

# Ross & Levy, LLC

## LAW OFFICES

Albany Atlanta Savannah

www.rossandlevylaw.com

C. Todd Ross  
Nathan C. Levy\*  
John David Blair  
Ernest R. Burriss, IV  
James A. Ivey  
Casey D. Bowen  
*\*also licensed in Alabama*

Correspondence:  
Post Office Box 71668  
Albany, GA 31708-1668

Toll Free: 866-995-8663  
Fax: 877-284-4034

Albany Office:  
415 Pine Avenue - Ste. 250  
Albany, GA 31701  
229-277-2555

Atlanta Office:  
10 GlenLake Parkway - Ste. 130  
Atlanta, GA 30328

Savannah Office:  
5500 Abercorn Street - Ste. 32  
Savannah, GA 31405

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Dear Friends:

We hope that you enjoy this edition of the Ross & Levy newsletter. This newsletter covers information and current events pertaining to developments in the law and changes in legal precedent with a focus on the impact for employers, insurers, and human resource professionals. \*†

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#### \*UPCOMING SEMINARS\*

06/03/11: Americus, EEOC Claims  
08/19/11: Dublin, Workers' Compensation  
11/04/11: Augusta, Workers' Compensation  
05/20/11: Columbus, Workers' Compensation

#### WORKERS' COMPENSATION SECTION (GEORGIA)

The following articles are focused on legal precedents and developments of particular interest to employers, human resource professionals, and workers' compensation insurers and adjustors:

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#### WILLFUL MISCONDUCT An Unlikely Defense

*Buck Burris*

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A defense against a claim based on "willful misconduct" is often an aggressive one, but

certainly appropriate in the right circumstance. As you would expect, willful misconduct is an affirmative defense, requiring the employer to prove, by a preponderance of the evidence, willful misconduct and that same is the proximate cause of the claimant's injury. The statute providing this defense, O.C.G.A. § 34-9-17(a), states, "No compensation shall be allowed for injury or death due to the employee's willful misconduct, including intentionally self-inflicted injury, or growing out of his or her attempt to injure another, or for the willful failure or refusal to use a safety appliance or perform a duty required by statute."

It has been held that, "Mere violations of instructions, orders, rules, ordinances, and statutes, and the doing of hazardous acts where the danger is obvious, do not, without more, as a matter of law, constitute willful misconduct. Such violations or failures or refusals generally constitute mere negligence, and such negligence, however great, does not constitute willful misconduct or willful failure or refusal to perform a duty required by statute, and will not defeat recovery of compensation by the employee or his dependents." Aetna Life Ins. Co. v. Carroll, 169 Ga. 333 (1929). The willfulness contemplated by the statute "amounts to more than a mere act of the will, and carries with it the idea of premeditation, obstinacy and intentional wrongdoing, so that the mere doing of a thoughtless act which does not constitute deliberate disobedience does not deprive one of compensation." Armour and Co. v. Little, 83 Ga. App. 762 (1951). As noted above, negligence or gross negligence on their face do not qualify as willful misconduct such that they will act as a bar to a recovery of workers' compensation benefits.

Willful misconduct may be found when a claimant is in violation of a criminal statute and same is the proximate cause of the claimant's injury or death. See Aetna Life Ins. Co. v. Carroll, 169 Ga. 333 (1929). It is important to note, however, that there are cases going both

ways under the rationale that the willful violation of a statute constitutes willful misconduct and an in-depth inquiry is certainly recommended when defending a claim on these grounds. It should be noted that violations of traffic laws are the most obvious places where this defense may be used when an employee sustains an injury. For example, our firm recently handled a claim involving a employee who was injured, when the dump truck he was operating was involved in a single vehicle accident. The claimant was traveling down a road that was not authorized for vehicles of the size that he was operating. Further, the claimant had been stopped by the sheriff the day before and was written a citation for unauthorized travel. Undeterred by his citation, the claimant again traveled down this narrow road and was involved in a rather spectacular crash, sustaining minor injuries, which arguably, were proximately caused by his willful misconduct. The fact that this defense was used provided the claimant with incentive to return to work, which he did, and led to a speedy resolution of the claim.

As you can see, this defense certainly has its place in the workers' compensation landscape and the appropriate use of this defense may lead to favorable resolution of a claim. If you have any questions regarding willful misconduct or any other defenses, please feel free to contact our firm.

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PROVING (or DISPROVING) A DILIGENT  
JOB SEARCH  
Master Craft Flooring v. Dunham

*John David Blair*

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The Appellate Division of the Georgia State Board of Workers' Compensation was recently affirmed by the Court of Appeals<sup>1</sup> after weighing

in on the question of what minimum amount of evidence is required for an employee/claimant “prove” a diligent job search following a light-duty medical release.

The Claimant must introduce at trial evidence that: (1) he or she submitted applications to potential employers; (2) he or she submitted applications for “suitable jobs”; (3) describes when and where such applications were made; and that (4) describes the prospective employer’s response.

### **Case Background**

- ❖ Employee/Claimant Dunham, after being terminated by his *subsequent* employer, Tub Doctor, filed a workers’ compensation claim in 2008 alleging a change in condition for the worse following a 2007 aggravation of a 2004 work injury with his *former* employer, Master Craft, and Master Craft controverted the claim on compensability grounds.
- ❖ The Administrative Law Judge (“ALJ”), following an April of 2009 hearing, granted Claimant’s change in condition for worse claim and awarded benefits.
- ❖ The Appellate Division of the State Board reversed the ALJ, and denied compensation.
- ❖ The Superior Court reversed the Appellate Division and reinstated the ALJ’s decision finding the Claimant experienced a change in condition for the worse.
- ❖ The Court of Appeals granted the petition for discretionary appeal filed by Former Employer Master Craft and its Insurer, Companion.

### **Decision/Ruling**

The Court of Appeals reversed the Superior Court and reinstated the decision of the

Appellate Division of the State Board of Workers’ Compensation. Thus, the claim was denied for failure of the Claimant to prove a change in condition for the worse.

- ❖ The Court of Appeals reversed the Superior Court on what has become known as the “any evidence” rule, which requires the courts, on appeal, to affirm the State Board if any evidence supports its rulings, except where there has been a purely legal error that warrants a reversal or remand.
- ❖ Because it found no purely legal error in the Appellate Division’s findings, the Court of Appeals determined that the Superior Court lacked the authority to reverse the Appellate Division.
- ❖ The decision of the Appellate Division, as reinstated by the Court of Appeals, found: (1) that the Claimant’s testimony was clearly unreliable as evidence due to damaging surveillance footage that called his credibility into question; and (2) that the Claimant failed to meet his burden to prove a diligent job search.

### **Impact**

Though it was not necessarily the primary deciding factor in this case, the Appellate Division expressly found that the Claimant failed in his burden to prove a diligent job search. What character and amount of evidence meets the Claimant’s burden of proving a “diligent job search” is a question argued often in workers’ compensation trials. For the most part, this is a decision left to the ALJ’s discretion. However, the Appellate Division (affirmed by the Court of Appeals) decided in this case that there must be at least *some* evidence capable of proving the following:

1. That the Claimant submitted applications to potential employers;

2. That the Claimant applied for “suitable jobs”;
3. When and where the Claimant applied for such suitable jobs; and
4. What response the Claimant received from the employers to whom the Claimant applied.

The Claimant in this case failed to meet this burden by offering at least some competent evidence to support it. It is not uncommon for an ALJ to rely only upon the Claimant’s testimony (if credible) as sufficient evidence to satisfy each of these four elements.

The Appellate Division, however, opined in this case that it will not affirm the ALJ where there is no credible testimony or evidence in the record at least indicating that the Claimant met his burden of proving each of these four elements. For employers and insurers, this case will serve as fuel for cross-examining the Claimant and defending generally any case in which the Claimant is required to prove a “diligent but unsuccessful job search.”

Also, while not necessarily a new development in the law, good surveillance footage of a Claimant engaged in physical activity inconsistent with his alleged condition is of *incalculable* value. This case was decided, first and foremost, on credibility grounds. To prove his claim of a change in condition for the worse, the Claimant’s case relied heavily on his own testimony. The ALJ reviewed damaging surveillance footage, but rather than discounting the Claimant’s testimony entirely, the ALJ chose only to close off the period of benefits awarded to the Claimant as of the date of the surveillance footage.

The Appellate Division, however, found the surveillance footage so damaging that it called all the Claimant’s allegations of a change in condition for the worse into question. Unlike the Superior Courts and higher appellate courts, the Appellate Division has the authority to

reverse the ALJ on credibility grounds. Though it is not regular practice for the Appellate Division to do this, it nevertheless elected to do so in this case because of the surveillance.

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LITIGATING SUBROGATION CLAIMS:

Austell Healthcare v. Scott

*John David Blair*

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The Georgia Court of Appeals has reaffirmed<sup>ii</sup> that employers and insurers, as intervening plaintiffs, may conduct such discovery and file such motions/pleadings as are necessary to pursue their subrogation lien in a tort action brought by an injured employee/claimant against a third-party tortfeasor. Additionally, employers and insurers are entitled to be heard on the issue of whether such an employee/claimant received a full recovery from any verdict *or settlement*.

However, where a judge denies the employer/insurer any of these rights, such denial will be considered harmless (non-reversible) error unless the employer/insurer has acted to offer evidence into the record at trial that would authorize the judge to find for them or show prejudice as the result of such denial. Lastly, the party appealing the trial court’s decision must ensure any errors are displayed properly in the record as transmitted to the appellate court.

**Case Background**

- ❖ Austell Healthcare and Traveler’s Insurance were intervening in a lawsuit brought by Plaintiff/Employee Scott against a third-party Defendant following a motor vehicle accident involving the Plaintiff/Employee and the Defendant.
- ❖ The Intervening Employer/Insurer (“Intervenors”) were seeking to perfect their

subrogation lien against any settlement or verdict the Plaintiff/Employee obtained against the Defendant.

- ❖ After the Plaintiff/Employee settled with the Defendant, the Plaintiff/Employee filed a motion with the trial court to “quash” (dismiss) the Intervenors’ subrogation lien.
- ❖ The trial court refused to permit the Intervenors to conduct discovery before ruling on the motion to quash.
- ❖ The trial court granted the motion, thus dissolving/denying the lien on grounds that the Plaintiff/Employee had not been fully compensated for his injuries by the settlement reached with the Defendant.
- ❖ “Full recovery” or “full compensation” from any settlement or verdict by the Employee/Plaintiff is a statutory requirement that the Intervenors are under a burden to prove same before they can collect any portion of that settlement/verdict to satisfy the subrogation lien.
- ❖ The trial court noted that the settlement was “lump sum” (i.e., not structured), and the judge opined that he was legally precluded from hearing evidence on whether there was a “full recovery” before a judgment or jury verdict was entered on the issue of liability.
- ❖ Because the trial judge felt his decision was based on “known precedents,” the judge ordered the Intervenors to pay the Plaintiff/Employee’s attorney’s fees in the amount of \$1,915.00.

### **Decision/Ruling**

The Court of Appeals ultimately *affirmed* the trial court’s decision to grant the Plaintiff/Employee’s motion to quash, though it *reversed* the trial court’s award of attorney’s fees as an abuse of discretion. The trial court’s

decision contained harmless errors that, while insufficient to warrant a full reversal, made the trial court’s award of attorney’s fees improper.

- ❖ First, though the trial court should have permitted the Intervenors to conduct discovery, the Intervenors failed to allege what specific prejudice this caused them in defending the motion to quash their lien by pointing to evidence that might have been uncovered relevant to the issues tried.
- ❖ Second, though the trial court erroneously opined that it was unable to hear evidence on the issue of whether there was a “full recovery” prior to a judgment/jury verdict on the issue of liability where there had been a settlement, this error was harmless because there was no evidence in the record competent to show the Court of Appeals that they were actually denied the opportunity to introduce evidence on this issue.
- ❖ Because they brought the appeal, in order to prevail, it was the Intervenors’ burden to ensure that the record transmitted to the Court of Appeals showed either that the Plaintiff/Employee was fully compensated or that the Intervenors were denied the opportunity to introduce such evidence that actually (not hypothetically) exists.
- ❖ Because the record showed no evidence of a full recovery, and because the record did not show that the Intervenors were denied the opportunity to offer such evidence, any error by the trial court was harmless.
- ❖ The Court of Appeals did have a record of the amount of the lump sum settlement, but it noted that appellate courts cannot determine whether an injured party has been fully compensated by a “lump sum” settlement, judgment, or verdict.
- ❖ The trial court erroneously interpreted the “clear legal precedents” it relied upon in

ordering the Intervenor to pay the Plaintiff/Employee's attorneys fees, and, though this error was harmless pertaining to the dissolution of their subrogation lien, it rendered the trial court's award of attorney's fees a reversible abuse of discretion.

### **Impact**

This case makes it clear that, when litigating a subrogation lien, employers and insurers are entitled, with a few exceptions, to avail themselves of the same discovery and litigation methods and tools as any other parties to that lawsuit. However, where this right is denied, or where the lien is dissolved, it is absolutely incumbent upon employers and insurers to be certain that the record shows some form of harm or prejudice. Otherwise, any appeal will certainly be denied. Subrogation litigation is a complex undertaking, and, whenever possible, it should be undertaken with the benefit of competent legal counsel.

## **EMPLOYMENT LAW SECTION**

The following articles are focused on legal precedents and developments of particular interest to employers and human resource professionals:

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### SENATE BILL 7: A Double-Edge Sword

*Casey D. Bowen*

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Employers face issues daily regarding noncitizens who are not employed legally and other unauthorized employees ("undocumented workers"). In addition to understanding the intricacies of current federal and state laws regarding such, employers should keep an eye

out for proposed state amendments that could drastically change their workers' compensation coverage of undocumented workers.

### **Current Law:**

On November 6, 1986, President Reagan changed the face of employment law by signing the Immigration Reform and Control Act of 1986 (IRCA). IRCA forces employers to complete and retain a Form I-9 for every individual hired. In completing the I-9, employers must examine identification and work authorization documents and attest that such documents appear to be genuine as to the individual employee. For those employers who knowingly employ undocumented workers, IRCA imposes civil monetary fines and even criminal penalties. While this process appears simple, employers are often confused by the variety of unfamiliar immigration documents that an employee may present to comply with the I-9. More recently, the Department of Homeland Security in partnership with Social Security Administration have addressed this problem by promoting E-Verify. This internet-based, free program compares the employee's I-9 information with records from the U.S. government in order to determine if the employee is eligible for employment. For more information regarding E-Verify and other compliance procedures see <http://www.uscis.gov>.

Despite IRCA, undocumented workers continue to secure employment within the United States. Once employment commences, employers must be prepared to address the rights of an injured undocumented worker. Under O.C.G.A. § 34-9-1, Georgia's workers' compensation legislature defines "employee" as every person in the service of another under any contract of hire or apprenticeship written or implied. Georgia cases addressing the inclusiveness of this statute are clear: undocumented workers are covered. In Continental Pet Technologies, Inc. v. Palacias, 604 S.E.2d 627 (Ga. App. Ct. 2004), the Court

ruled “every person” includes undocumented workers. Moreover, in Earth First Grading v. Gutierrez, 606 S.E.2d 332 (Ga. App. Ct. 2004), the Court specifically upheld the payment of income benefits where an undocumented worker was unable to work because of his injury.

After considering the breadth of Georgia’s workers compensation scheme, many employers are left asking: Why should I have to pay benefits to someone I am not legally entitled to employ? In Continental Pet Technologies, Inc. v. Palacias, 604 S.E.2d 627 (Ga. App. Ct. 2004), the Court addressed this contradiction by noting that while IRCA deals with the hiring of undocumented workers, it does not claim to intrude into the areas of what protections a State may afford these workers. In other words, Georgia is free to include undocumented workers within their workers’ compensation statutes to the extent the Courts and Legislature deem appropriate. Thereafter, in Martines v. Worley & Sons Construction, 628 S.E.2d 113 (Ga. App. Ct. 2006), Georgia offered some degree of protection to Employers by upholding the denial of income benefits where the Claimant, an undocumented worker, rejected his employer’s offer of a suitable light-duty position as a truck driver due to his inability to secure a valid Georgia’s drivers license.

#### **Proposed Legislation:**

As previously mentioned, Georgia’s legislature or General Assembly has the power to amend state workers’ compensation coverage of undocumented workers. On January 21, 2011, the Senate exercised this power as they heard the first reading of Senate Bill 7. This proposed bill would amend O.C.G.A. § 34-9-1 to provide that workers’ compensation benefits shall not be paid to noncitizens who are not employed legally and that such payments shall not be made unless the noncitizen is present in this country legally at the time such payments are made. As such, an injured employee who is in the country illegally

would be automatically denied weekly indemnity and medical benefits.

Following the initial reading, the Senate assigned the bill, sponsored by Senator Bill Heath of Breman, to the Senate Insurance and Labor Committee. Therein, it briefly appeared on a subcommittee hearing agenda in early March 2011, before Chairman Senator Tim Golden of Valdosta quickly removed it from the agenda. Despite the current appearance of a weakening interest in Senate Bill 7, this bill or another similar bill will likely continue to spark debates in the future. As such, it is important for employers to understand the potential impact of Senate Bill 7.

#### **Potential Impact:**

At first glance, Senate Bill 7 appears to offer a great benefit to employers. How could a bill that will eliminate payment of workers’ compensation benefits to undocumented workers cause employers harm?

What allows Georgia’s workers’ compensation scheme to operate effectively is the unique “exclusive remedy” protection provided under O.C.G.A. § 34-9-11. In exchange for providing a wide range of workers’ compensation benefits, an injured employee is prohibited from seeking tort damages as against the employer. In the vast majority of claims, the employee has no option but to accept this trade-off. By removing undocumented workers from workers’ compensation coverage and destroying this trade-off, Senate Bill 7 potentially opens the employer to tort liability. Thus, if the undocumented worker is successful in proving the employer’s negligence or intentional acts caused his injury, the employer faces increased exposure in the form of punitive damages and damages from “pain and suffering.” Additionally, the employee would no longer be limited to the caps regarding the amount and length of income benefits.

The failure of Senate Bill 7 to address potential tort exposure has lead Georgia Self Insurers Association and Georgia Traditional Manufacturers Association to oppose this well-intentioned proposal. Regardless of if Senate Bill 7 or another similar bill eventually becomes state law, Georgia employers remain exposed to federal audits of IRCA compliance. With the continuing popularity and improvement of E-Verify, employers have little to lose and much to gain through verifying the employment eligibility of employees.

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**UNEMPLOYMENT INSURANCE REFORM**  
Potential Advantage for Employers?

*James A. Ivey*

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On March 11, 2011, the Georgia State Senate passed Senate Bill 151 by a vote of 40 – 5. The bill was introduced by Senator Tim Golden, a District 8 Republican. This bill would enable the Commissioner of Labor to have the option of increasing unemployment insurance rates by up to 50 percent during 2012. As it now stands, insurance rates are set to increase by 100 percent on January 1, 2012. Of note, former Commissioner of Labor Thurmond utilized his option to increase rates by 35 percent this year but this option is set to expire on December 31, 2011. Therefore, new legislation is required. Due to increased unemployment, Georgia has had to borrow more than \$600 million from the federal government to fund weekly unemployment benefits such that it is not prudent to keep rates where they are.

Also, the Georgia House of Representatives is currently considering House Bill 292 which includes the provisions set forth in Senate Bill 151 but which would also extend for five years the new employer rate of 2.62 percent of payroll up to \$8,500 and the .08 percent administrative assessment which is used to fund programs

offered by the Georgia Department of Labor to assist those who are unemployed

## **LITIGATION SECTION**

The following articles are focused on legal precedents and developments of particular interest to businesses, property owners, employers, and general liability insurers and adjusters:

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**CONFORMING THE GEORGIA EVIDENCE  
CODE TO THE FEDERAL RULES OF  
EVIDENCE**  
House Bill 24

*John David Blair*

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For the purposes of most parties to civil litigation, it is desirable for proceedings to be governed by rules consistent with, or at least similar to, those rules used in the court systems of other states and the United States. If the rules in the Georgia and federal court systems were identical, then, hypothetically, anyone experienced litigating in a Georgia court would likely be comfortable and competent litigating in a federal court. Ideally, the rules in one forum for conducting discovery, motion practice, and introducing evidence at trial would mirror the same rules in the other forum, yielding simple, predictable, and reproducible results.

Though there are presently many similarities between Georgia and federal court rules/procedures, there are unfortunately a myriad of differences as well. Experience litigating civil cases in federal court (though useful) does not in and of itself prepare one to litigate in state court, or vice versa. The Rules of Evidence, in particular, are written quite differently in the Georgia and federal systems.

Every state, like the federal judiciary, observes certain rules governing the admissibility of evidence in contested cases. Many states in the southeastern United States observe evidence rules that almost precisely mirror the Federal Rules of Evidence. For instance, South Carolina has not only adopted the federal rules, but it has conformed its rules to use the same numbering system as the federal rules for ease of citation.<sup>iii</sup> The same is true for Alabama<sup>iv</sup>, Tennessee<sup>v</sup>, Florida<sup>vi</sup>, and even Louisiana<sup>vii</sup>, a state known for the uniqueness of its legal system.

Georgia's rules, however, do not track with the federal rules or the rules of the foregoing states, a fact that has surely caused a great deal of confusion for those unfamiliar with the Georgia evidence code. For instance, hearsay is defined almost identically in the federal, Alabama, Tennessee, Florida, and Louisiana systems, each of which have entitled that definition Rule 801, or something very similar. In Georgia, however, hearsay is defined at O.C.G.A. § 24-3-1 (not Rule 801), and, unlike all the systems of the federal and other state courts, Georgia's definition does not address admissions. Instead, in Georgia, admissions are discussed in not less than ten separate statutes<sup>viii</sup> (and confessions require yet another four<sup>ix</sup>).

Despite these differences, the Georgia rules pertaining to hearsay and admissions are quite similar *in substance* (if not form) to the rules employed by the federal courts and the courts of other states. In fact, the Georgia and federal rules are so similar in practical application that it is not unheard of for Georgia attorneys to cite a federal evidence rule in a Georgia court when he or she cannot recall the precise statutory citation for the rule in question.

Georgia House Bill 24 will not change these differences completely overnight, but its goal is to narrow the gap between state and federal practice, an increasing trend in other states as well. According to the Duke University School of Law, "*Since 1939, many states have adopted*

*rules of procedure modeled after the federal rules, and many states have patterned their rules of evidence after the federal rules since those were adopted.*"<sup>x</sup> These states, as alluded to earlier, are largely using the same rule numbers to further simplify their use in court.

The benefits in terms of reducing complexity in the litigation process are clear enough, but for those companies and businesses that find themselves regularly litigating in both state and federal courts, the benefits of reciprocal evidence rules are immense. For instance, the results of trials involving similar issues will be far less likely to produce different results in state versus federal courts if the laws governing the admissibility of evidence and testimony in those cases are more congruent.

In the past, it has been the case that evidence could be deemed inadmissible under the Georgia rules but not the federal rules, or vice versa. Though this will likely still occur to some degree, companies doing business across state lines (and thus regularly exposed to the risk of litigation in both Georgia and US courts) can expect that their cases will usually not result in vastly different judicial decisions based on the exclusion of critical evidence or testimony.

Additionally, the Georgia rules of evidence (codified at O.C.G.A. §§ 24-1-1, *et seq.*) govern trials in personal injury actions, contract disputes, and even workers' compensation claims.<sup>xi</sup> By bringing the Georgia rules in-line with the federal rules, not only do businesses benefit from the consistency, but these benefits will also be shared by employers, persons involved in motor vehicle accidents with out-of-state drivers, and also workers' compensation and liability insurance carriers/adjustors who work to tirelessly to defend claims in multiple jurisdictions.

The Georgia House voted overwhelmingly (162-5) to pass House Bill 24, which is presently being reviewed by the Georgia Senate. It is

widely supported by attorneys (particularly the defense bar), various business groups, and several lobbying organizations. This bill, in its most current form, can be reviewed and printed online through the official website for the Georgia General Assembly.<sup>xii</sup> If this bill becomes law, it will be a major change for Georgia, with far-reaching and positive consequences. We will continue to monitor this bill and report on its progress.

## **CONSTRUCTION LAW** **SECTION**

The following articles are focused on legal precedents and developments of particular interest to construction companies, contractors, architects, mechanic's, materialmen, developers, and financial institutions and investors financing construction projects:

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### PROTECTION FROM BANKRUPT SUBCONTRACTORS

*John David Blair*

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Very few construction projects these days are completed without any subcontracted labor. In the current economy, it is not unheard of for even the most historically reliable subcontractors to lose their financial footing. Often, the result is a subcontractor seeking protection from creditors under the Bankruptcy Code. When this happens, many problems arise for the general contractor, other subcontractors, and even the material providers who worked with the now bankrupt subcontractor.

One such problem that can often occur is where the bankruptcy trustee for the debtor/sub requires the other contractors and material providers to pay money into the subcontractor's bankruptcy estate. Over-simplified, this means

that it is possible, as a result of the Bankruptcy proceedings, that creditor-contractors may be forced to pay money to the debtor-subcontractor that owes them money.

To illustrate how this problem arises, let us examine a hypothetical scenario:

- ❖ General Contractor Acme receives word, during the course of a construction project, that Subcontractor Foundations-R-U's has filed for bankruptcy and will not be completing the project despite having completed only 50% of its subcontracted work on the foundation.
- ❖ General/Acme is left with the responsibility under its contract with Client/Property Owner for performing the remainder of foundation work that it had already subcontracted to Foundations-R-U's.
- ❖ Of course, Acme has budgeted and planned for the foundation work to be performed by Foundations-R-U's, and it has neither the laborers nor materials to perform the work.
- ❖ Acme must either hire laborers and purchase the materials itself, or find another subcontractor to finish the foundation work.
- ❖ Unfortunately, Acme learns that Material Provider "Concrete Solutions" has placed a lien on the project for the concrete it provided to Foundations-R-U's that was incorporated into the property but for which it will not be paying.
- ❖ Fortunately, Acme has yet to pay Foundations-R-U's and could use that money to shop for another subcontractor and pay for the materials.
- ❖ Unfortunately, the Bankruptcy Trustee sends Acme a demand that any money it owes to

Foundation-R-U's be paid into the Debtor-Sub's bankruptcy estate.

- ❖ Now Acme not only must hire a new subcontractor to finish the foundation work, but it must actually pay the subcontractor who abandoned the project.

Fortunately, there is a solution to this dilemma: it is called "recoupment" (or, depending on the circumstances, "set-off"). This is a bankruptcy precedent that addresses the relationship between contractors in the hypothetical scenario above and in similar situations.

"The right of setoff ... allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'"<sup>xiii</sup> "Recoupment is the setting up of a demand arising from the same transaction as the plaintiff's claim, to abate or reduce that claim. Recoupment, a creditor's right long recognized in bankruptcy proceedings, is merely the means used to determine the proper liability on the amounts owed."<sup>xiv</sup>

In simpler terms, when confronted with the question of how to complete the subcontractor's work and pay the materials provider without having to pay the bankrupt subcontractor (unless there is a surplus of funds – unlikely), the answer is to seek "recoupment," a principal of law that allows the general (or other contractors) to reduce the monetary amounts that must be paid over to the Bankruptcy Trustee by the amount of a credit taken against the amount owed under the subcontract. The proper amount of the credit should be equal to the costs in completing the subcontractor's duties, including payment for materials.

There are two requirements for recoupment: (1) the costs for which a credit and reduction is sought must arise from the same transaction; and (2) the costs for which a credit is sought must

have been costs that the general (or other creditor-contractor) was legally compelled/obligated to pay.

The first requirement is simpler than it seems. It is merely requiring that any costs for which a credit is sought have been paid (or owed) in completing that specific subcontractor's work on the project. In other words, it is impossible to take a credit/reduction against amounts owed under one subcontract for costs incurred in a separate subcontract (no "cross-pollinating," as it were), and this is true *even if the separate subcontract was with the same* (now bankrupt) subcontractor. Every subcontract must be evaluated separately and independently.

The second requirement is quite straightforward: there can be no credit/reduction taken for "gratuities" or payments that were undertaken voluntarily. This is a simple rule that becomes complicated when applied. For instance, what is the proper result if the bankrupt subcontractor failed to pay a material provider but that provider's lien was not valid?

Unless there is a judgment in favor of the material's provider, payment may not have been legally required, and, therefore, it is possible that payment will be deemed "voluntary" – this is true regardless of whether one feels "morally obligated" to pay or thinks that paying is "good business." What matters is that the costs paid are *legally* mandated.

There is always a risk, in any event, that the Bankruptcy Court will deny all or part of the recoupment sought. Perhaps the costs to finish the job will be permitted, but not the costs to pay the materials provider. Additionally, the court may issue sanctions or penalties (think fines) for recouping costs not subject to recoupment. Of course, this is unlikely in most cases where the improper recoupment was completely accidental, but the error would still need to be corrected by reversal/payment.

There is an obvious way to mitigate these risks, however, and that is through careful contract drafting and negotiations. If the contract(s) make it clear, in plain English, who is owed what and when, then it becomes very difficult for the Bankruptcy Court or even the Trustee to argue that payments were not legally required. Additionally, a right of recoupment can often be expressly drafted into the contract, though this must typically be done uniquely for each project. A standard form contract could be used, however, to merely set forth the obligations of each party to pay in terms of amounts and deadlines in such a fashion as to create a presumption that recoupment is proper.

Obviously, this solution requires a written contract be executed for each subcontract. Though a custom contract for each project is more likely to prove effective for this purpose, where this is cost-prohibitive, a well-drafted

standard form contract addressing recoupment would be the best alternative. While this may seem like a heavy burden, given the number of subcontractors filing for bankruptcy in the current economy, it is likely that the long-term financial benefits outweigh the immediate/short-term burden for most contractors and materials providers.

If using standard form agreements, then it is probably a good idea to revisit them to ensure that they are leaving you the option of recoupment without fear of sanction (as well and actually accomplishing any other goals for which they were employed such as requiring arbitration of disputes, etc.). With or without a detailed contract, claiming recoupment is a decision that should be made with the benefit of competent legal counsel.

*\* If you would like to subscribe to the mailing list (or if you would like to unsubscribe), please contact Christie Eades of Ross & Levy at 866-995-8663(toll free) or by email to [info@rossandlevylaw.com](mailto:info@rossandlevylaw.com).*

The law firm of Ross & Levy, LLC represents and defends employers and insurers in the areas of workers' compensation (including longshore matters), premises liability claims, personal injury claims, business/contract disputes, general litigation, and other areas. The firm has offices throughout Georgia. Questions and comments about the firm and its services, for all regions, may be addressed to:

Ross & Levy Law  
P.O. Box 71668  
Albany, Georgia 31708-1668  
Toll Free Telephone: (866) 995-8663  
Toll Free Facsimile: (877) 284-4034  
Website: <http://www.rossandlevylaw.com>  
Email: [info@rossandlevylaw.com](mailto:info@rossandlevylaw.com)

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<sup>i</sup> Master Craft Flooring v. Dunham, 2011 WL 904363 (Ga. App. March 6, 2011) (No. A10A184).

<sup>ii</sup> Austell Healthcare v. Scott, 2011 WL 833688 (Ga. App. March 11, 2011) (No. A10A2346).

<sup>iii</sup> See generally, <http://www.sccourts.org/courtReg/indexEvd.cfm>.

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<sup>iv</sup> See generally, [http://judicial.alabama.gov/library/rules\\_ev.cfm](http://judicial.alabama.gov/library/rules_ev.cfm).

<sup>v</sup> See generally, <http://www.tsc.state.tn.us/opinions/tsc/rules/tnrulesofcourt/01evid.htm>.

<sup>vi</sup> See generally,

[http://www.leg.state.fl.us/statutes/index.cfm?App\\_mode=Display\\_Statute&URL=0000-0099/0090/0090ContentsIndex.html&StatuteYear=2010&Title=%2D%3E2010%2D%3EChapter%2090](http://www.leg.state.fl.us/statutes/index.cfm?App_mode=Display_Statute&URL=0000-0099/0090/0090ContentsIndex.html&StatuteYear=2010&Title=%2D%3E2010%2D%3EChapter%2090).

<sup>vii</sup> See generally, <http://www.legis.state.la.us/lss/lss.asp?folder=70>.

<sup>viii</sup> See O.C.G.A. §§ 24-3-30 through 24-3-38.

<sup>ix</sup> See O.C.G.A. §§ 24-3-50 through 24-3-53.

<sup>x</sup> See generally, <http://www.law.duke.edu/lib/researchguides/courtr> (March 22, 2011).

<sup>xi</sup> O.C.G.A. § 34-9-102(e)(1).

<sup>xii</sup> [http://www1.legis.ga.gov/legis/2009\\_10/fulltext/hb24.htm](http://www1.legis.ga.gov/legis/2009_10/fulltext/hb24.htm).

<sup>xiii</sup> *Citizens Bank of Maryland v. Strumpf*, 116 S. Ct. 286, 289 (1995) (quoting *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913)).

<sup>xiv</sup> See [http://www.justice.gov/usao/eousa/foia\\_reading\\_room/usam/title4/civ00067.htm](http://www.justice.gov/usao/eousa/foia_reading_room/usam/title4/civ00067.htm), citing *Reiter v. Cooper*, 113 S. Ct. 1213, 1218 n.2 (1993); *Bull v. United States*, 295 U.S. 247, 262 (1935) ("recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded");