



THE LEGAL PAD

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CONTRACTORS BEWARE: *Your Corporate Shield is Cracked*

By Richard A. Prosser

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In *White v. Collins Building, Inc.*, issued January 4, 2011, the Court of Appeals extended individual liability to the president of a corporate general contractor for his role in defective construction. The Court's decision, based on the principle that a corporate officer is personally liable for his or her own torts, is the first to extend individual tort liability to a corporate officer in the construction context.

At issue was the construction of a personal residence in Wrightsville Beach, North Carolina. Collins Building, Inc. ("Collins Building") contracted with a developer to build the home, and Edwin E. Collins, Jr. ("Collins"), president and licensing qualifier for Collins Building, oversaw and supervised construction.

After the home was purchased from the developer, the homeowners began experiencing problems with the windows and doors, and, consequently, water intrusion. The homeowners' efforts to remedy the problems brought to light additional issues. Ultimately, a lawsuit was

filed against the developer, Collins Building and Collins, individually, for negligent supervision of construction.

On appeal, the issue before the Court was whether Collins could be held personally liable for negligence committed in his capacity as a representative of Collins Building. The court, relying on the principle that a corporate officer is individually liable for his own torts, sided with the homeowners, holding that the allegations of the homeowners' complaint adequately stated a claim against Collins, individually, notwithstanding that he was acting on behalf of the corporation.

Although the Court has previously addressed the imposition of tort liability on corporate officers, this decision is the first to address the issue in the construction context. Whether the holding is perceived as an expansion of law or the clarification of an existing point, it undoubtedly casts a spotlight on a crack in the contractor's corporate shield.



PREFERENTIAL TRANSFERS IN BANKRUPTCY:

How to Minimize the Preference Risk

By James R. Vann

For suppliers of goods and services, nothing may be more unsettling than discovering that a customer has filed for bankruptcy. To add insult to injury, there is a risk that any recently received payment or settlement might be recaptured by the bankruptcy trustee as a preferential transfer or “preference.”

The first thing to remember if you receive a letter from the bankruptcy trustee requesting money to be returned to the bankruptcy court is not to panic. You likely have defenses which may eliminate the need to return the money or at least reduce the amount.

Fortunately for you, there are defenses that can be raised against these preference claims. Creditors should be aware that there are contexts in which payment can be exacted from a debtor without fear that the transfer will be avoidable at some future date. Following, we provide a basic overview of the criteria that give rise to bankruptcy preferences, and also highlight some common defenses available to creditors in preference actions.

What is a “preference” payment?

Section 547 of the Bankruptcy Code governs preferences. Under this section, a trustee or debtor-in-possession may recover – as “preferences” – any payments or other transfers of assets by a debtor to a creditor within the 90 days prior to the debtor’s bankruptcy filing. There are two main purposes for this policy: to prevent a debtor from favoring any of its general unsecured creditors over the others; and to discourage creditors, upon hearing that the debtor is about to file bankruptcy, from storming the courthouse to collect their individual debts.

The elements of a preference claim are typically stated as follows: (1) the debtor transferred property to or for the benefit of the creditor (i.e., made a payment); (2) the transfer was made on account of a debtor’s pre-existing

debt to the creditor; (3) the debtor was insolvent at the time of the transfer; (4) the transfer was made within the 90 days prior to the debtor’s bankruptcy filing, or within one year if the creditor is an insider on account of an old debt; and (5) the creditor obtained a larger sum from the transfer than they would have in a Chapter 7 liquidation had the transfer not occurred. Note that payments to a fully secured creditor fail to meet these criteria, as the secured creditor will not receive any more from the debtor than the value of the collateral, which is what he would receive in bankruptcy.

Common Preference Defenses

The Bankruptcy Code provides a series of defenses that creditors can assert to evade preference treatment. These defenses are primarily aimed at encouraging creditors to continue doing business with financially troubled companies. Some of the defenses most frequently asserted are (1) the contemporaneous exchange for new value defense, (2) the ordinary course of business defense, and (3) the small transfer defense. If a creditor is to avoid preferences, a working knowledge of these defenses is imperative.

1. The Contemporaneous Exchange for New Value Defense

The contemporaneous exchange defense is codified at Section 547(c)(1) of the Bankruptcy Code. It excuses any payment or other transfer that the debtor and creditor intend as a contemporaneous exchange for new value, and that is, in fact, a substantially contemporaneous exchange. In other words, if a creditor provides new goods and/or services and receives payment at substantially the same time, the payment will not receive preference treatment. An example of such a contemporaneous exchange would be payments received on a C.O.D. basis.

(cont.)

Notable to the construction industry, there is recent case law from the U.S. Bankruptcy Court for the Western District of N.C. that suggests that a subcontractor's waiver of inchoate lien rights against a construction project may qualify as a contemporaneous exchange. The reasoning is as follows: if the owner owes funds to the debtor, a lien from a lower tiered subcontractor will give rise to an indemnification claim by the owner against the debtor; but when the lower tiered subcontractor waives his lien rights, the owner's indemnification claim is consequently released, resulting in a contemporaneous exchange between the debtor and the lower tiered subcontractor. Note that for this defense to be valid, the debtor cannot also be the owner in the project. Be aware that the Bankruptcy Court for the Eastern District reached the opposite conclusion in its Precision Walls decision.

2. The Ordinary Course of Business Defense

Under Section 547(c)(2) of the Code, payments received in the ordinary course of business on debts incurred in the ordinary course of business are excepted from preference treatment. Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the ordinary course defense required proof that: (1) the payment was made in the ordinary course of business of the debtor and the supplier; and (2) that the transfer was made according to ordinary business terms. The new Act replaces the conjunctive "and" with the disjunctive "or," effectively creating two independent defenses from the former. In other words, a creditor may utilize the ordinary course defense in either of the following contexts: (1) where payment is received in its ordinary business with the debtor, or (2) where payment is received according to the ordinary business in that industry.

As to the first test, the court's basic inquiry involves a subjective evaluation of the debtor/creditor relationship. This generally takes the form of a consideration of the length of time the parties have had a business relationship, and whether the amount or form of payment at issue differed from past business practices between the parties. The longer the business relationship, and the lesser the difference between the payment history before the preference period and that within the preference period, the greater the likelihood that the supplier will prevail.

As to the second test, a more objective inquiry is utilized. The supplier must establish that the terms by which it extended credit to the debtor were "ordinary" within industry standards. This does not mean that all invoices are required to be paid within the invoice terms. The creditor needs to show that payments are made sporadically or outside invoice terms in the particular industry involved, or at least in a manner and form consistent with the payment practice being challenged.



3. The Small Transfer Defense

The small transfer defense is another product of the 2005 Act. This exception bars preference claims in the case of primarily non-consumer debt for payments of up to \$5,850. Creditors should keep this ceiling amount in mind when structuring payment from debtors. As a matter of strategy, creditors may prefer payments of \$5,849 to payments not appreciably greater than that amount. However, a caveat is in order: any payments received during the 90-day preference period accumulate against the maximum protected amount. Thus, if a monthly payment schedule is in place, the \$5,849 maximum must be distributed over the preceding three months.

Conclusion

Often, bankruptcy trustees will file preference claims against all creditors who have received payment from the debtor in the 90 days immediately preceding a bankruptcy filing. The strategy is to file the claims upfront, and then sort out the merits later in the process. A basic understanding of preferences can help creditors avoid making a reflexive, yet unnecessary, refund payment. If you have questions, please feel free to contact us.



NORTH CAROLINA GENERAL ASSEMBLY RATIFIES E-VERIFY LEGISLATION

By Cody R. Loughridge

According to the U.S. Citizen and Immigration Services, E-Verify is described as “an Internet-based system that compares information from an employee’s Form I-9, Employment Eligibility Verification to data from U.S. Department of Homeland Security and Social Security Administration records” in order to confirm employment eligibility. If the information matches, the employee is eligible for employment. While compliance with Form I-9 is mandatory, participation in E-Verify is currently voluntary for most employers. According to the Department of Homeland Security, there are currently more than 238,000 employers using E-Verify, with over 1,400 companies enrolling weekly.

North Carolina House Bill 36, first introduced on February 3, 2011, proposed an act prohibiting state and local government contracts with contractors who employ illegal immigrants. Moreover, House Bill 36 required that prior to submitting a bid or entering into a contract with any State department, institution or governing body of any political subdivision of the State, a contractor would have to verify the legal status of each individual employee employed by the contractor to perform work under the contract, in accordance with the E-Verify Program. As proposed, this bill would have effectively removed the voluntary nature of E-Verify participation in state and local government contracts in North Carolina.

On June 18, 2011, after over four (4) months of negotiation and revision, the North Carolina General Assembly ratified House Bill 36. The ratified version of North Carolina House Bill 36 goes beyond the original bill which required E-Verify participation in only the context of state and municipal contracts. While the ratified version of House Bill 36 does require that counties and municipalities register and participate in E-Verify, it also requires that any and all employers (as defined as “any person, business entity, or other organization that transacts business in this State and that employs 25 or more employees in this State”) verify the work authorization of each employee using the E-Verify system. In other words, if an employer employs 25 or more employees, then the employer

will be required by the State of North Carolina to verify each employee’s work authorization using E-Verify.

Enforcement of E-Verify participation for counties and municipalities becomes effective on October 1, 2011. Employers that employ 500 or more employees shall be required to participate in E-Verify beginning on October 1, 2012. For those employers who employ 100 or more employees, but less than 500, the required participation shall be effective as of January 1, 2013. And finally, the enforcement of E-Verify participation for employers that employ 25 or more employees, but less than 100, shall be effective as of July 1, 2013.

The consequences for failing to participate in the E-Verify program, once an employer falls under the legislation’s purview, are graduated. The first violation requires that the employer file a sworn affidavit within three business days of the discovered violation, stating that the employer has consulted with the employee and requested verification of work authorization through E-Verify. Should the employer fail to timely file the affidavit, the Commissioner of Labor shall order the employer to pay a civil penalty of ten thousand dollars (\$10,000). A second violation shall result in additional civil penalties of one thousand dollars (\$1,000), regardless of the number of required employee verifications the employer failed to make. A third violation shall result in an additional civil penalty of two thousand dollars (\$2,000) for each required employee verification the employer failed to make.

Proponents of House Bill 36 claim that North Carolina, in joining several states such as Arizona, Colorado, Georgia, Mississippi and Utah in passing some form of E-Verify legislation, has taken a proactive approach at addressing the growing illegal immigration problem. Detractors of the legislation claim that mandatory participation in E-Verify places additional burdens on already constrained employers. As more North Carolina employers become subject to mandatory E-Verify participation, we shall see if the ends justify the means.