however, a decedent's estate may have contingent or unliquidated claims. In those situations, the North Carolina statutes grant the clerk of court specific procedures to follow. In general, a contingent claim is a claim that "depends on some event that has not yet occurred and may never occur."<sup>39</sup> On the other hand, an unliquidated claim is a debt in which the exact amount has not been determined.<sup>40</sup> The process is straight forward if either a contingent or unliquidated claim becomes absolute prior to the distribution of the decedent's estate. In that case the claim falls into its respective class of claims and is paid along with all other claims in that class.<sup>41</sup>

However, if the contingent or unliquidated claim does not become absolute prior to the distribution of the decedent's estate, then the clerk can provide for payment in one of four

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<sup>35</sup> N.C. GEN. STAT. ANN. § 30-15.

<sup>36</sup> N.C. GEN. STAT. ANN. § 30-17.

<sup>37</sup> N.C. GEN. STAT. ANN. § 28A-19-6(a).

<sup>38</sup> N.C. GEN. STAT. ANN. § 30-15.

<sup>39</sup> Kathleen Michon, *When Is a Bankruptcy Claim Contingent, Unliquidated, or Disputed?*, NOLO, <http://www.nolo.com/legal-encyclopedia/when-is-bankruptcy-claim-contingent-unliquidated-disputed.html> (last visited Feb. 16, 2015).

<sup>40</sup> *Id.*

<sup>41</sup> N.C. GEN. STAT. ANN. § 28A-19-5(a).

ways.<sup>42</sup> The executor and creditor can agree to the value of the contingent or unliquidated claim, and therefore the claim becomes absolute and drops into one of the nine classes of claims.<sup>43</sup> If that fails, the clerk can order the executor to retain sufficient funds to pay the claim, if and when it becomes absolute.<sup>44</sup> Similarly, the clerk can distribute “the estate as though the contingent or unliquidated claim did not exist, but the [decedent’s] heirs” are still liable to the creditor in the event the claim becomes absolute in the future.<sup>45</sup> Finally, the clerk can use any other method they deem appropriate to resolve the claims.<sup>46</sup> Once all the creditor’s claims have been properly classified and priority determined, the executor must begin to pay the claims.

### III. The Sale of Assets by the Executor

In general, all of the decedent’s assets, including both real and personal property, are available for paying the claims against the estate.<sup>47</sup> In the case of a decedent’s estate where there are sufficient liquid assets to pay the creditors, the executor’s job is straight forward. The executor simply issues payment directly to the creditor. However, when there are no probate assets, or insufficient liquid assets, or the decedent’s estate is insolvent, the executor has the more challenging task of trying to bring non-probate assets back into the estate or selling assets of the estate to generate the revenue necessary to pay the estate’s debts. This section will focus on the necessary steps the executor must take to sell A) Personal property of the estate; B) Real property of the estate and C) Bring non-probate assets back into the estate to satisfy outstanding claims.

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<sup>42</sup> N.C. GEN. STAT. ANN. § 28A-19-5(a).

<sup>43</sup> N.C. GEN. STAT. ANN. § 28A-19-5(a)(1).

<sup>44</sup> N.C. GEN. STAT. ANN. § 28A-19-5(a)(2).

<sup>45</sup> N.C. GEN. STAT. ANN. § 28A-19-5(a)(3).

<sup>46</sup> N.C. GEN. STAT. ANN. § 28A-19-5(a)(4).

<sup>47</sup> N.C. GEN. STAT. ANN. § 28A-15-1(a).

### **A. Sale of Personal Property by the Executor**

Generally speaking, the executor has the power to act as the decedent otherwise could have, regarding the administration of the decedent's estate.<sup>48</sup> The executor must carry out that duty in a reasonably prudent manner and distribute the decedent's estate "in a safe, orderly, accurate, and expeditious manner."<sup>49</sup> Ultimately, this may involve the sale of the decedent's personal property to satisfy the debts of the estate. At the time of the decedent's death, title to personal property automatically vests in the decedent's heirs, subject to the appointment of an executor.<sup>50</sup> Once an executor has been appointed, title to personal property vests in the executor<sup>51</sup> and the executor has the power to sell or lease the property.<sup>52</sup> This may be done with<sup>53</sup> or without<sup>54</sup> a court order and it is up to the executor to determine which assets to sell in a manner that will "promote the best interests of the estate."<sup>55</sup>

However, when paying the debts of the estate, the executor must satisfy those claims by selling the personal property of the estate prior to selling the real property.<sup>56</sup> Additionally, the decedent's furniture may not be sold to satisfy outstanding claims, if the surviving spouse is still living in the marital home.<sup>57</sup> Therefore, there are at least some guidelines in place to help the executor determine which personal property may be sold to pay the debts of the estate. Furthermore, in most cases the executor will sell the intangible personal property first prior to selling the tangible personal property. However, in the case of an insolvent estate, the personal

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<sup>48</sup> N.C. GEN. STAT. ANN. § 28A-13-3(a).

<sup>49</sup> N.C. GEN. STAT. ANN. § 28A-13-3(a).

<sup>50</sup> N.C. GEN. STAT. ANN. § 28A-15-2(a).

<sup>51</sup> N.C. GEN. STAT. ANN. § 28A-15-2(a).

<sup>52</sup> N.C. GEN. STAT. ANN. § 28A-16-1(a).

<sup>53</sup> N.C. GEN. STAT. ANN. § 28A-16-2.

<sup>54</sup> N.C. GEN. STAT. ANN. § 28A-16-1.

<sup>55</sup> N.C. GEN. STAT. ANN. § 28A-15-1(b).

<sup>56</sup> *City of Durham v. Hicks*, 135 N.C. App. 699, 703 (1999).

<sup>57</sup> N.C. GEN. STAT. ANN. § 28A-16-3.

property alone may be insufficient to satisfy all of the outstanding claims. In that situation the executor may have no other option but to sell the estate's real property.

### **C. Sale of Real Property by the Executor**

Once it has been determined that the proceeds from the sale of the decedent's personal property are insufficient to satisfy the claims against the estate, the executor must now exercise his powers over real property. Similar to his powers involving personal property, the executor may "sell, lease, or mortgage any real" property as necessary to pay the claims against the estate.<sup>58</sup> However, unlike personal property, title to real property vests in the devisees of the decedent's estate at the time of the decedent's death.<sup>59</sup> Therefore, the executor does not hold title to the real property and must obtain a court order to sell the property.<sup>60</sup> There is one notable exception. If the real property was devised to the executor under the terms of the will, then the executor can sell, lease, or mortgage the property without a court order.<sup>61</sup> Thus, in most situations the executor will have to petition the court before he can sell the property to pay the debts of the estate.

In that case, the executor initiates a special proceeding with the clerk of court in the county where the decedent's property is located.<sup>62</sup> In a petition for sale the executor must include:

- (1) [a] description of the real property and interest therein sought to be sold;
- (2) [t]he names, ages and addresses, if known, of the devisees and heirs of the decedent; [and]
- (3) [a] statement that the personal representative has determined that it is in the best interest of the administration of the estate to sell the real property sought to be sold.<sup>63</sup>

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<sup>58</sup> N.C. GEN. STAT. ANN. § 28A-15-1(c).

<sup>59</sup> N.C. GEN. STAT. ANN. § 28A-15-2(b).

<sup>60</sup> N.C. GEN. STAT. ANN. § 28A-15-2(b).

<sup>61</sup> N.C. GEN. STAT. ANN. § 28A-15-2(b).

<sup>62</sup> N.C. GEN. STAT. ANN. § 28A-17-1.

<sup>63</sup> N.C. GEN. STAT. ANN. § 28A-17-1.

Furthermore, “no order to sell real property shall be granted until the heirs and devisees of the decedent have been made parties to the special proceeding . . . .”<sup>64</sup> Once the petition for sale is granted, the executor may sell the property, but the proceeds from the sale must be used to satisfy all liens against the property before satisfying other claims against the estate.<sup>65</sup> On the other hand, if the court determines that a sale of the real property is not in the best interest of the estate, the executor may petition the court to lease or mortgage the property instead.<sup>66</sup>

There is however, one notable exception where real property may pass to a decedent’s heirs and the executor has no power to bring the property back into the estate. This situation arises when real property is titled as tenants by the entirety.<sup>67</sup> If that is the case, then the property transfers outside the decedent’s will, and the executor has no vested interest in the property.<sup>68</sup> More importantly, the property passes free of all debt and therefore cannot be used to satisfy any claims against the decedent’s estate.<sup>69</sup>

### **C. Bringing Non-Probate Assets Back into the Estate**

In general, *all* of the decedent’s assets are available for the discharge of the claims against the decedent’s estate.<sup>70</sup> However, in a well planned estate most if not all of the decedent’s assets may pass outside of probate and thus not be under the executor’s direct control. In that case, the executor is left with little if any property to pay creditor claims. Fortunately, N.C.G.S. § 28A-15-10 gives the executor the ability to bring non-probate assets back into the estate for the limited purpose of satisfying creditor claims. This includes: (i) death bed gifts made by the

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<sup>64</sup> N.C. GEN. STAT. ANN. § 28A-17-4.

<sup>65</sup> *City of Durham v. Hicks*, 135 N.C. App. 699, 703 (1999).

<sup>66</sup> N.C. GEN. STAT. ANN. § 28A-17-11.

<sup>67</sup> *In re William Howard Knapp*, 285 B.R. 176, 179 (2002).

<sup>68</sup> *See In re William Howard Knapp*, 285 B.R. 176, 179 (2002).

<sup>69</sup> *In re William Howard Knapp*, 285 B.R. 176, 179 (2002).

<sup>70</sup> N.C. GEN. STAT. ANN. § 28A-15-1(a).

decedent; (ii) joint deposit accounts with right of survivorship; (iii) jointly owned corporate stocks or other investment securities with right of survivorship; and (iv) assets with a transfer on death (TOD) or payable on death (POD) designation.<sup>71</sup> In addition, the executor can sue for and recover "any and all personal property or real property, or interest therein, which the decedent may in any manner have transferred or conveyed with [the] intent to hinder, delay, or defraud the decedent's creditors."<sup>72</sup> Therefore, assets that initially were not part of the decedent's probate estate can nevertheless be brought back into the decedent's estate for the purpose of paying the decedent's debts.

In the end, the executor's job can be very challenging when trying to handle all of the creditor's claims. Fortunately, the statutes equip the executor with certain tools to help alleviate some of the burden. Nevertheless, the executor and the heirs are continually exposed to additional liability until all of the claims against the estate have been addressed.

#### IV. Fiduciary Liability for the Decedent's Debts.

In general, the executor and the heirs of an estate are not personally liable for the claims or debts owed by the decedent.<sup>73</sup> The heirs are not personally liable because title to the decedent's property vests in the executor rather than the heirs.<sup>74</sup> Thus, the heirs have no right to the decedent's property until the property is actually distributed to them by the executor. On the other hand, the executor is acting in a fiduciary capacity and thus is liable for his actions with respect to the decedent's property.<sup>75</sup> In addition, because title to the decedent's property is vested

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<sup>71</sup> N.C. GEN. STAT. ANN. § 28A-15-10(a)(2)-(4).

<sup>72</sup> N.C. GEN. STAT. ANN. § 28A-15-10(b).

<sup>73</sup> N.C. GEN. STAT. ANN. § 28A-13-10(a) and N.C. GEN. STAT. ANN. § 28A-15-2(a).

<sup>74</sup> N.C. GEN. STAT. ANN. § 28A-15-2(a).

<sup>75</sup> N.C. GEN. STAT. ANN. § 28A-13-2.

in the executor, the executor may be personally liable for failing to pay the decedent's debts.<sup>76</sup> This is particularly the case when dealing with federal tax liens on the decedent's property.

Internal Revenue Code section 6321 grants the U.S. government a lien on "all property and rights to property, whether real or personal, belonging to such person."<sup>77</sup> Thus, the essential function of section 6321 is to grant the IRS lien priority against other creditors. The phrase "all property and rights to property" has repeatedly been construed in a very liberal manner favoring the government.<sup>78</sup> Additionally, property acquired by the taxpayer after a tax lien arises is also subject to the lien.<sup>79</sup>

U.S. Code section 3713, on the other hand, extends the taxpayer's liability to representatives of the taxpayer. In other words, if a representative pays other debts of the taxpayer prior to paying the IRS, then the representative may be personally liable to the extent of the payment.<sup>80</sup> The cases define a representative of the taxpayer as someone who is appointed to handle the taxpayer's liabilities and who is acting in a fiduciary capacity.<sup>81</sup> This includes guardians, trustees, executors, administrators, receivers, or conservators. Thus, an executor could be held personally liable under section 3713(b), for paying other debts of the decedent prior to paying known tax liens against the decedent's property.

The heirs on the other hand, may be "subject" to the claims of the decedent's estate, meaning the property transferred to the heirs may still be reachable by the creditor to satisfy his

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<sup>76</sup> N.C. GEN. STAT. ANN. § 28A-13-10.

<sup>77</sup> IRC § 6321

<sup>78</sup> Glass City Bank v. U.S., 326 U.S. 265 (1945).

<sup>79</sup> In re Anderson, 2000-1 USTC ¶50,453 (Bankr. E.D. Ky. 2000).

<sup>80</sup> 31 USC § 3713(b).

<sup>81</sup> Bramwell v. U.S. Fed. & Guar. Co., 269 U.S. 483 (1926); LaPadula & Villani, Inc. v. U.S., 563 F. Supp. 782 (S.D.N.Y. 1983). See also U.S. v. Turner, No. 90CV7473 (N.D. Ohio 1992) (defendant, who followed taxpayer's instruction to pay certain creditors before paying IRS, is personally liable under 31 U.S.C. §3713 because he was under duty to pay taxpayer's debts to IRS first).

claim.<sup>82</sup> This however, does not mean the heirs' personal assets would be reachable by the creditor. Instead the creditor would only be entitled to go after the decedent's property that was actually transferred to the heir and subject to the creditor's claim.<sup>83</sup> This is especially the case when the decedent's estate has contingent or unliquidated claims. If either a contingent or unliquidated claim does not become absolute prior to the distribution of the decedent's estate, then to extent the property subject to the claim is distributed to the heirs, the heirs take the property subject to the claim. As mentioned above, the heirs' liability only extends to the extent of the creditor's claim in the underlying property.<sup>84</sup> Thus, the heirs ultimately may be required to give the property back or post a bond securing the creditor's claim on the property,<sup>85</sup> but in the end the heirs have some piece of mind in knowing the creditor's right to pursue his claim is time sensitive and can be barred.

### CONCLUSION

Dealing with a decedent's estate is already a difficult task, as a loved one has just passed away. Add to those emotions the claims of numerous creditors, and the executor has quite a task to properly administer the estate. Fortunately, state statutes set forth guidelines for handling creditor's claims, and often give priority to the decedent's estate.<sup>86</sup> This trend is reflected in North Carolina's statutes which allow the surviving spouse to take her spousal allowance right off the top, potentially leaving nothing behind for creditors in a small estate.<sup>87</sup> Furthermore, North Carolina sets forth nine specific classes of creditors and prioritizes their payment based on their class.<sup>88</sup> As a result, a creditor in class eight or nine may never get paid. Additionally,

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<sup>82</sup> N.C. GEN. STAT. ANN. § 28A-15-3 and N.C. GEN. STAT. ANN. § 28A-19-5(a)(3).

<sup>83</sup> N.C. GEN. STAT. ANN. § 28A-15-3 and N.C. GEN. STAT. ANN. § 28A-19-5(a)(3).

<sup>84</sup> See N.C. GEN. STAT. ANN. § 28A-19-5(a)(3).

<sup>85</sup> N.C. GEN. STAT. ANN. § 28A-19-5(a)(3).

<sup>86</sup> *Supra* note 1, at 75.

<sup>87</sup> N.C. GEN. STAT. ANN. § 28A-19-6(a).

<sup>88</sup> N.C. GEN. STAT. ANN. § 28A-19-6(a).

creditors must comply with strict guidelines for filling claims against the estate, or risk having their claim permanently barred.<sup>89</sup> In the end, careful and thoughtful estate planning can alleviate many issues for the executor and allow for a smooth transition of the decedent's estate to his heirs.

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<sup>89</sup> *Id.* § 28A-19-3.

# Bouncing Your Last Check: Does Death Really Put an End to Your Debts?

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## Creditors' Claims Against the Decedent's Estate

- Creditors' Claims
- Classes of Creditors
- Satisfying Claims
- Fiduciary and Heir Liability



## What Constitutes a Claim?

- North Carolina does not provide a statutory definition for “claim”
- N.C.G.S. § 28A-19-3 provides the basis for defining a claim

**A claim can be anything “due or to become due, absolute or contingent, liquidated or unliquidated, secured or unsecured, founded on contract, tort, or [any] other legal basis...”**

## Typical Claims Include

- Debts owed by the decedent
- Liens on the decedent’s property
- Judgements against the decedent
- Potential lawsuits against the decedent



## Other Claims?

- Purchase Options
  - Buy/Sell Agreements
  - Operating Agreements
  - Shareholder Agreements
- Default provisions under a promissory note

The courts in North Carolina have provided no guidance with regard to these “claims”

## Notice Must be Given

- Executor must notify all persons, firms or corporations
  - Published in the newspaper once per week for 4 weeks
  - Personally notify known creditors or reasonably ascertainable creditors
- Failure to comply can have serious consequences



## Presentment of Claims

- Creditors must submit in “writing and state the amount or item claimed, the basis for the claim, and the name and address of the claimant”
- Claim must be delivered to the executor or to the Clerk of Court in the County where the estate is pending

**Failure = Harsh Penalty**

## Presentment of Claims

- But what happens when there is no estate or no executor has been appointed?
  - Option 1 – Mail notice of the claim directly to the Clerk of Court for the County where the decedent is a resident
  - Option 2 – Creditor appoints himself as the executor

## Failure to Comply



- May result in a permanent bar
  - If claim existed prior to decedent's death
    - Creditor MUST submit claim within 90 days of notice
  - If claim arose at or after decedent's death
    - Creditor MUST submit claim within 6 months of the claim
  - If executor rejects a claim
    - Creditor MUST petition court to reinstate claim

## Executor Fails to Give Notice

- No notice either by publication or mail or the notice given is defective
  - The executor no longer can rely on the time limitations to bar a creditors claim
  - The creditor now has 3 years from the date of the decedent's death to bring their claim
  - Where no executor has been appointed the limitations period are extended until the executor qualifies

## Hypothetical

- Shareholder A and Shareholder B execute a Buy/Sell Agreement giving B the option to buy A's stock at A's death. B has one year to exercise his purchase option.
- Arguably B only has 6 months after A's death to purchase A's stock
- Keep this mind when advising clients

## Exceptions

- All claims of the United States
- Claims of the NC Dept. of Revenue
- Claims by Heirs
- Warranty claims in connection with real estate
- Claims by Secured Creditors
- Claims Covered by Insurance

## Priority of Payment

1. Specific liens on property up to property's value
2. Funeral expenses up to \$3,500
3. Burial expenses up to \$1,500
4. Claims of the United States
5. Claims of North Carolina
6. Court Judgments
7. Employee Wages up to 12 months
8. Claims for Equitable Distribution
9. All other claims



## Except . . .

- All creditor claims are secondary to:
  - General Administrative Expenses
  - Executor Commissions
  - Spousal and Child Allowances
    - Spouse = Up to \$30,000
    - Each Child = Up to \$5,000



# Unresolved Claims



- Contingent vs. Unliquidated
  - Contingent – Claim depends on a future event
  - Unliquidated – Exact amount of claim is unknown
- If either type becomes absolute then it is paid according to its class
- If claim remains unresolved then it is paid in one of four ways
  1. Executor and creditor can agree on the amount and the claim becomes absolute
  2. Clerk can order the executor to retain funds to pay the claim
  3. Clerk can ignore the claim but the heirs are liable to the creditor
  4. Any other appropriate method

# Making Payment

- Where there are sufficient liquid assets, the executor simply pays the creditor
- When the liquid assets are insufficient the executor must sell assets



## Personal Property

- Title vest in executor once appointed
- Can sell or lease with or without court order
- Must promote best interest of the estate
- Must sell prior to real property

## Real Property

- Title vest in the heirs, unless devised to the executor
  - Except property title tenants by the entirety
- Generally requires court order to sell
- Must make heirs a party to the court order
- If court order is not granted executor may lease or mortgage the property

## Executor & Heirs' Liability

- Generally, decedent's heirs are not personally liable
  - Heirs have no right to the decedent's property until it's distributed
  - May take property "subject" to creditors' claims
    - See Contingent or Unliquidated Claims
- Executor may be personally liable for failing to pay decedent's debt
  - Title to decedent's personal property automatically vest in the executor
  - 31 U.S.C. § 3713 imposes personal liability on the executor



## Conclusion

- What constitutes a claim is very broad
  - Alternative claims
  - Exceptions
- Creditor's must comply with short statutory time frames
  - Executor must give notice
- Executor may be personally liable
- Heirs take property subject to the debt

## Questions or Comments

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