



JOHNSON,  
HEARN,  
VINEGAR,  
GEE &  
MERCER, PLLC

SPRING 2003 Edition

# BUSINESS LAW NOTES

Two Hannover Square, Suite 2200, Raleigh NC 27601 ♦ 919-743-2200 or fax 743-2201

## THE “B” IN BANKRUPTCY MEANS *BEWARE!*

By Jean Winborne Boyles

The “B” in bankruptcy stands for *beware!* Too many individuals receive a notice that they are creditor in a bankruptcy (or the bankrupt owes them money) and throw it away and do not think about it again. You may be throwing away your opportunity to recover money owed you, or the inattention may subject you to what are called “claw backs” of money you have been paid. As soon as you hear that a debtor of yours is thinking about filing bankruptcy or has filed bankruptcy, immediately notify your attorney. If your business attorney does not practice bankruptcy, he should associate one that does. The days immediately preceding the filing of a bankruptcy and those immediately following the filing most likely will dictate what one will receive and how one will be treated in the bankruptcy.

A creditor has many rights in bankruptcy, but like many other legal rights, these may be lost if not quickly and formally asserted. As the old saying goes, use it or lose it. For example, a seller of goods may be able to reclaim the goods he delivered to the debtor on the eve of bankruptcy, but only if such claim is formally made within 10 days of delivery.

Each creditor’s claim is not only evaluated but its status as to its activity within the bankruptcy is also assessed. If a large amount of funds is at stake and a creditor does not actively assert its rights early on, it may soon be determined that this creditor will not assert his claims. A clever debtor will assume a creditor who does not quickly and formally participate is not a “player” and therefore will take advantage of his non-participation in drafting motions and proposing a plan within the bankruptcy.

Creditors are classified either as *secured* or *unsecured*. A secured creditor may think it is automatically safe and will get its money. Wrong! A secured creditor must protect its security interest and assert that position immediately. Creditors Committees are established early in the bankruptcy process. Certain financing is established and certain rules governing the bankruptcy are adopted. If a creditor is not vocal in these early times, many of the its rights may be lost or may be made more difficult to assert.

When a bankruptcy is filed, an “*automatic stay*” is instituted which means that a creditor cannot take any actions to collect the debt or intimidate a debtor to pay. The fine print in the notice of the automatic stay warns the creditor not contact the debtor or attempt to collect the debt. There have been times when the Court has sanctioned and fined creditors for “going on to get their money.”

Whether you like bankruptcy or not, it is a legal form of relief for debtors. It does not mean that the creditor loses everything, but it does mean that without competent immediate representation some creditor’s rights may be lost or prejudiced. Always keep all the mail you receive about a bankruptcy and take them to your attorney.

There are several types of bankruptcy brought under different chapters of the bankruptcy code -- chapters 7, 11 or 13 -- which vary in the treatment of creditors. Generally, secured debts take priority over unsecured debts in all chapters. A Chapter 7 is a total liquidation of the debtor’s assets. A Chapter 11 is a reorganization of either a corporate or individual debtor with a substantial amount of assets as well as debts. A Chapter 13 is wage earner plan in which an individual debtor or a debtor and spouse may file bankruptcy and pay a certain percentage of their debts to all unsecured creditors while making secured creditors whole during the pendency of the plan.

An assessment of the likelihood of recovery of your debts can only be done by an attorney who early on is familiar with and participates in the bankruptcy from its earliest stages when the parameters are established and from there you can make good business decisions of how and when to participate.

## THE TOP TEN REASONS NOT TO SIGN THAT CONTRACT (or *The Large Print Giveth and the Small Print Taketh Away*)

by M. Blen Gee, Jr. and George G. Hearn

All businesses enter into short one- or two-page contracts presented to them for relatively small transactions. Frequently, no one reads the fine print or thinks about what the terms really mean. Months or years later, the company may discover that it signed on for more than it bargained for. Here are ten red-flag issues that should be examined carefully in all contracts, even for seemingly insignificant transactions:

**10. Automatic Renewal Provisions** - You have put up with poor service for five years and finally the term of the contract has expired. You call your sales

rep to tell him you are not doing business with him anymore, and he tells you that you had to give notice of *non-renewal* six months earlier. Since you did not give the advance notice, your contract has been renewed for five more years! (This happens every day and frequently leads to litigation.)

**9. Liquidated Damages Clauses** - Circumstances have changed; you need to get out of a contract. The other guy is not suffering any harm because of the early termination, but you find you have agreed to a "liquidated damages" clause that imposes a heavy penalty for early termination.

**8. One-Sided Attorneys Fee Provisions** - You get into a lawsuit and find that if the other side wins you have to pay their attorneys fees, but if you win, you do not receive attorneys fees. (NOTE: Attorneys' fee provisions are not always enforceable in North Carolina.)

**7. Your Personal Guaranty** - Owners of a closely-held business are routinely required to personally guarantee bank loans. Frequently landlords will also insist on personal guaranties of the lease by the company's shareholders (though in a down market this can frequently be avoided). Surprisingly, many vendors will sneak a personal guaranty provision into their contracts.

**6. Your Spouse's Personal Guaranty** - Under North Carolina law, real property owned jointly by a husband and wife is normally exempt from claims of creditors. However, if both you and your spouse personally guarantee a debt, your personal residence and other jointly-held real property are placed at risk.

**5. Hidden Security Interests (Liens)** - Frequently commercial leases will have a paragraph in them granting the landlord a security interest (lien) on all of your company's property located on the leased premises. Such paragraphs allow the landlord to legally repossess all of your furniture, fixtures and equipment if you ever default on your lease.

**4. "Entire Agreement" Clauses** - You have had long and detailed negotiations with a sales rep who promises you the world. Then, he presents you with a short contract containing none of the important promises that he made to you. Instead, there is a paragraph that recites that the written agreement is the "entire agreement" between the parties and supercedes all previous oral or written promises. Such clauses are routinely enforced by the courts. If you sign a contract with this type of clause, all of your oral negotiations have just gone out the window.

**3. The Magic Word "(Seal)"** - Every business person has likely seen the little word "(Seal)" by the signature line of a contract. Most people probably consider this a relic of ancient times, which it is. In North Carolina, it also raises a legal presumption of the adequacy of the contract and *increases the statute of limitations for a breach of the contract from three to ten years!*

**2. Forum Selection Clauses** - How would you

like to defend a \$5,000 claim in a state court in New York in January? If this does not interest you, you had better check all of your contracts for a forum selection clause which says that your company can be sued in some other state. Worse, the clause may say that all suits have to be brought in some other state. By statute, North Carolina law voids forum selection clauses in some circumstances. However, application of the statute is tricky and the statute may not apply to your situation. If the forum selection clause is joined with an arbitration clause, federal law requires that it be enforced.

**1. And the Number One Reason Not to Sign That Contract** - You have not to let your lawyer review it!

---

## **PRIVACY NOTICE**

**As attorneys we are bound by stringent professional standards of confidentiality and we never disclose non-public personal information except upon client consent or as required by law. We routinely obtain various forms of private information from our clients in order to provide quality legal services. We also may, from time to time, request non-public personal information from diverse sources other than our clients; however, we never obtain such information without our client's specific authorization as to the type of information and the source from which it may be obtained. Non-public personal information is disclosed to attorneys and employees of our firm only when needed to perform legal services. Non-public personal information is disclosed to third parties only with the client's consent. We maintain physical, electronic and procedural safeguards to guard all confidential information, including our clients' non-public personal information. Clients always have the right to request, at any time by any method of communication, that the firm not release non-public personal information.**

---

## **PART 2: PAYING REASONABLE COMPENSATION TO THE S-CORP SHAREHOLDER/EMPLOYEE**

By F. Stephen Glass

An S-Corporation must pay reasonable compensation (subject to employment taxes) to shareholder-employee(s) in return for the services that the employee provides to the corporation, before a non-wage distributions may be made to that shareholder-employee. This issue has been identified by the IRS as an area of non-compliance and will receive greater scrutiny in the foreseeable future.

Unlike a partnership, flow-through income from an S-corp is not subject to self-employment tax. In direct contrast, a partnership's flow-through ordinary income is generally subject to self-employment tax. On the surface, this appears to be a clear tax advantage of an S-corp vs. a partnership. However, in terms of "shareholder-employees" of an S-corp, the analysis does not end here.

If a shareholder-employee of an S-corp provides services to that S-corp, then *reasonable compensation* (subject to employment taxes) generally needs to be paid in return before any non-wage distributions may be made to that shareholder-employee.

Several court cases support the authority of the IRS to reclassify other forms of payments made to the shareholder-employee as a wage expense. (See Winter 2003 edition of *Business Law Notes*.)

If an S-corp shareholder is an employee and has received an actual distribution, the question is what amount of compensation is considered "*reasonable*" for that particular shareholder-employee, based upon all the relevant facts and circumstances.

---

### **DO I REALLY NEED A LAWYER FOR THIS LITTLE LAWSUIT?**

By M. Blen Gee, Jr.

Your company has been sued for a relatively small amount of money and you really do not want to pay a lawyer to defend such a simple case. Is it even necessary? On December 31, 2002, the N. C. Court of Appeals answered this question with an emphatic YES! A corporate officer or employee cannot represent the corporation in N.C. District or Superior Courts unless you are a licensed attorney.

Small Claims Court is an exception to the general rule; corporate officers and employees are allowed to represent the company and you do not have to have a lawyer. However, if there is an appeal from Small Claims Court to District Court, your company must hire a lawyer. No exceptions.

Individuals can still represent themselves (called a "*pro se*" appearance). However, it is strongly recommended that an individual always have an attorney to represent him in District or Superior Court. There are many procedural traps that non-attorneys may fall into. Also, trial judges have very little patience with *pro se* parties who do not understand the rules and clog up their calendars.

A particularly dangerous trap for the non-lawyer is the "Request for Admissions." This is a fairly innocuous looking document sent by regular mail that requests you to admit or deny certain facts within 30 days. If you are not a lawyer, you may not know that if you do not properly and timely answer these Requests for Admissions, they are DEEMED ADMITTED! Collections attorneys frequently request that you admit all of the allegations that they have made in the lawsuit, hoping that you will not file a timely response to the Request for Admissions. If you do not answer, the collections attorney will then file a Motion for Summary Judgment based on your "deemed" admission that you owe the money. The result can be a judgment against your company for money that you clearly did not owe.

The unfortunate reality is that the court process is fraught with risk. Corporations must have,

and individuals should have, a licensed attorney to represent them for any state court proceeding other than Small Claims Court.

### **TERMINATING OLDER WORKERS AND AGE DISCRIMINATION LAW SUITS.**

By F. Stephen Glass

A business' greatest risk of a law suit in which illegal discrimination is alleged by an applicant or an employee is from a person who is age 40 or older. The average jury awards in age discrimination cases are up to 300 percent higher than those in discrimination cases involving sex, race and disability. Generally, job applicants and employees are protected by the federal *Age Discrimination in Employment Act* ("ADEA") if they are 40 years of age or older.

ADEA prohibits age discrimination in hiring, discharge, pay, promotions and other terms and conditions of employment. ADEA applies to private employers of 20 or more workers. ADEA also prohibits retaliation against a person who files a charge under the act, participates in an investigation or opposes an unlawful employment practice.

Protect your company (and yourself) by making sure that there is a legitimate business reason for all refusals to hire and all terminations. Avoid using a pretext to terminate an older worker simply because of his or her age. If there are legitimate business-related incidents and reasons that support the decision not to hire an applicant or to terminate persons age 40 or older, document those reasons in the personnel files.

---

### **BUY-SELL AGREEMENTS**

By F. Stephen Glass

Planning for the orderly succession to your business interest is important. "Business succession planning" enables a business owner determine how his or her interest in a business will be transferred upon certain agreed-upon triggering events, including the death or disability of the owner.

A *Buy-Sell Agreement* or "Shareholders' Agreement" permits the business owner to preserve the family's control over the business. Such an agreement may create a mechanism for liquidating the shares or interests of children who are not active in the family business. Mechanisms that are often used include either stating the price for which the business interest may be purchased upon a triggering event or establishing a formula for determining the price of that interest.

It is important that a shareholders' agreement be adopted by the company early in its formative stage when attitudes are in harmony. If a shareholders' agreement is not in place when a dispute arises among the shareholders, it may be impossible for the various factions to carry on the business of the corporation.

Some of the provisions of a typical shareholders' buy-sell agreement might include:

❑ An agreement to restrict the transfer of stock and that the restricted shares will not be sold or otherwise transferred in a way that violates the agreement.

❑ A shareholder who decides to sell any or all of his/her stock, and receives an offer from an outside party, must first make the same offer to the corporation. If the corporation does not accept the offer to purchase all the shares offered, it must notify the other shareholders that the shares are available for purchase. Each shareholder may choose to buy some or all of the shares offered. Any shares not purchased by the corporation or the other shareholders may then be purchased by the outsider. The outside purchaser must also agree to all the provisions of the agreement.

❑ A valuation formula, such as book value, multiple of earnings, etc. is often set up in the agreement. Another method for establishing the value or sale price of the shares is by utilizing a third-party appraisal.

❑ If a shareholder dies, becomes legally incapacitated or permanently disabled, the corporation agrees to buy that shareholders stock at the value established by the formula. In the event of death or permanent disability, purchase money could be available through by an insurance policy owned by the Corporation for each shareholder.

❑ If a shareholder's ex-spouse receives any of the stock pursuant to a divorce, the terms of the agreement can require that the shares be purchased back by the corporation to keep the business "in the family."

There are many good reasons for having a shareholders agreement. The time to adopt one is before a triggering event occurs. The cost of the agreement is a modest investment that enables the corporation to avoid expensive and emotional battles



when a triggering event occurs.

## BUSINESS LAW NOTES

P.O. Box 1776  
Raleigh, North Carolina 27602-1776

### ➡ About the authors:

**George G. Hearn** concentrates his practice in Administrative Law; Civil Litigation; Legislative Practice. He is a member of the Wake County (Director) and N.C. Bar Associations; and N.C. Academy of Trial Lawyers.

**M. Blen Gee, Jr.** is an honors graduate of the University of North Carolina School of Law. His areas of concentration include business and corporate law, including sales of businesses; business litigation, including arbitration and mediation; franchise law; automobile dealer law; and insurance company insolvency.

**F. Stephen Glass** is the author of *The Legal Handbook for North Carolina Businesses*, and *Your Estate Planning Handbook*. His practice is concentrated in the areas of business, employment and corporate law, business litigation, business succession planning and estate planning. He serves on the Cary board of Capital Bank.

**Jean Winborne Boyles**, concentrates her practice in health law, corporate law, bankruptcy and creditors' rights, commercial leasing, antitrust and state administrative law.

---

### JOHNSON, HEARN, VINEGAR, GEE & MERCER, PLLC

Our law firm has provided exceptional legal services to clients throughout the state and the U.S. for more than 45 years. A full-service firm founded in 1955, we have built a reputation for helping clients solve difficult problems with sound counsel, sophisticated analysis and superior performance.

A hallmark of our firm is personalized client service. Recognizing that each of our clients has a unique set of issues, objectives and needs, our firm is committed to individualized attention and works as an integrated team to respond to our clients' needs. We serve diverse clients, including Fortune 500 companies, government agencies, professional associations, closely held corporations, limited liability companies, partnerships and individuals.

---