



## Workers Comp Fraud Cases: More Than Meets the Eye

It can be frustrating. You think you have an open-and-shut case of workers comp fraud—you even have the videotape to prove it. But then your carrier or the local prosecutor reviews the file and tells you there’s just not enough evidence to get a judgment in your favor. You have to either get more solid evidence of intent or let the case go.

There’s a fine line between abuse and fraud, and proving that a claimant crossed that line to commit fraud is extremely difficult, though not impossible, according to Liberty Mutual fraud specialists.

“When it comes to workers comp fraud, the burden of proof on the employer, the insurer, and the district attorney is significant,” says Christine Wilson, western region special investigations unit manager for Liberty Mutual. “It can be very frustrating to a risk manager, because so often he or she is convinced a claimant is taking the company for a ride. Yet proving it is like baking the perfect cake: you need a number of different ingredients, and if you’re missing just one, the whole thing falls flat.”

### “MILK” BUILDS STRONG CASES

While the necessary elements for proving fraud may vary across jurisdictions, in general a prosecutor needs to satisfy the following four requirements to successfully prosecute a case of fraud:

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## NC Bankruptcy Court Torpedoes Subcontractors’ Lien Rights

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*“Damn the torpedoes! Full speed ahead!”*

*- Adm. David Farragut, USN (8/5/1864)*

*“#@\*% him!”*

*- Captain of the lead ship (8/5/1864)*

A recent bankruptcy court decision reversed decades of common practice regarding subcontractors’ lien rights in bankruptcy. Historically, subcontractors in North Carolina have been able to file liens on projects after the general contractor declared bankruptcy. This past summer, however, the United States Bankruptcy Court for the Eastern District of North Carolina in Raleigh held in the case of *In re Harrelson Utilities, Inc.* that subcontractor liens filed after the general contractor filed for bankruptcy were void and unenforceable. Under the U.S. Bankruptcy Code, creditors are prohibited by law from “any act to create, perfect, or enforce any lien against the property of the estate.” This prohibition, known as the “automatic stay,” goes into effect as soon as the debtor files for bankruptcy. One exception to the automatic stay is an act taken to “perfect[] an interest in property ... acquire[d] ... before the date of perfection.” Since, under North Carolina law, claims of lien on real property relate back to the date of first work, subcontractor mechanic’s liens had – up until now – been considered “inchoate,” or pre-existing interests in property. As such, mechanics’ liens were exempt from the automatic stay and subcontractors could still file their liens after a general contractor filed for bankruptcy, so long as they met all of the other statutory lien requirements, such as the 120 day time limit. That exemption may have just been sunk.

In the *Harrelson* case, four unpaid subcontractors, Ferguson Enterprises, Inc., Smith Setzer & Sons, Inc., S.T. Wooten Corporation, and Tindall Corporation, sought to enforce approximately \$600,000 in liens for work performed on various projects on which the bankrupt debtor, Harrelson Utilities, Inc., had acted as general contractor. Ferguson, Smith Setzer, and Tindall had served their notices of claim of lien on funds and filed subrogated claims of lien on real property after the date Harrelson filed for Chapter 11 bankruptcy. S.T. Wooten, still within its 120 days, was petitioning the court for permission to serve and file its lien claims. In response, Harrelson contended that filing the liens post-petition violated the automatic stay and further requested that the court sanction Ferguson and Smith Setzer for knowingly breaking the law. After a hearing, the bankruptcy

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**Materiality:** are the party's actions relevant or significant; do they matter?

**Intent:** did the party intend to lie or defraud?

**Lie:** is there a specific, provable falsehood?

**Knowledge:** did the party knowingly lie?

These requirements are commonly referred to by the acronym "MILK."

To get a better idea of how to apply MILK to a situation you suspect might be fraud, consider the following scenario:

Jim, a heavy-equipment operator at a midsize manufacturing company, suffered a shoulder injury on the job at the beginning of August. He saw a doctor, who made a diagnosis and recommended that Jim be placed on light duty. Since the employer could not accommodate the light-duty request, Jim was placed on temporary total disability (TTD).

After some employee-related gossip made its way from the factory floor to the risk manager's office, the risk manager asked her insurance carrier to send a surveillance team to Jim's neighborhood to see whether there was any evidence that he was using his shoulder as if it were not injured.

The carrier's surveillance vendor videotaped Jim carrying a ladder from his garage to his front porch, carrying several boxes from the house to the porch, and hanging party decorations on the front of the house.

The risk manager is convinced that Jim is committing workers comp fraud and would like to contact the district attorney's office.

Does the risk manager have a good case?

### **APPLYING THE TESTS FOR FRAUD**

The first question we must ask is about materiality—are Jim's actions significant?

Since Jim is collecting TTD benefits based on an injury to a shoulder that he is shown using liberally throughout the videotape, then, yes, his actions do matter; they are relevant and significant. Had he simply carried a cardboard box of decorations to the front porch and used only the uninjured shoulder when he was hanging them, then the materiality requirement may not have been satisfied.

Second, we test for intent: did Jim intend to commit fraud? "This is the most difficult aspect of fraud to prove," says Tony Hurtado, Liberty Mutual senior special investigator. "You must prove the claimant is intentionally doing something, such as faking an injury and lying about the pain he's experiencing, to receive benefits he otherwise shouldn't receive."

Hurtado says that if, for example, you had a recording of Jim telling someone that he had faked the injury to get paid while taking time off, then you might be on your way to proving intent. But getting such proof is rare.

"Though your videotape might show Jim using his shoulder as if he had not injured it, there might be much more to the story," Hurtado says. "For instance, he might simply be ignoring the doctor's advice and working outside the doctor's restrictions. But that doesn't mean he isn't experiencing pain or that his doctor would change his mind about Jim being able to return to work. In fact, if you presented the evidence to the doctor, he might even agree that Jim should not be hanging party decorations and should keep his shoulder immobile. But that doesn't mean Jim's actions

constitute the intent to commit fraud."

Third, is there a specific, provable lie? "First, you should know the circumstances under which telling a lie is considered workers comp fraud," Wilson says. "For instance, if a claimant lies to an investigator from the district attorney's office, it's not considered workers comp fraud. The only lie that 'counts' is one the claimant tells to an individual who can provide or continue the claimant's benefits, such as a claim manager or doctor."

Did Jim lie to the doctor? Maybe. You'd have to speak with the doctor directly, because a lot transpires during a medical appointment that the notes don't necessarily reflect. "If the doctor reports that Jim told him that he's been totally out of commission, can hardly get himself dressed, and can't use his arm at all, then it looks as though Jim may have lied," Wilson says. "If, on the other hand, he reports that Jim told him he had hung party decorations and his shoulder was killing him the next day, then that's probably not fraud. These are things you'd have no way of knowing by watching that videotape."

Finally, did the claimant knowingly lie? Suppose the risk manager reads that at the initial appointment Jim told the doctor he had never injured that shoulder before. Yet the risk manager checks the files and finds that Jim did indeed injure the same shoulder five years earlier and received a disability rating and "compromise and release" payment. You might have evidence of Jim knowingly telling a lie. However, if you found that Jim only slightly injured his shoulder a decade ago and was never on disability, then it would be difficult to prove fraud. It might simply be a case of the employee forgetting about a minor injury.

### **DON'T GET DISCOURAGED**

Even if the case under investigation fulfills the MILK requirements, your insurer still needs to convince a prosecutor that the case is worth pursuing and will also serve to deter others. As Wilson says, "Proving fraud is a big step. Convincing the district attorney that a jury will agree that fraud exists beyond a reasonable doubt is another matter altogether."

However, it's helpful to remember that even if you cannot prove fraud, presenting a videotape or other evidence of the claimant's physical activity may help convince a doctor to release the employee to return to work, which would end the TTD benefits. So while you might not be able to prove fraud, you might be able to lower your costs.

Yet risk managers can and do help successfully prosecute workers comp fraud all the time, according to Wilson. "Work with your carrier to learn the best ways of detecting and proving fraud," she says. "Every case you prove not only helps your company save money in the short term, but can also discourage others from attempting fraud, which can lower your overall costs over time."

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court ruled that filing the liens post-petition violated the automatic stay and ordered that all of the liens be “removed from the record,” but denied Harrelson’s request for sanctions because “[t]he subcontractors were doing what subcontractors in North Carolina have been doing for years.”

The subcontractors argued unsuccessfully that the new holding would force subcontractors to serve notices of liens when they deliver the materials to the project site or risk losing their lien rights and “create havoc in the construction industry.” The subcontractors also argued that the holding will give those subcontractors who learn [*or are told*] of a general contractor’s intent to file bankruptcy an unfair advantage by being able to file their liens pre-petition. The bankruptcy court recognized that the subcontractors had made strong public policy arguments, but stated that “these persuasive arguments cannot alter the construction of the relevant statutes.”

The bankruptcy court based its decision, not on decades of practice, but on its own analysis of the wording of North Carolina’s lien laws. The court noted that a subcontractor’s statutory claim of lien upon funds is “effective upon the obligor’s receipt of the notice.” As such, the court reasoned, a subcontractor’s interest in the funds does not relate back to the date of first work (like a lien on real property), but only arises when the notice of claim of lien upon funds is served. Stating that “[t]he post-petition creation of the statutory lien is not the ‘perfection’ of a pre-existing interest, but the creation of interest for the first time...,” the court concluded that the subcontractors’ lien rights upon funds were not covered by the exception to the automatic stay and that serving claims of lien on funds after Harrelson filed for bankruptcy violated Federal bankruptcy law.

After concluding that the post-petition claims of lien upon funds were invalid, the court then analyzed the subcontractors’ lien on real property rights. The court read the statute’s language stating that a “... subcontractor, *who gives notice of claim of lien upon funds* as provided in this article, may, *to the extent of this claim*, enforce the claim of lien on real property of the contractor...” to mean that North Carolina’s lien law, as written, requires a subcontractor to serve a notice of claim of lien upon funds before filing a subrogated claim of lien on real property. The court then reasoned: if a subcontractor cannot serve a notice of claim of lien upon funds post-petition without violating the automatic stay, and a subcontractor cannot file a claim of lien on real property without first serving a notice of claim of lien upon funds, then a subcontractor cannot file a claim of lien on real property after a debtor files for bankruptcy without violating the automatic stay. As such, the bankruptcy court held that Ferguson’s, Smith Setzer’s, and Tindall’s liens were in violation of the automatic stay and none of the four had any enforceable post-petition lien rights.

The *Harrelson* court’s decision is under appeal to the United States District Court, and is currently binding only in the Eastern District of North Carolina. If the general contractor files its bankruptcy petition in the Eastern District of North Carolina, then this decision will be binding on your case. If the decision survives appeal, it is very likely that the district courts for the Western (Charlotte) and Middle (Greensboro) districts of North Carolina will follow the Eastern District’s lead and the ruling could become binding au-

thority throughout North Carolina.

What’s a poor subcontractor to do? Keep up with both your accounts receivable and the financial condition of the general contractors you work under. If you are not already serving Notices of Subcontract on every project, start. Contracting is essentially a relationship business. Filing a lien on an ongoing project can damage the relationship between a subcontractor and a general contractor, but so can not getting paid. The loud and clear message from the United States Bankruptcy Court for the Eastern District of North Carolina is: if you are a subcontractor on a North Carolina project, file your liens as soon as possible. Up until now, subcontractors knew they had 120 days to negotiate before they had to pull the lien trigger. That rule may have just changed. The new law of the land may be that you now have 120 days or until the general contractor files for bankruptcy, whichever comes first. Are you feeling lucky?

<sup>1</sup> *In re Harrelson Utilities, Inc.*, Case No. 09-02815-8-ATS (Bankr. E.D.N.C., July 30, 2009).

<sup>2</sup> 11 U.S.C. § 362(a)(4).

<sup>3</sup> 11 U.S.C. §§ 546(b) and 362(b)(3).

<sup>4</sup> N.C. Gen. Stat. § 44A-10.

<sup>5</sup> Holders of inchoate statutory liens are secured creditors when (1) the lien holder remains eligible to perfect the lien under state law and (2) such perfection is not otherwise avoidable under the Bankruptcy Code. *In re The Electron Corp.*, 336 B.R. 809, 813 (10th Cir. BAP 2006), citing *In re 360networks (USA) Inc.*, 327 B.R. 187 Bankr.S.D.N.Y., 2005). Also see *In re J.A. Jones*, 361 B.R. at 100-101 (Bkrcty. W.D.N.C., 2007), in which Judge Whitley, Chief Judge, U.S. District Court for the Western District of North Carolina, in dicta questioned the holding in *Precision Walls v. Crampton*, 196 B.R. 299 (E.D.N.C. 1996) that unfilled subcontractor claims failed to create a lien for the purposes of 11 U.S.C. §547(b), noting that “most reported decisions take the opposite view.” *In re J.A. Jones*, 361 B.R. at 100.

<sup>6</sup> N.C. Gen. Stat. § 44A-18(6).

<sup>7</sup> N.C. Gen. Stat. § 44A-23(a). (Emphasis added.) This wording is the same in both subsection (1) covering first tier subs and subsection (2) covering second and third tier subs.

<sup>8</sup> N.C. Gen. Stat. § 44A-23(b).

<sup>9</sup> Note: In South Carolina, a subcontractor must file and serve its mechanic’s lien before the debtor files its bankruptcy petition in order to enforce a mechanic’s lien in bankruptcy. *In re Georgetown Steel Company, LLC*, Case No. 03-13156-w (Bankr. D.S.C. August 19, 2005).



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