To Assert or Not To Assert?

Can Contractors Afford to Wait to Assert Their Lien Rights?

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The Bankruptcy Court for the Eastern District of North Carolina has entered a series of recent rulings that change the landscape for subcontractors and suppliers attempting to assert and preserve Chapter 44A lien rights. In three separate orders, one entered by Judge J. Rich Leonard and two entered by Judge A. Thomas Small, the Bankruptcy Court ruled that, if a subcontractor or supplier has not served its notice of claim of lien on funds before a bankruptcy petition is filed by someone higher up in the contract chain, then its right to a lien on funds is lost. Moreover, because a subcontractor's or supplier's right to a "subrogated" claim of lien on real property is tied directly to the service of a proper notice of claim of lien on funds, the subcontractor's or supplier's right to a claim of lien on the real property is also lost if the notice of claim of lien on funds is not served pre-petition. The rulings will have a detrimental impact on the lien rights of subcontractors and suppliers and may result in general contractors and owners facing an increase in the number of liens filed on construction projects.

Contractor Lien Rights

It has long been recognized under North Carolina law that a party who provides labor or materials to improve real property has the right to assert a lien against funds owed by the property owner or against the improved real property as a means to secure payment for its services. This right is rooted in the North Carolina Constitution, which provides: "[t]he General Assembly shall provide by proper legislation for giving to mechanics and laborers an adequate lien on the subject matter of their labor." N.C. Const., Art. X, Sec. 3. The North Carolina General Assembly adopted Article 2 of Chapter 44A of the North Carolina General Statutes based on this constitutional mandate.

> *"...it WAS commonly accepted practice in N.C. Bankruptcy Cases to serve the non-debtor property owner with a notice of claim of lien on funds, accompanied by a claim of lien on real property...this practice has been abolished."*

Chapter 44A provides for two different types of liens depending upon the relationship of the contractor or supplier to the property owner. Chapter 44A provides for a claim of lien that can be asserted against the improved real property. There are three situations in which such a lien can be asserted: where the contractor or supplier contracts directly with the owner of the real property (N.C.G.S. § 44A-8); where a first through third tier subcontractor or supplier perfects its subrogation lien rights in the real property (N.C.G.S. § 44A-23); and where a subcontractor or supplier of any tier acquires a

direct lien on the real property due to the owner making a payment to a party higher in the chain after receipt of the subcontractor's or supplier's notice of claim of lien on funds (N.C.G.S. § 44A-20). For parties who contract with someone other than the property owner, Chapter 44A also provides for a claim of lien against funds held by the property owner that are owed to a party higher in the contract chain than the party asserting the lien. N.C.G.S. § 44A-18.

If the party asserting lien rights fully complied with both the procedural and timeliness requirements set forth in Chapter 44A[i], prior North Carolina practice recognized that the right of payment was protected to the extent funds remained due and owing from the property owner regardless of whether there was an intervening bankruptcy filed by another party in the contract chain. In fact, it was commonly accepted practice in North Carolina bankruptcy cases for subcontractors and suppliers with unasserted lien rights to serve the non-debtor property owner with a notice of claim of lien on funds, accompanied by a claim of lien on real property. This practice was well recognized in the Eastern District of North Carolina. *See* **In re Sigma Construction Co., Inc.**, Case No. 01-01522-8-ATS (Bankr. E.D.N.C. Nov. 2, 2001) (Court approval was not needed in order to serve a notice of claim of lien on funds and a claim of lien on real property owned by a non-debtor); *see also* **In re Denmark Construction, Inc.**, Case No. 08-02764-8-RDD (Bankr. E.D.N.C. May 29, 2008).

The recent trilogy of cases from the Eastern District has abolished this practice and, more importantly, a subcontractor's or supplier's ability to preserve lien rights post-petition.

Recent Eastern District of North Carolina Bankruptcy Court Decisions

The recent Eastern District cases addressed whether a subcontractor or supplier actually possesses an interest in funds owed to the debtor prior to service of the notice of claim of lien on funds. The timing of when the interest in property of the estate is created is determinative of whether the right survives the debtor's bankruptcy filing.

The commencement of a bankruptcy case creates a bankruptcy estate. Generally speaking, any interest of the debtor in property as of the petition date is property of the bankruptcy estate. Pursuant to 11 U.S.C. § 541, property of the estate includes, among other things: (1) all legal or equitable interests of the debtor in property; and (2) proceeds, product, offspring, rents, or profits of property of the estate. 11 U.S.C. § 541.

Rights in estate property are closely guarded by the Bankruptcy Code. To that end, 11 U.S.C. § 362(a)(4) imposes an automatic stay against any entity (including a subcontractor or supplier of the debtor) of any act to create, perfect or enforce any lien against property of the estate. Any attempt to pursue such rights post-petition is a violation of the automatic stay, which voids the act attempted and can result in the offending party being sanctioned by the Bankruptcy Court. 11 U.S.C. § 362(k).

In re Shearin Family Investments, LLC

The recent challenges to the validity of subcontractors' or suppliers' post-petition efforts to serve and enforce liens on funds began with an order entered in the case of **Shearin Family Investments, LLC**, Case No. 08-07082-8-JRL (Bankr. E.D.N.C. April 17, 2009) ("**Shearin**"). The debtor in **Shearin** was a landowner and developer that filed a petition for relief under Chapter 11 of the Bankruptcy Code. In **Shearin**, subcontractors and suppliers challenged the debtor in possession's right to receive post-petition financing free and clear of liens which they asserted against project funds. The Bankruptcy Court determined that the subcontractors and suppliers had no right to the funds as their notices of liens on funds had been served post-petition in violation of the automatic stay.

Section 362(b)(3) provides an exception to the automatic stay that allows perfection of a lien to "relate back" to the time the lien was created. The **Shearin** court found that the lien claimants did not fit the exception of § 362(b)(3) as a notice of a claim of lien on funds "creates" a lien and does not simply "perfect" a lien. The court

noted that the statute creating the lien on funds, N.C.G.S. § 44A-18(1), is written in the future tense, suggesting that no lien arises until it is perfected by giving notice and made effective upon receipt.

In re Harrelson Utilities, Inc. & In re Mammoth Grading, Inc.

The issue arose again in the cases of **Harrelson Utilities, Inc.**, Case No. 09-02815-8-ATS (Bankr. E.D.N.C. July 30, 2009) ("**Harrelson**"), and **Mammoth Grading, Inc.**, Case No. 09-01286-8-ATS (Bankr. E.D.N.C. July 31, 2009) ("**Mammoth**"). Judge Small held a joint hearing in the **Harrelson** and **Mammoth** cases to address the numerous motions filed by various parties with regard to the lien issues.

Harrelson involved a utilities contractor that filed Chapter 11 and continued operating as a debtor in possession. Several subcontractors and suppliers served notices of claims of lien on funds and filed claims of lien on real property post-petition without seeking relief from the automatic stay. Based upon the ruling in **Shearin**, the debtor challenged the liens as improper attempts to create liens post-petition in violation of the automatic stay. While the subcontractors and suppliers argued that their actions were consistent with long standing practice and permissible under the § 362(b)(3) exception to the automatic stay, the debtor argued that the subcontractors and suppliers should be sanctioned because their actions were in willful violation of the automatic stay following the **Shearin** order.

The debtor in **Mammoth** was a site development contractor that filed a petition for relief under Chapter 7 of the Bankruptcy Code. Post-petition a number of subcontractors and suppliers served notices of claims of lien on funds and claims of lien on real property upon the owners of various projects on which the debtor had worked. Relying on **Shearin**, the Chapter 7 Trustee challenged the lien claims and opposed the subcontractors' and suppliers' efforts to seek relief from the automatic stay in order to file state court actions to perfect their claims of lien on real property of owners holding contract proceeds owed to the debtor.

In analyzing the subcontractors' and suppliers' rights in **Harrelson** and **Mammoth**, the court considered whether a subcontractor or supplier is permitted to assert a claim of lien on funds pursuant to N.C.G.S. § 44A-18(6) post-petition without violating the automatic stay imposed by 11 U.S.C. § 362. Specifically, the **Harrelson/ Mammoth** court considered the interplay between 11 U.S.C. § 362(b)(3) and Chapter 44A of the North Carolina General Statutes. [ii]

Whether the § 362(b)(3) exception to the automatic stay applies is a matter of federal bankruptcy law. However, application of the § 362(b)(3) exception is dependent upon an assessment of when the interest of the subcontractor or supplier in the funds is created under North Carolina state law. Section 362(b)(3) provides that a bankruptcy petition does not operate as a stay "of any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection under 11 U.S.C. § 546(b) of this title or to the extent that such act is accomplished within the period provided under 11 U.S.C. § 547 (e)(2)(A)." Thus, if the subcontractor's or supplier's lien right in funds owed to the debtor is created prior to the giving of the notice of the lien, then the exception contained in § 362(b)(3) applies. However, if the right to the lien is created only at the time of and as a result of the subcontractor or supplier giving actual notice to the party holding the funds, then the exception does not apply.

Section 362(b)(3) allows perfection of a lien to relate back to the time the lien was created. Thus, retroactive perfection supersedes the rights of the trustee or hypothetical bona fide purchaser to the extent the strong arm powers are subject to perfection under § 546(b) or perfection is achieved within the grace period of § 547(e)(2)(A).

Section 546(b) provides:

> The rights and powers of a trustee under sections 544, 545, and 549 of this title are subject to any generally applicable law that –

(A) permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection; or

(B) provides for the maintenance or continuation of perfection of an interest in property to be effective against an entity that acquires rights in such property before the date on which action is taken to effect such maintenance or continuation.

In evaluating the extent to which a subcontractor or supplier has an "interest in property" so as to fall within the exception, the **Harrelson/ Mammoth** court evaluated the two types of liens created by Chapter 44A. First, Chapter 44A, Article 2, Part 1 sets forth the lien rights afforded parties who contract directly with the property owner, providing "[a]ny person who performs or furnishes labor . . . or furnishes materials . . . pursuant to a contract . . . with the owner of real property for the making of an improvement thereon shall, upon complying with the provisions of this Article, have a right to file a claim of lien on the real property to secure payment of all debts owing for labor done . . . or materials furnished . . . pursuant to the contract." N.C.G.S. § 44A-8. This claim of lien is deemed perfected upon the filing of the lien. N.C.G.S. § 44A-12. Under North Carolina law the claim of lien "relates back" to the time of the first furnishing of labor or materials by the person claiming the lien, and the lien has priority over any other liens or encumbrances that arise after the date of the claimant's first furnishing of labor or materials to the project site. N.C.G.S. § 44A-10.

Likewise, Chapter 44A, Article 2, Part 2 provides for two types of lien rights for subcontractors and suppliers: (1) a claim of lien on funds owed by the property owner to a party higher in the contract chain; and (2) the right to assert, by subrogation, a claim of lien against the improved real property. N.C.G.S. § 44A-18 and § 44A-23. The right of a subcontractor or supplier to pursue a claim of lien on the property, by subrogation, is dependent upon the proper service of a notice of claim of lien on funds. N.C.G.S. § 44A-23(a) and (b). The lien on funds is perfected upon the giving of notice of claim of lien on funds in writing to the obligor as provided in N.C.G.S. 44A-19 and is effective upon the obligor's receipt of the notice. N.C.G.S. § 44A-18(6). A lien on funds has "priority over all other interests or claims theretofore or thereafter created or suffered in the funds by the person against whose interest the lien on funds is asserted, including, but not limited to, liens arising from garnishment, attachment, levy, judgment, assignments, security interests, and any other type of transfer, whether voluntary or involuntary." N.C.G.S. § 44A-22. In the event there are insufficient funds to satisfy all properly asserted claims of lien on funds, then the subcontractors and suppliers having competing lien claims against the funds are entitled to receive a pro rata share of the funds available. N.C.G.S. § 44A-21.

Upon analyzing the interplay of these provisions of the Bankruptcy Code and the North Carolina General Statutes, the **Harrelson/Mammoth** court concluded that, while North Carolina law gives a priority to subcontractors and suppliers with a properly perfected lien on funds, it does not give them any interest in the funds prior to their proper service of a notice of claim of lien on funds. N.C.G.S. §§ 44A-18(6) and 19(d). The court held that until the notice of claim of lien on funds is served, the subcontractor or supplier only possesses an entitlement to a lien, and an entitlement is not the same as an interest in property. The court found that a lien on funds is deemed "empty, imprecise, indeterminate and illusive, and, in essence, it does not exist until notice is served on the obligor pursuant to § 44A-19(d)." Thus, the owner holding funds owed to the debtor is not impacted by the existence of the subcontractor's or supplier's entitlement to a lien and may act with impunity in releasing those funds to other parties. It is only upon receipt of the notice of the claim of lien on funds that the owner must withhold the funds.

Based on this analysis, the **Harrelson/Mammoth** court held that any post-petition effort to assert a lien on funds is not an act to perfect a pre-existing interest in property that would fall within the § 362(b)(3) exception. Rather, it would be an effort to create a lien on property of

the bankruptcy estate, which is expressly prohibited by the automatic stay. In addition, the court noted that in order to have a valid subrogation lien on real property, the subcontractor or supplier must first have a valid lien on funds. Since the post-petition notices of lien were void, the court determined that the post-petition subrogation liens on real property were void as well.

While recognizing the far reaching implications of its decision on subcontractors and suppliers (and potentially the construction industry as a whole), the **Harrelson/Mammoth** court emphasized that disallowing the post-petition assertion of liens on funds is consistent with the guiding principle of the Bankruptcy Code which is "to secure equal distribution among creditors." Accordingly, the court directed that all post-petition liens on funds asserted by the subcontractors and suppliers be cancelled and all accompanying claims of lien on real property be removed from the public record. Despite this conclusion, the court refused to impose sanctions on the subcontractors and suppliers for having asserted the liens on funds in violation of the automatic stay, recognizing that the subcontractors and suppliers had acted in accordance with what had been the prevailing practice for many years prior to **Shearin** and was consistent with a reasonable understanding of the law. As well, the **Harrelson/Mammoth** court granted subsequent motions of various subcontractors and suppliers to stay the enforcement of these rulings as to those parties until the issues could be considered by the appellate court. Both the **Harrelson** and the **Mammoth** decisions are now on appeal to the United States District Court for the Eastern District of North Carolina.

It is important to note that there was no change in either the applicable North Carolina statutes creating lien rights or the Bankruptcy Code that prompted the reversal in the handling of subcontractor and supplier lien rights. In addition, in its analysis of the issues, the court did not place significance on the differing facts giving rise to the subcontractor or supplier lien claims, or the fact that the cases arose under different chapters of the Bankruptcy Code.

An open issue remains with regard to whether service of a notice of claim of lien on funds and claim of lien on real property within 90 days of the petition date can be challenged as a preference under 11 U.S.C. § 547(b) and deemed an invalid transfer. In the **Mammoth** order, the court recognized this is an open issue, but it did not signal how the issue might be resolved other than to say that it would need to be addressed in a separate adversary proceeding.

Implications for the Construction Industry

The effect of the loss of post-petition lien rights by subcontractors and suppliers is that: (1) it takes away a subcontractor's or supplier's right to the contract proceeds due to the debtor on a project; (2) the subcontractor or supplier loses its status as a secured creditor in a bankruptcy case; and (3) the subcontractor or supplier loses the right to a subrogation lien on the real property upon which it provided labor or materials. As such, a subcontractor or supplier that has not perfected its liens pre-petition will likely be deemed an unsecured creditor in the bankruptcy case, which often equates to only minimal or no recovery from the estate.

The subcontractors and suppliers in **Harrelson** and **Mammoth** argued that negating the long standing practice that allowed the post-petition assertion of claims of lien on funds will have far reaching implications on the construction industry. It was argued that such implications may include prompting a substantial increase in premature lien filings, providing incentive for owners and general contractors to file bankruptcy in order to redirect contract proceeds to banks or other secured lenders in satisfaction of personally guaranteed debts, altering the clear intent of the N.C. Constitution and lien statutes, and creating a windfall for creditors who did nothing to generate the revenue for the estate.

Contractors throughout North Carolina should be aware of the risks outlined above. With this new line of cases, it is foreseeable that subcontractors and suppliers may be quick to file liens upon any indication of financial trouble with parties up the contract chain, and that "protective liens" may be filed more frequently upon the delivery of materials or in connection

with payment applications. If so, then general contractors and owners may see a marked increase in lien filings that could trigger lien "bond-off" obligations in contracts with owners and lenders.

Conclusion

The **Shearin**, **Harrelson** and **Mammoth** cases create risks for the unsuspecting subcontractor or supplier that continues to conduct business as usual. A subcontractor or supplier that is not cautious with outstanding receivables and diligent in pursuing lien rights may lose those rights upon the filing of a bankruptcy case. Just as importantly, however, a subcontractor or supplier runs the risk of violating the automatic stay by unknowingly serving a post-petition notice of claim of lien on funds as had been the well established practice in the Eastern District of North Carolina prior to these cases.

If not overturned at the appellate level, these decisions will have far reaching implications for the construction industry in North Carolina, especially given the struggles facing the industry in this challenging economic climate and with the increasing number of bankruptcy cases being filed by construction related companies in our state.

End Notes

i. The North Carolina courts closely scrutinize lien documents and will void liens that fail to comply with the technical and timeliness requirements set forth in Chapter 44A. It is beyond the scope of this article to provide a detailed discussion concerning the Chapter 44A procedural requirements for asserting lien claims.

ii. After conducting a joint hearing on the lien issues in both the **Harrelson** and **Mammoth** cases, the court entered separate orders in the two cases. The court's order in **Harrelson** contained a detailed legal analysis of the relevant lien statutes and bankruptcy code provisions. In **Mammoth**, in a less detailed order, the court referred to the order entered in **Harrelson** for justification of its ruling in **Mammoth**.

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