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Construction Suppliers Beware: The Bankruptcy Code's Automatic Stay May Bar Post-Petition Perfection of Your Lien Rights

Most states have enacted statutes that allow creditors providing goods and/or services to a contractor on a construction job to file a “mechanics’ lien” or “construction lien” directly against a third-party owned construction project in which (a) the creditor provided goods and/or services to the contractor, (b) the contractor used the goods and/or services on the construction project, and (c) the contractor had not paid for the materials or services. Under certain circumstances, the creditor might also be able to benefit from its lien rights by stepping into the contractor’s shoes and directly collecting the project owner’s indebtedness to the contractor.

Mechanics’ or construction lien rights are a powerful collection tool for trade creditors involved in the construction industry. These lien rights, if exercised properly, can potentially elevate an otherwise general unsecured claim that oftentimes recovers only pennies on the dollar to a much more valuable secured claim that in many instances receives full recovery.

Well, what happens if the contractor files bankruptcy? Can the creditor file its mechanics’ lien post-petition? The answer depends on the lien law of the state where the construction project is located and whether the lien law allows for the retroactive perfection of lien rights to before the bankruptcy filing.

had obtained post-petition liens in the contractor’s assets consisting of accounts receivable the owners owed to the contractor on the projects into which the contractor had incorporated the creditors’ goods. It did not matter that the creditors had also obtained their post-petition lien rights against the property interests of the nondebtor project owners, which were not property of the contractor’s bankruptcy estate.

The Third Circuit’s decision is a warning to suppliers of goods and/or services on construction projects in New Jersey and other states with similar lien laws to quickly file their mechanics’ or construction liens. Significantly, the outcome might have been different in other states whose lien laws grant creditors additional time to file their liens by providing for the retroactive perfection of lien rights to before the bankruptcy filing when, for example, the lien arose (i.e., when the creditor had furnished goods or services for the project).

The New Jersey Construction Lien Law

Pursuant to the New Jersey Construction Lien Law, N.J.S.A. § 2A: 44A (the “NJ Lien Law”), “[a]ny contractor, subcontractor or supplier who provides work, services, material or equipment pursuant to a contract, shall be entitled to a lien for the value of the work or services performed, or materials or equipment furnished. ...” The lien arising under the NJ Lien Law attaches to the “interest of the owner or unit owner of the real property development ...” and is “limited to the amount that [the owner] agreed in writing to pay ...” less amounts paid by the owner prior to the filing of the lien.

There are various limitations on construction liens under the NJ Lien Law. For example, there generally is no lien if the property owner is no longer indebted to the contractor when the lien was filed. In addition, a lien claimant cannot receive more than (a) the amount the owner had agreed to pay the contractor less payments by or on behalf of the owner prior to the filing at the lien, and (b) the unpaid portion of the contract price owing to the lien claimant.

Significantly, construction liens arising under the NJ Lien Law are only effective as of the date of the filing of the lien. This is in contrast to other states’ lien laws where a timely filed lien relates back to an earlier date, such as when the lien arose under state law.

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The Third Circuit Court of Appeals, in *In re Linear Electric Company Inc.*, recently dealt with New Jersey’s construction lien statute, N.J.S.A. § 2A: 44A. The court held that two creditors that sold goods to an electrical contractor for use in several construction projects had violated the automatic stay that arose in the contractor’s bankruptcy case by filing construction liens against the owner’s interest in the projects after the bankruptcy filing. The court concluded the creditors had violated the stay because, under New Jersey’s lien law, the creditors

The Impact of a Contractor's Bankruptcy Filing on State Law Lien Rights

According to Bankruptcy Code section 362(a), a debtor's bankruptcy filing triggers an automatic stay that bars a wide variety of creditor actions against the debtor and/or the debtor's property, unless the bankruptcy court grants relief from the stay. For instance, sections 362(a)(4) and (a)(5) stay a creditor's creation, perfection, or enforcement of a lien against property of the debtor and/or the debtor's estate.

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Bankruptcy Code section 362(b) creates exceptions to the automatic stay. One such exception is contained in section 362(b)(3). This section permits a creditor to perfect a mechanics' or construction lien subsequent to a contractor's bankruptcy filing to the extent that a bankruptcy trustee's rights and powers are subject to such perfection under section 546(b) of the Bankruptcy Code. Section 546(b)(1), in turn, permits the post-petition perfection of a lien that arose prior to a debtor's bankruptcy filing where applicable nonbankruptcy law permits the perfection to relate back to when the lien arose pre-petition so as to defeat an intervening lien creditor or any other third party that acquired rights in the property prior to perfection. Significantly, the NJ Lien Law lacks any such retroactive perfection of construction lien rights.

Factual and Procedural Background

Cooper Electrical Supply Co. ("Cooper") and Samson Electrical Supply Co. Inc. ("Samson") sold electrical materials to an electrical contractor, Linear Electric Co. Inc. ("Linear"). Linear used these materials in various construction projects. The construction project owners had not fully paid Linear for its work on the projects when Linear had filed its Chapter 11 petition in the United States Bankruptcy Court in New Jersey (the "Bankruptcy Court") on July 1, 2015 (the "Petition Date"). Linear, in turn, still owed Cooper \$1,234,100.48 and Samson \$142,980.17.¹

Two weeks after the Petition Date, both Cooper and Samson filed construction liens against the projects. They argued that their lien filings did not violate the automatic stay in Linear's bankruptcy case because the liens attached to the projects owned by non-debtors and not to assets of the contractor's bankruptcy estate. Thereafter, on July 20, 2015, Linear filed a motion with the Bankruptcy Court seeking to discharge Cooper's and Samson's post-petition lien filings because they had violated the automatic stay in Linear's Chapter 11 case. The Bankruptcy Court directed Cooper and Samson to discharge their liens, ruling that Cooper and Samson had violated the automatic stay

Mind Your Mannerisms— and Your Manners, Too

There are times when I exchange my suit and tie for a polo shirt and jeans when I go on a customer visit. My customers are farmers, and sometimes their office is a barn. At one dairy farm a customer told me to go ahead and take a seat. The seat was a turned-over five-gallon bucket. It was no problem at all. Adapting to the situation and mannerisms of your customer builds rapport.

Any time you have a downturn in the economy and you have industries under pressure, you are going to be asked to do more location visits. Sometimes the sales staff asks me to do more visits because they are having trouble with first-line collections. Or maybe your customer is trying to establish lines of credit and you need to see what additional things you can do, such as getting a personal guarantee. Salespeople are not always comfortable having that conversation with their customers; they need someone else who is more of an expert in the financial arena.

One of the biggest advantages in doing customer visits is establishing trust with that customer. If they don't know who I am and what I look like I'm just an anonymous person on the phone. But after having that conversation, I'm no longer a faceless person; I'm Kevin. When you've established that rapport with a customer, they are more likely to pick up the phone when they see your name on their Caller ID. They are more likely to pay the person who is asking for money.

I have a customer who lives a few miles from me with whom I've worked for 10 years. We're on a first-name basis and we've formed a tradition. Every 26th of December he goes on a trip, but his account is due at the end of the year. He calls me every Christmas Eve to make sure the account gets paid. He has even come to my house on Christmas Eve and given me Christmas presents. He has my number on his cell phone just so that he can call me on Christmas Eve and get his account paid. He wants to make sure the check is in my hands before the end of the year. That rapport we've established has become an enjoyable tradition every year.

Establishing rapport with customers means matching your mannerisms to them. I have some customers that if I approach their farms in a suit and tie, I'd be thrown out. On one visit, the salesperson handed me a ball cap. I asked what it was for. He told me that the customer would not meet with me without a ball cap on. Otherwise, he would think I was a banker or an insurance salesman.

It's fine by me. Building rapport with your customer will pay you back tenfold. And sometimes you get to wear jeans to work, too. ■

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by filing their construction liens post-petition and the liens were, therefore, void *ab initio*.

Both Cooper and Samson appealed the Bankruptcy Court's orders to the United States District Court for the District of New Jersey (the "District Court"). The District Court affirmed the Bankruptcy Court's decisions and both Cooper and Samson then appealed to the Third Circuit.

The Third Circuit's Decision

The Third Circuit held that the construction liens filed by Cooper and Samson after the Petition Date had violated the automatic stay in Linear's bankruptcy case. The court concluded that due to the procedure Cooper and Samson had followed under the NJ Lien Law, the post-petition payment of Cooper's and Samson's liens from Linear's accounts receivable owed by the project owners reduced Linear's receivables, which were property of Linear's estate.²

The Third Circuit noted that construction liens governed by the NJ Lien Law are effective upon filing and do not relate back to prior to the bankruptcy filing when the liens arose. As a result, construction liens in New Jersey are not subject to the exception to the automatic stay contained in section 362(b)(3) and any post-petition filing would violate the stay.

Thus, the key issue in the *Linear* case was whether the construction liens had attached to property of Linear's bankruptcy estate. The Third Circuit concluded that the NJ Lien Law allowed Cooper and Samson to file their construction liens for the value of the materials they had sold to Linear and that Linear had used in the projects. Cooper and Samson had liens both in the projects owned by the nondebtor project owners, which were not property of Linear's bankruptcy estate, and in the accounts receivable the owners owed Linear for its work on the projects, which were property of Linear's estate. Cooper's and Samson's post-petition lien filings violated the automatic stay by enabling them to collect the receivables (Linear's asset) and reduce the amounts the owners owed to Linear by an amount equal to those payments.

The Third Circuit then compared the *Linear* case, governed by the NJ Lien Law, to cases involving analogous facts where the project is located in a state whose construction or mechanics' lien law allows a retroactive perfection of lien rights to a date prior to the bankruptcy filing. In *In re Yobe Electric Inc.*, a case filed in the United States Bankruptcy Court for the Western District of Pennsylvania, a subcontractor (like Cooper and Samson) had filed a mechanics' lien after a general contractor

(like Linear) had filed for bankruptcy. However, unlike *Linear*, the subcontractor's lien in *Yobe Electric* was governed by Pennsylvania's lien law which permits a mechanics' lien to relate back to when the subcontractor had provided goods for the project. Accordingly, since the subcontractor/supplier had provided goods prior to the contractor's bankruptcy filing date in *Yobe Electric*, the subcontractor's timely post-petition perfection of the lien did not violate the automatic stay as a result of the relation back provision under Pennsylvania's lien law.

Conclusion

As the Third Circuit's decision in *Linear* illustrates, mechanics' and construction lien rights vary from state to state and are governed by the lien law of the state where the project is located. A construction lien filing following a contractor's bankruptcy filing in states like New Jersey violates the automatic stay because the lien attaches to property of the contractor's bankruptcy estate (the receivable the project owner owes the contractor), becomes effective post-petition upon the filing of the lien, and does not relate back to an earlier date prior to the bankruptcy filing when the lien arose. That will land the creditor filing the lien in hot water, exposing it to unnecessarily costly and time consuming litigation.

In states with statutes like the NJ Lien Law, the best practice for a construction creditor that learns about a contractor's financial distress is to quickly file its lien prior to the contractor's bankruptcy filing when there is no bankruptcy stay that would otherwise stand in the way. If the contractor files for bankruptcy prior to the creditor's exercise of its lien rights in such states, the automatic stay would preclude any exercise of lien rights, and the creditor would be left with the expensive alternative of moving for relief from the stay to file its lien against the project. However, that would be unnecessary and the creditor would not be barred from timely filing its lien post-petition where the project is located in a state, like Pennsylvania, whose lien law includes a relation back provision.

Aren't lien rights fun!

1 After the Petition Date, Cooper and Samson were paid \$257,026.63 and \$15,755.54, respectively. Consistent with the NJ Lien Law, both claimants reduced their claims to reflect the payments.

2 The Third Circuit rejected Cooper's and Samson's arguments that they had not violated the automatic stay because (i) their liens attached to the real property interests of the non-debtor project owners and not to Linear's property (its accounts receivable), and (ii) Linear did not have any interest in the debts owed by the project owners.

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