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THE LEGAL PAD

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A NEWSLETTER OF CURRENT BUSINESS AND LEGAL MATTERS

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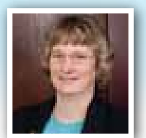

Bankruptcy Decisions Leave More Questions Than Answers

By Nan E. Hannah

A recent decision from the United States District Court for the Eastern District of North Carolina in the appeal of the now famous (infamous?) Mammoth Grading bankruptcy has combined with the recent Chapter 11 bankruptcy filings by Cox & Schepp, Inc. in the Western District of North Carolina and Construction Supervision Services, Inc. (CSSI) in the Eastern District to place the spotlight back on the issue of liens and bankruptcy. In the two current cases, extremely active and apparently successful contractors filed petitions without warning leaving many of their subcontractors and suppliers holding unsecured claims. For many of these subcontractors and suppliers, the thought of liens had arisen, but the accounts were not so old as to raise real warning flags and partial payments kept creditors at bay. The decision from the District Court further confused matters as it vacated the Bankruptcy Court's decision in Mammoth without touching the companion decision in Harrelson (which could not be addressed since it was not before the court). The door is now open for further litigation.

Challenges and Issues

In the arguments before the bankruptcy court in the Harrelson and Mammoth bankruptcies, the crux of the dispute centered on the fact that the right to assert a lien on funds arises as soon as the first work is performed or delivery made (and possibly even earlier, but we will work from first performance for this article). In that court's view, subcontractors and suppliers make a business decision not to use the protective power of the lien on funds at the earliest possible moment. Business practicalities say that to do so would be economic suicide. The lien upon funds serves to stop the entire flow of money from the owner down on a project, so serving such a document before payment is due rarely makes sense. In an industry which the state courts have long recognized survives by the use of credit, serving a lien on funds even on the first day of default makes little sense. Add to that the fact that a reputation for pulling a quick trigger on serving liens can result in an industry "black ball," subs and suppliers all too often find themselves in a damned if they do and damned if they don't position. How do you know when to protect yourself?

Add the issue of potential preference payments to this mix. If a sub or supplier accepts an aggregate amount of more than $5,850 in the 90-days prior to a bankruptcy filing and if those payments are outside the ordinary course of business (as defined by the bankruptcy court), the trustee or debtor-in-possession may seek to recover those funds as preferential payments. In the Eastern District, if a lien has not been actually asserted (i.e. served or filed), then the new value defense created by the lien may not be available.

New Wrinkle

Within the order vacating the decision in Mammoth, Judge Howard drew a road map indicating concerns

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Bankruptcy Decisions Leave More Questions Than Answers *(continued from p.1)*

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that the holding in Mammoth is incorrect. Because the appellant in Mammoth had accepted a settlement from the trustee, the court held that the matter was moot, vacated the order (essentially erases it from the record), and returned the case to the Bankruptcy Court. Since the Harrelson appeal was abandoned by the appellants earlier, the end result of this decision is that Judge Small's decision in Harrelson remains in place, but it is not binding on other judges or courts.

As this change was unfolding, motions for relief from the automatic stay were being filed in both the Cox & Schepp and CSSI cases. Extensive arguments were heard in the CSSI case. Judge Doub took the matter under advisement and should render his decision fairly quickly. It is quite likely that if he chooses to follow the map set out by Judge Howard, we will find ourselves with varying precedents and no clear interpretation of the law. In Cox & Schepp, the court decided to allow the liens to be served and reserved for a later date a decision on whether the liens are appropriate or not.

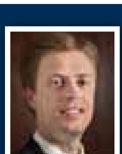
Protective Action

It appears that this returns lien claimants to a position of needing to file motions in all cases requesting leave from the court to assert lien claims. At present, filing or serving a lien without permission of the court exposes a lien claimant to the risk of sanctions. Such motions most likely need to be filed promptly with a request for an expedited hearing so that funds are not paid out on projects while you are waiting for the court.

It is possible that Judge Doub and/or Judge Whitley will provide additional guidance as the Cox & Schepp and CSSI bankruptcies role forward, but for now, it is important to understand that the only thing for certain is that if no action is taken by a lien claimant, the funds will be depleted especially in a Chapter 11 where the Debtor-in-Possession and the lender are both going to be reaching for A/R at every turn.

Conclusion

The reality of the circumstances described in this article is that no one has an accurate crystal ball. Unless and until the legislature acts to clarify the point in time at which a lien upon funds arises, the bankruptcy courts will continue to debate the issue. As long as there is a lack of certainty on this issue, lien claimants and creditors alike or going to need to be pro-active on serving liens on funds whenever a question arises as to the solvency of anyone in the lien chain. Stay tuned. ■



Establishing a Social Media Policy

By Jim Beck

Most people are familiar with and use social media sites such as Facebook, LinkedIn and Twitter to communicate with friends, to network and connect with people, and for entertainment purposes. It is highly likely that many people use these sites while at work. In addition, many businesses are taking advantage of these social media tools to get information out to the public and to create awareness about their brands. While social media can offer some great benefits to your business, it can also be a detriment. Therefore, it is important that your company establish, maintain and enforce a social media policy.

Several major concerns illustrate the need for a business to establish a social media policy. These include, among others, protecting the company's image in the community, safeguarding confidential or proprietary information and making sure the company is in compliance with various laws including those regarding employee privacy. Developing and implementing an effective social media policy can alleviate most of these concerns.

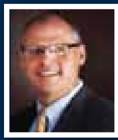
A company's social media policy should include several key components. Essentially, it should set out what an employee can and cannot do while at work, establish guidelines to be followed by employees while at work and when posting work-related information and updates on social media sites, and provide for compliance with privacy and other legal restrictions. In addition, the policy should provide for training and a process for reporting issues and violations.

An example of an issue that can damage your company occurred on the Chrysler Twitter account. In 2011, a person with access to Chrysler's Twitter posted a tweet using inappropriate and unprofessional language. Certainly, potential customers were offended and perhaps sales were lost.

An effective social media policy would help deter situations like this from occurring. A well-written, understandable policy should limit access to a company's official Twitter account to one or two trusted professionals. It is also important that employees understand that they should not use a company's name or logo in their username or on their Facebook or Twitter page.

A social media policy, regardless of how thorough and clear it may be, is useless if it is not enforceable. Thus, it is vital that it is not in violation of privacy laws, overbroad and does not infringe upon legally protected activities.

As the use of social media becomes more prevalent in the business community, companies need to be prepared to deal with all of the implications and potential issues that may arise. Employees must be made aware that their actions can negatively impact the business and that there are limits on what they should be sharing with others on public forums. A social media policy tailored to your company's specific needs will help you avoid unnecessary harm. ■



Protecting Yourself As a Director on a Board of Directors

By Paul A. Sheridan

Many of us try to be well rounded and responsible citizens and often we give back to our communities and neighborhoods by volunteering time to non-profit organizations and homeowners' associations as directors and officers. It is flattering to be asked to serve and it is a positive reflection that others trust in your values, beliefs, and trustworthiness. What is truly frightening is that in this altruistic endeavor many board members, directors and officers have no idea that their benevolent act of volunteering may place their personal assets at risk.

There is a way to reduce this risk, however. Directors and Officers Liability Insurance, often called D&O insurance, is liability insurance payable to the directors and officers of the organization, or the organization itself, as indemnification for certain losses or advancement of defense costs in the event that the insured suffers a loss as a result of a legal action brought for alleged wrongful acts in conjunction with the performance of their duties as they relate to the organization. This is similar in concept to errors and omissions coverage, although it is not synonymous. Errors and Omissions Insurance focuses on performance failures and negligence with respect to services, and not necessarily the performance and duties of management. As opposed to errors and omissions, D&O insurance is protection against a breach of "duty" by the directors and officers. It is important to the individual volunteering that they obtain professional advice in regards to coverage, as it is often wise to carry additional stand-alone insurance covering them above the limitations and exclusions of the non-profit or homeowners' association insurance policy.

For example, stand-alone coverage may provide additional coverage in the case where a D&O add-on endorsement only covers the people that are part of the primary name insured. A property management company is neither an employee nor a member of the board and thus there would be no coverage in the case where a property manager's actions may have triggered a lawsuit. Often the property management contract shifts the burden of risk to the board by requiring that the board provide liability coverage. Failure to provide this coverage could be a material breach of the management contract. Additionally, matters of insurance are often excluded in D&O endorsements. This means that the board can be sued for failing to purchase enough coverage or the correct insurance coverage. Finally, many endorsements do not provide coverage for non-monetary lawsuits or claims which may arise, including claims for injunctive relief to enforce a rule or covenant, or a claim for specific performance to require the board to perform repairs.

What protections are there for the director or officer that is sued? The first falls under the business judgment rule which provides relief for board members that may have breached a duty of care to the organization, but acted in good faith and exercised informed judgment such as acting on the advice of independent advisers or consultants in making their decisions. Secondly, North Carolina is among those states that allow non-profit entities to limit the liability of board members in lawsuits brought by the corporation or on its behalf. This limitation, known as exculpation, must be stated in the articles of incorporation and relate to claims for breach of fiduciary duties. These exculpation clauses do not apply in scenarios where the board member knowingly acted contrary to the best interests of the entity. Additionally, statutory immunity is provided in North Carolina's Nonprofit Corporation Act which states that a person serving as a director or officer of a non-profit corporation shall be immune individually from civil liability for monetary damages, except to the extent covered by insurance for any act arising out of this service, except where the person is compensated, was not acting within the scope of his official duties, was not acting in good faith, committed gross negligence or willful and wonton misconduct resulting in damage, derived improper personal financial benefit, incurred the liability as a result of the operation of a motor vehicle or arises out of a loan to or guaranties of the director or officer. Thus, while a board member or director acting responsibly or in good faith may be protected, often what constitutes responsible behavior is not clear and lawsuits and the costs related to defense can drag on for long durations before determinations are made.

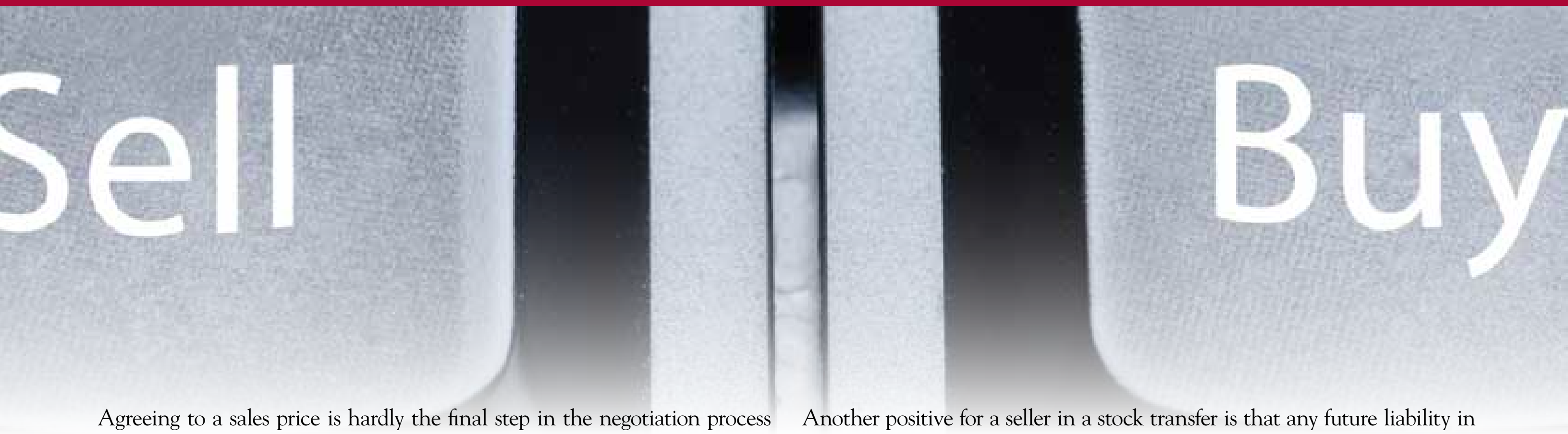
It is important to remember that state law cannot provide immunity from federal statutes such as ERISA, the Americans with Disabilities Act or Civil Rights laws.

One of the most important things to remember is that you are providing a needed service when you volunteer on a board of directors. Many forget that they are "serving" as opposed to "joining" a board. If you become familiar with the organizational structure, study the corporate powers, understand the mission of the organization and seek counsel before you have claims, you can protect yourself. Non-profit associations count on and entrust to leaders such as you to volunteer and assist in issue solving. By joining a board of directors, you can lead the way to great success. ■

Buying or Selling a Closely Held Business

A Few Steps to Consider

By James R. Vann



Agreeing to a sales price is hardly the final step in the negotiation process in the sale of a business. Even once the discussions have led a preliminary agreement to transfer ownership of a business at a particular price, the parties to the transaction still might not be on the same page as to what exactly entails "the business" that is being transferred. The buyer's understanding of "the business" might be limited to the "purchase" of staff, assets and the client list, while the seller might think the transaction simply means the business will stay the same with the new owner simply taking over his spot in "the boss's chair." Each side's understanding can be shaped by any number of factors, from maximizing tax savings to minimizing liability in the future.

Ultimately, many of the buyer's goals may directly conflict with the seller's. For example, a seller can't absolve itself of future liability without passing that future liability to the buyer. However, that conflict does not mean that negotiations and the final terms of the deal have to be adversarial, as open communications between both parties can often facilitate both parties reaching a mutually satisfactory compromise.

Seller's Interests

Regardless of the reasons for selling the business, almost all sellers have the same ultimate goal in the transaction – maximizing financial gain (or the sale is to cut losses, at least trying to minimalize financial loss) while removing future liability. To reach that end, majority owners and sole owners of company stock would be much more interested to have the sale involve the transfer of stock ownership rather than focusing on the company's assets.

Wanting the sale of the company to take place in the form of stock transfer makes sense on several fronts for the outgoing owner. Assuming a successful run as owner, the company's historical success could translate to an increased value of the company's stock. Depending on the differences in the capital gains tax and the income tax at the time of the sale, the net value of the transaction for the seller could be substantially higher by executing the sale as a stock transfer rather than a cash sale.

Another positive for a seller in a stock transfer is that any future liability in the company transfers to the owner of the stock. By passing that liability through the sale, the seller may be able to avoid any unexpected financial responsibilities for actions brought against the company in the future.

Buyer's Interests

Buyers are also interested in maximizing the value of their purchase. One of the main tools available to a buyer is to purchase the company as a group of assets. By taking on the assets of the other company, the value of the company is extended through yearly depreciation and amortization of those assets, which allows for long-term value protection.

Another major benefit of purchasing a company as assets rather than as stock is the ability to eliminate potential liabilities in the future for the company's past actions. Taking on only the company's assets prevents any future surprises for the buyer.

Issues for Both Sides to Consider

Other important portions of the transaction can be easy to overlook without careful consideration of the full implications of the deal. If the business will continue to operate under the same trade name after the sale, the company trademark or any copyrights must be written to be a valid transfer of ownership. If the support staff or other employees will not follow the new ownership, should the new owner have them sign a non-competition agreement? Regardless of the nature of the transition, will there be an overlap where the outgoing owner shares the intangibles such as client introductions, or will it be a clean break with no expectation of knowledge transfer?

Even with often-conflicting interests, open communication and realistic expectations by both parties can make the entire transfer process one that leaves both parties feeling their best interests were achieved.

If you have questions regarding the legal issues surrounding the sale or purchase of a business, please feel free to contact us. ■

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