Imagine the following scenario: Your general contractor client has just completed the construction of a building for a local government or school administrative unit under a written contract. The certificate of occupancy is granted by the inspector. The contractor’s final invoice is submitted to the appropriate person at the local government or school administrative unit. In response, your client receives a letter from the local government or school administrative unit stating that it is not required to pay your client for its services because the local government or school administrative unit never placed a “preaudit certificate” on the contract. Your client calls you and asks you what a preaudit certificate is.

The requirement for a preaudit certificate has been around since the 1970s, but has reappeared on the radar with a recent statutory change. Unless the preaudit formality is addressed when the contract is formed, the above scenario could potentially happen to a contractor (or design professional or supplier) providing goods or services to local governments or school administrative units in North Carolina. This article will explain the statutory basis for the requirement of a preaudit certificate along with the courts’ application of the statutes. Fortunately, your client can protect itself, but those efforts must take place at the time the contract is entered into with the local government or school administrative unit, or else it could be too late.

**Preaudit Certificate Statutes**

When a contractor enters into a written contract with any client, whether public or private, and performs under that contract, one would expect that the contract to be enforceable – assuming the requisite contractor license is held, if required. When dealing with government (i.e. taxpayer) money, there is another legal issue – and that is making sure that the government’s money is appropriately authorized and within budget. To protect local governments and school administrative units from spending beyond their means, the General Assembly has adopted two similar statutes – one for local governments (N.C.G.S. § 159-28) and one for school administrative units (N.C.G.S. § 115C-441).

Section 159-28(a) covers expenditures that should be authorized by either a budget ordinance or a project ordinance. It is likely that most construction projects are funded through a project ordinance. Section 159-28(a) provides that no obligation may be incurred by a local government or public authority “unless the budget ordinance includes an appropriation authorizing the obligation.” The statute does not define “obligation,” but it is generally accepted in government accounting that obligations are expenditures that a government entity may be legally required to meet out of its resources.

Section 159-28(a) also requires that an “unencumbered balance remains in the appropriation sufficient to pay the sums obligated by the transaction for the current fiscal year.” Thus, if a contract, purchase order, or other agreement commits the local government unit to an expenditure of money during the current fiscal year, an obligation is incurred under the statute. No obligations may be incurred for capital and grant projects authorized by a project ordinance unless the project ordinance includes an appropriation authorizing the obligation. Some local government related entities are exempt from the preaudit certificate requirement under Section 159-28 including joint municipal power agencies (N.C.G.S. § 159-41(b)), public hospitals (N.C.G.S. § 159-39(b)) and public housing authorities (N.C.G.S. § 159-42(b)).

The preaudit certificate requirement lies in the next part of the statute. If the obligation arises from a contract or agreement requiring the payment of money, or by a purchase order for supplies and materials, the contract or agreement, or purchase order “shall include on its face a certificate stating that the instrument has been preaudited to assure compliance” with Section 159-28. The certificate must be signed and dated by the finance officer or deputy finance officer and shall take substantially the following form: “This instrument has been preaudited in the manner required by the Local Government Budget and Fiscal Control Act.” Finally, the statute provides that “an obligation incurred in violation of this subsection is invalid and may not be enforced.” Yes, you heard that correctly. If a contract does not have a preaudit certificate, the local government is not required to pay the other contracting party for services performed or goods provided.

The statute applicable to school administrative units (N.C.G.S. § 115C-441) is very similar to the statute for local governments. One difference is that the appropriation authorizing the obligation arises from the school board’s budget resolution (not the budget ordinance), which is the funding mechanism for school administrative units in North Carolina. There is no analogous provision in Section 115C-441 for capital and grant projects. This may be because capital and grant projects for schools are generally authorized at the county level. The preaudit certificate must take substantially the following form: “This instrument has been preaudited in the manner required by the School Budget and Fiscal Control Act.”

**Recent Amendments to Section 159-28**

The General Assembly amended Section 159-28, the preaudit statute applicable to local governments, in June 2012 (Session Law 2012-156). The amendment became effective immediately. The legislation does not affect Section 115C-441, the preaudit statute ap-
### Preaudit Certificate Court Decisions – Transportation Services

In *Transportation Services of North Carolina, Inc. v. Wake County Board of Education*, 198 N.C. App. 590, 680 S.E.2d 223 (N.C. App. 2009) (“Transportation Services”), the court examined the statute applicable to contracts with school administrative units. The Wake County Board of Education (“Wake Co. BOE”) entered into a written contract with Transportation Services of North Carolina, Inc. (“TSNC”), a transportation provider for special needs students in the school system. The contract provided that TSNC was to receive compensation on a per-student assigned basis, whether or not those students were actually transported on a given day. Wake Co. BOE subsequently refused to pay TSNC for students on days when they were not transported by TSNC. TSNC brought suit against Wake Co. BOE alleging breach of contract, estoppel, and negligent misrepresentation. Wake Co. BOE alleged the contract was invalid because a preaudit certificate was never prepared.

**Transportation Services** marked the first time the court was asked to interpret Section 115C-441. The court cited a number of prior decisions interpreting the preaudit certificate statute for local governments, including *Data General*. Noting the similarity between the two statutes, the court applied the reasoning from the cases interpreting Section 159-28 to the school administrative unit statute. The court found that in the absence of a preaudit certificate, the contract between Wake Co. BOE and TSNC was invalid and unenforceable. *Id.* at 596. TSNC admitted there was no preaudit certificate, but argued that Wake Co. BOE actually did perform the preaudit, thus the contract should be valid. The court did not consider whether the audit was actually performed and pointed to the plain language of the statute – requiring the signed preaudit certifi-
cate be attached to the contract. TSNC argued that Wake Co. BOE should be “estopped from asserting the contract’s invalidity because [Wake Co. BOE] previously treated the contract as valid and accepted benefits flowing from that contract.” The court followed the estoppel reasoning in Data General – that estoppel is not available in the absence of a valid enforceable contract – and finding that “applying estoppel to hold [Wake Co. BOE] liable would allow [TSNC] to escape the purpose of the legislature in enacting [the preaudit statute].” Id. at 599.

**Preaudit Certificate Court Decisions – Systel**

Do settlement agreements involving a payment made by a local government or school administrative unit require a preaudit certificate? The Court of Appeals addressed this question in *Cabarrus County v. Systel Business Equipment Company*, 171 N.C.App. 423, 614 S.E.2d 596 (N.C.App. 2005) (“Systel”). Cabarrus County and Systel entered into an equipment rental contract for photocopier services. When the lease term ended, Cabarrus refused to renew the contract per the rental contract. Systel objected and in response Cabarrus County pointed out that the rental contract lacked a preaudit certificate rendering the rental contract unenforceable. Cabarrus County brought suit against Systel in order to determine the validity of the rental contract. The parties entered settlement discussions and reached a settlement that was approved by the Cabarrus County Commissioners. One week later the commissioners voted to rescind their approval of the settlement agreement and to continue settlement negotiations. Systel filed a motion against Cabarrus County to enforce the settlement agreement. The settlement agreement, low and behold, had a preaudit certificate affixed, but was not signed by the finance officer. The court noted that settlement agreements are interpreted according to general principles of contract law. Since the settlement agreement created an obligation on the part of Cabarrus County, the court found that Section 159-28 applied and held that the settlement agreement was unenforceable because the preaudit certificate on the settlement agreement lacked the signature of the Cabarrus County finance officer.

**Preaudit Certificate Court Decisions – Plymouth**

Section 159-28 applies to obligations incurred in the “current fiscal year.” How could this affect a multi-year construction contract? There is only one published case that specifically addresses an obligation incurred in a subsequent fiscal year, and it is a non-construction case that does not easily apply to a construction contract scenario. *Myers v. Town of Plymouth*, 135 N.C.App. 707, 522 S.E.2d 122 (N.C.App. 1999) (“Plymouth”). Plymouth involved a town manager who was fired by the town council. The town manager had entered into an employment agreement with the Town of Plymouth, but the agreement was entered into during the fiscal year prior to the town manager’s dismissal. Upon the dismissal, the Town refused to pay out the severance that was included as part of the employment agreement citing the absence of the preaudit certificate. The court ruled that because the severance payment, the “obligation,” was not incurred during the fiscal year in which the employment agreement was signed, there was no requirement for a preaudit certificate, thus the agreement was valid and enforceable. The court also found that Section 159-28 does not require that a “town's financial officer pre-audit a long-term contract each year the contract is in effect.”

The unique circumstances of the employment dispute in Plymouth make it difficult to know how the holding might apply to other scenarios. A severance payment could occur years down the road or not at all, much different from the typical construction contract where obligations have more certainty. Plymouth appears to be a results-driven opinion that should be applied narrowly. *Data General* and *Transportation Services* all involved multi-year contracts where some of the obligations were incurred in years after the fiscal year in which those contracts were entered into, but the courts found that the preaudit statute applied in those instances. As a result, the mere fact that work performed under a construction contract could last more than one fiscal year should not eliminate the need for a preaudit certificate on the contract. If the holding in Plymouth was applied to a construction contract, then there could conceivably be a narrow exclusion to the preaudit requirement where the fiscal year changes between the time the contract is entered into and when the work begins. This exclusion, if applicable, should apply whether or not the construction work is performed during one fiscal year or more than one, as long as the contract was entered into during the fiscal year prior to when the work begins.

**May a Contractor Assert the Lack of Preaudit as a Defense?**

Another question that has not been addressed by the courts is whether the contractor could be excused from performance when the preaudit requirement has not been met. Imagine a scenario where the general contractor has been terminated for cause and its surety is called on by the locality to take over. There is no preaudit certificate on the general contract. Prior to the termination, the locality has made progress payments to the general contractor. May the general contractor and surety rely on the lack of the preaudit certificate as a defense to performance? Sureties are generally allowed to assert any defenses their principals may have.

The reported court decisions all involve circumstances where the owner points to the lack of a preaudit certificate as a defense to payment and the courts finding the contracts invalid and unenforceable. While likely not contemplated by the drafters of the legislation, it would be inconsistent to hold that the contract is invalid and unenforceable as against the owner but not the other contracting party. The only argument the locality may have here is that the other contracting party should be quasi-estopped from raising the defense. The *Data General* and *Transportation Services* courts both held that the sovereign is not subject to a claim of estoppel, and that is where the estoppel inquiry ended in those cases.

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Open Questions

Because of the dearth of case law interpreting the statutes, a number of questions remain unanswered. For example, upon discovery of a failure to meet the preaudit certificate requirement, must the contractor disgorge any payments received from the locality? This issue has yet to be considered by the courts. May a locality, upon discovering that it failed to affix the preaudit certificate to a contract, “ratify” the contract by meeting that requirement at a later date? Neither the statutes nor the case law address that specific question. Allowing ratification would appear to circumvent the intent of the statutes, which is to ensure localities perform the preaudit process and affix the certificate prior to the obligation being incurred. Nonetheless, this remains an open question.

Upon violation of the statute, Section 159-28(e) provides for liability of the finance officer – “if an officer or employee of a local government or public authority incurs an obligation or pays out or causes to be paid out any funds in violation of [the preaudit requirements], he and the sureties on his official bond are liable for any sums so committed or disbursed.” There is an analogous provision in Section 115C-441(e). Obviously, the finance officer would be liable to the locality, but would the finance officer be liable to the other contracting party? Probably not. While the statutory language suggests that the liability is automatic, it is likely within the discretionary authority of the locality to impose the liability. This question has not been specifically addressed by the courts, however, and remains unanswered. A related question also remains open: In the event that the local government chose not to pursue liability against the finance officer, could a taxpayer bring suit on the officer’s fidelity bond?

Conclusion

What would cause or motivate a locality to raise the absence of a preaudit certificate as a defense to a breach of contract action made by a contractor? The locality may interpret the statutes to give them no choice. Perhaps a dispute has arisen over the quality of the contractor’s work and the locality points to the preaudit certificate to merely gain leverage in a dispute. Maybe the locality’s representative who entered into the contract did not ensure the obligation was authorized and budgeted for, and the local government accordingly refuses to pay. The local government or school board may have just forgotten to affix the preaudit certificate to the contract. Regardless of the local government’s or school board’s motives, it is important to realize that the lack of a preaudit certificate could be fatal to the contractor’s attempts to collect payment on its invoices – whether or not there is anything deficient with the contractor’s work.

What is the takeaway from these statutes and the court cases discussed? Simply this: A contractor can enter into a written contract (including settlement agreements) signed by a locality, but if the preaudit certificate is not affixed to the contract, the contract is invalid and unenforceable. The contractor may not realize the requirement for a preaudit certificate exists until after the work is performed and invoiced. The courts have interpreted the statutes strictly, holding that even if all of the authorization and budgetary requirements (i.e. the “preaudit”) were met by the locality, the absence of the actual preaudit certificate on the contract was enough to invalidate the contract and remove any obligation to pay. The contractor who performs work under a contract with a locality should ensure the preaudit certificate is affixed to the contract – before any work is performed. Please help spread the word among your clients!

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