

THE LEGAL PAD

Practice of Excellence

A NEWSLETTER OF CURRENT BUSINESS AND LEGAL MATTERS



Business and Succession Planning

By Jim A. Beck

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Business planning is an important topic to business owners. Most business owners are focused on getting things done so that their businesses can make money. While it is this full steam ahead mentality and drive for success that makes entrepreneurs successful, going forward without a plan can cause problems. On occasion, we all need to slow down, write down some goals and establish a plan. Doing so can make a business more efficient and profitable.

“A key aspect of business planning that is often overlooked is succession planning.”

There are several legal issues that certainly need to be addressed in a business plan. In particular, choice of entity, incorporation, licensing, and exit strategy are key elements of a successful plan from a legal perspective. Important legal documents that must be part of a business include bylaws, shareholders' agreements and a buy-sell agreement.

The purpose of sound legal business planning is to protect you, the business owner, from common issues that arise throughout the life of a business and to limit the potential for expensive litigation.

Many issues have been addressed by the North Carolina Business Court that could have been avoided with proper planning. For example, in *NRC Golf Course, LLC v. JMR Golf, LLC*, the court ruled that an option to purchase is invalid if there is no definite price term or a sufficient method by which to determine the price term.

From a practical business planning standpoint, business owners must be careful in light of this application of the law. Specifically, if partners have an agreement that one will buy the other out if one wishes to leave the business, it is imperative that the agreement is clear on how the buy-out price will be determined.

A key aspect of business planning that is often overlooked is succession planning. A succession plan sets out the details of a business owner's departure from his or her business and often helps avoid family disputes.

According to Ian Mount, small business expert for the New York Times, “[b]usiness owners who do not form a succession plan create a time bomb that can not only destroy their companies but tear apart their families. ‘A lot of families fight and fight until the business is gone,’ said Jim Clay, who heads the trusts and estates department at the law firm of Morrison Fenske & Sund in Minnetonka, Minn. ‘It eats up everyone’s inheritances.’”

Family businesses in particular face the succession issue in a very personal and emotional manner. It is important that a specific plan is in place that sets out who will control the assets and management of the business and how the transition will occur.

In order for any business plan or business succession plan to be effective, a business owner should obtain the advice and guidance of a lawyer and a CPA. There are substantial legal and tax hurdles involved in business planning. Proper planning throughout the life of your business can make things run smoother and allow you to spend more time on the important stuff—making money!



Does THIS count as a Personal Guaranty?

North Carolina Court of Appeals sides with Vann & Sheridan, Attorneys at Law

By Cody R. Loughridge

In North Carolina, a personal guaranty or any other promise to answer the debt of another must comply with the "statute of frauds". In other words, in order for a party to sue another on a personal guaranty, there must be a written instrument containing a special promise to answer the debt, signed by the party against whom the personal guaranty is sought to be enforced. While most personal guaranty agreements are similar in their form and content, it is important to note that other written instruments can be construed by the courts as a personal guaranty so long as it contains a written special promise to pay a debt.

Recently, a client presented our firm with a signed letter they had received from the individual organizers of one of our client's customers, which was simply addressed to "vendors, customers, and partners". The letter continued on to explain "a change of business structure" and that the debts of the customer "shall be transferred wholly" to the individuals executing the letter. After a default by the customer, our client sought to enforce the letter as a personal guaranty against the individuals whom had executed the letter.

We thereafter filed a lawsuit on behalf of our client, seeking enforcement of the letter as a valid personal guaranty, arguing the individuals had personally guaranteed the debts of the defaulting company. Months later, oral arguments were held before Judge Marvin K. Blount in Wake County Superior Court,

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wherein we prevailed on the personal guaranty theory and were awarded a judgment of \$79,486.38, plus interest and attorneys' fees. The ruling was appealed to the North Carolina Court of Appeals by one of the individuals who had executed the letter and against whom the judgment was entered.

The appealing party argued that that the letter did not comply with the statute of frauds because the letter did not contain a "special promise to answer the debt" and that therefore it could not be construed as a personal guaranty agreement. We presented the converse, arguing that the letter constituted an unconditional personal guaranty agreement which complied with the statute of frauds. Specifically, we argued that the letter was a clear and unambiguous written instrument, containing a promise to answer a debt, signed by the parties against whom enforcement is sought and therefore in compliance with the statute of frauds.

The North Carolina Court of Appeals, siding with our arguments, concluded that the letter did contain a special promise to answer a debt in that "the parties knew the amount that they had agreed to and when those payments were due, pursuant to their existing credit agreement" and that the letter was "cogent and not composed of incomprehensible sentence fragments". The ruling by the trial court was thereby AFFIRMED by the North Carolina Court of Appeals.

For more information on personal guaranty contracts, please feel free to contact our firm. For additional information on the case referenced above, please visit <http://appellate.nccourts.org/opinions>, No. COA11-96.



Independent Contractors/Employees

Latest News from the Internal Revenue Service

By James R. Vann

As a business owner, how do you classify the people who work for you? Are they independent contractors or employees? The classification is important and can be scrutinized by the Internal Revenue Service (IRS) and others.

The distinction between an employee and an independent contractor is important for several reasons. The following are a few areas of importance:

- Impacts tax liability
- Impacts liability
- Impacts workers compensation issues

Many times, as businesses hire workers, they may classify the worker as an employee. Typically, employees follow orders, direction or supervision from the employer. Employees also receive regular paychecks, work year round and their actions are controlled by the employer.

As an independent contractor, the worker typically completes the work in a manner they prefer, they are paid by the job, are temporarily employed, and the method, manner and means of completing the work is determined by the independent contractor.

National Research Project by the IRS

The IRS is interested in how workers are classified due to the apparent loss

of revenue which the IRS believes it is missing. Due to the apparent loss of revenue, the IRS has begun a national research project to collect data to assist the IRS to focus on areas where mistakes are most likely to occur and focus attention to those most likely to have erred. This project will randomly select 2000 small, large and self employed taxpayers to examine their employment tax returns each for the years 2010-2012.

The research project will focus on the following 4 areas: worker classification, fringe benefits, compensation of company principals and reviews of 1099s.

Recent IRS Break for Employers

The IRS recently announced a new program entitled the "Voluntary Worker Classification Settlement Program". This new initiative provides that the IRS will allow businesses to reclassify workers and make only a small payment to cover past payroll taxes for improper classifications. To be eligible for the program, employers must have consistently treated workers as nonemployees, filed 1099s for the worker for the previous 3 years, and not be under an IRS or worker classification audit.

Classification of Workers

How a worker is classified (employee or independent contractor) can be based on a multiple of factors. The IRS has established its own standards and characteristics for determining whether a worker is an employee or

Independent Contractors/Employees (Cont.)

Latest News from the Internal Revenue Service

independent contractor. Likewise, many states have established standards as well. The IRS looks at three basic characteristics to help with the classification.

They are:

1. **Behavioral Control:** does the business have the ability to direct how the work is to be completed? Does the business conduct training, providing instructions, provide a handbook and/or set the guidelines for the relationship?
2. **Financial Control:** does the business owner have the right to determine the financial portion of the work? Does the business owner control the business portion of the work?
3. **Type of Relationship:** how does the worker perceive their relationship with the business, as an employee or independent contractor?

The IRS has also determined twenty factors to determine whether the employer can exercise enough control to establish an employer-employee relationship. Not all factors must be present. These are guidelines for the IRS to determine the situation. They are:

- (1) **Instructions.** An employee must comply with instructions about when, where and how to work. The control factor is present if the employer has the right to require compliance with the instructions.
- (2) **Training.** An employee receives on-going training from, or at the direction of, the employer. Independent contractors use their own methods and receive no training from the purchasers of their services.
- (3) **Integration.** An employee's services are integrated into the business operations because the services are important to the business. This shows that the worker is subject to direction and control of the employer.
- (4) **Services rendered personally.** If the services must be rendered personally, presumably the employer is interested in the methods used to accomplish the work as well as the end results. An employee often does not have the ability to assign their work to other employees, an independent contractor may assign the work to others.
- (5) **Hiring, supervising and paying assistants.** If an employer hires, supervises and pays assistants, the worker is generally

categorized as an employee. An independent contractor hires, supervises and pays assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the result.

- (6) **Continuing relationship.** A continuing relationship between the worker and the employer indicates that an employer-employee relationship exists. The IRS has found that a continuing relationship may exist where work is performed at frequently recurring intervals, even if the intervals are irregular.
- (7) **Set hours of work.** A worker who has set hours of work established by an employer is generally an employee. An independent contractor sets his/her own schedule.
- (8) **Full time required.** An employee normally works full time for an employer. An independent contractor is free to work when and for whom he or she chooses.
- (9) **Work done on premises.** Work performed on the premises of the employer for whom the services are performed suggests employer control, and therefore, the worker may be an employee. Independent Contractor may perform the work wherever they desire as long as the contract requirements are performed.
- (10) **Order or sequence set.** A worker who must perform services in the order or sequence set by an employer is generally an employee. Independent Contractor performs the work in whatever order or sequence they may desire.
- (11) **Oral or written reports.** A requirement that the worker submit regular or written reports to the employer indicates a degree of control by the employer.
- (12) **Payments by hour, week or month.** Payments by the hour, week or month generally point to an employer-employee relationship.
- (13) **Payment of expenses.** If the employer ordinarily pays the worker's business and/or travel expenses, the worker is ordinarily an employee.
- (14) **Furnishing of tools and materials.** If the employer furnishes significant tools, materials and other equipment by an employer, the worker is generally an employee.

- (15) **Significant investment.** If a worker has a significant investment in the facilities where the worker performs services, the worker may be an independent contractor.
- (16) **Profit or loss.** If the worker can make a profit or suffer a loss, the worker may be an independent contractor. Employees are typically paid for their time and labor and have no liability for business expenses.
- (17) **Working for more than one firm at a time.** If a worker performs services for a multiple of unrelated firms at the same time, the worker may be an independent contractor.
- (18) **Making services available to the general public.** If a worker makes his or her services available to the general public on a regular and consistent basis, the worker may be an independent contractor.
- (19) **Right to discharge.** The employer's right to discharge a worker is a factor indicating that the worker is an employee.
- (20) **Right to terminate.** If the worker can quit work at any time without incurring liability, the worker is generally an employee.

North Carolina Factors for Classification

The State of North Carolina has established factors in determining the classification as well. A big factor in North Carolina is the degree to which the employer retains the right to control the work performed.

The following factors are considered whether the performing party:

1. Is engaged in an independent business;
2. Has independent use of special skills, knowledge or training
3. Is performing work for a fixed price or lump sum
4. Is not subject to discharge based on the method of performance
5. Is not in the regular employ of the contracting party
6. Is free to use assistants as needed; and
7. Selects their time to perform the work

Generally, the tests are applied based on a totality of the circumstances. No single factor is totally determining. Are your workers properly classified?

If you have questions about classification of workers, written employment policies or other similar topics, we hope you will contact us.



Court of Appeals Reverses Itself

Lien on Funds No Longer Attaches to Bank Distributions

By Chad J. Cochran

On March 15, 2011, the North Carolina Court of Appeals set aside a decades old mechanic's lien standard when it held that a bank's active deed of trust subjected it to lien on funds responsibilities. The decision threw a shockwave through the North Carolina construction law community. Six months later, the court strangely reversed itself and reinstated the decades-old understanding that a construction lender is not typically subject to lien on funds responsibilities.

N.C.G.A. § 44A-20(a) provides, "[u]pon receipt of the notice of claim of lien upon funds provided for in this Article, the obligor shall be under a duty to retain any funds subject to the lien or liens upon funds..." If an obligor makes further payment to a contractor or subcontractor after receiving a lien on funds, "the obligor shall be personally liable to the [party] entitled to the lien on funds..." N.C.G.A. § 44A-20(b).

The **Pete Wall Plumbing v. Sandra Anderson Builders** case involved six parcels of real property which were originally owned by the Housing Authority of the City of Greensboro. The housing authority then entered into ground leases for each parcel with a development company. The development company next subleased each parcel to a general contracting company. Carolina Bank, the financing company, then entered into a financing arrangement which provided deeds of trust in the contracting company's subleasehold interests in the six parcels. Furthermore, Carolina Bank entered into a recorded Multiparty Agreement with the housing authority, the development company, and the general contracting company which subordinated those entities interests in the properties to the bank's deeds of trust.

In July 2008, the Plaintiff filed "Notices of and Claims of Lien" upon the six parcels. Liens on funds become active claims only upon "receipt" of the lien. N.C.G.A. § 44A-20(a). Accordingly, the court analyzed the lien on funds claims in two categories, focusing on whether a particular parcel was subject to the deed of trust at the time the bank received the lien on funds. The first category involved four parcels which were deeded to third parties

prior to lien on funds service. The court applied established deed of trust standards providing that, as a title theory state, a deed of trust holder enjoys legal title to the land for security purposes. When the parties sold four parcels and released the deeds of trust, the bank no longer held an ownership interest in the property. Without an ownership interest, the bank no longer constituted an "obligor". Accordingly, since Carolina Bank did not represent an obligor when it received the liens on funds, it was not subject to potential lien liability on those four parcels.

The second controversial category involved two properties where Carolina Bank held active deeds of trust when it received the lien on funds filings. The court originally held that, since Carolina Bank represented an "obligor" by way of their deed of trust, a lien on funds analysis was required. A lender would likely have been directly liable for any direct loan distributions after receipt of the lien on funds. Prior to the first Pete Wall

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opinion, a deed of trust holder did not constitute an "obligor" under section 44A-20. **Con Co, Inc. v. Wilson Acres Ltd.**, 289 S.E.2d 633 (N.C. App. 1982). The North Carolina Court of Appeals overruled that 1982 decision for six months and then reinstated it. At the end of the day, most subcontractors/suppliers can analyze the value of a lien on funds as they have done in years past.

A look at the bigger picture and the court's unusual actions suggests that the court is grappling with larger issues involving the application of

complex construction transactions to the current lien law regime. While Judge Calabria's opinion contains the underlying legal reasoning, Judge Steelman's concurrence states that "the present state of our law does not provide adequate protection to suppliers of labor and materials as envisioned by Article X, section 3 of the North Carolina Constitution." In light of the ongoing tension between modern construction transactions and an antiquated lien law regime, one might reasonably expect additional judicial developments to follow.