



Materialman's Lien Rights: Post-Petition Perfection Approved

A mechanic's or materialman's lien is a state law lien granted to secure payment of the claims of creditors that supply goods and/or labor to improve real property. While all states have mechanic's or materialman's lien laws, their lien laws differ in the manner in which these liens arise and are perfected.

Mechanic's and materialman's liens generally attach to the debtor's real property. North Carolina's lien law, contained in Chapter 44(A) of the North Carolina General Statutes, (the North Carolina Lien Law) sets forth the requirements for a contractor and subcontractor on a North Carolina construction project to obtain and perfect their lien rights. Contractors and subcontractors, who deal directly with the owner of real property and satisfy the requirements of the statute, obtain lien rights in the owner's real property. According to Section 44A-18, the provision of the North Carolina Lien Law at issue in the case discussed in this article, a subcontractor, who deals with someone other than the owner of real property and satisfies the statute's requirements, also obtains a lien in funds owed on account of the construction project for which the subcontractor had provided goods and/or services. This lien in project funds arises upon the subcontractor's delivery of goods and/or the provision of services. The lien is perfected upon the creditor's providing written notice of the lien.

The subcontractors invoked an exception to the automatic stay that allows a creditor to perfect its lien rights post-petition.

Recently, the United States Court of Appeals for the Fourth Circuit, in *In re Construction Supervision Services, Inc.*, ruled in favor of the subcontractors who provided goods to their customer on various North Carolina construction projects, prior to the customer's bankruptcy filing, and then sought to perfect their "inchoate" lien rights in project proceeds during the bankruptcy case. The subcontractors argued that they were not barred by the automatic stay from perfecting their lien rights post-petition by giving post-petition notice of their liens. The subcontractors invoked an exception to the automatic stay that allows a creditor to perfect its lien rights post-

petition if such rights are an "interest in property" on the bankruptcy filing date and state law allows such perfection to relate back to the creation of the lien and be effective against third parties with a perfected pre-petition interest in the same property.

The Fourth Circuit ruled that the subcontractors satisfied Section 362(b)(3)'s stay exception and could, therefore, perfect their lien rights post-petition. That enabled the subcontractors to obtain priority status in project funds over the rights of the debtor's lender with a perfected blanket security interest in the funds. Quite a nifty little device. Read on to see why!

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

According to Bankruptcy Code Section 362(a), a debtor's bankruptcy filing triggers the automatic stay. The automatic stay 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. So does the stay bar a creditor from perfecting its lien rights post-petition? Not so fast!

Bankruptcy Code Section 362(b) creates exceptions to the automatic stay. One such exception, contained in Section 362(b)(3), permits a creditor "...to perfect..., an *interest in property* to the extent that the trustee's rights and powers are subject to such perfection under section 546(b) [of the Bankruptcy Code]..." This stay exception applies to mechanic's and other lien creditors that can satisfy Bankruptcy Code Section 546(b).

Section 546(b)(1) states that a bankruptcy trustee's rights

"...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 such perfection...."

Section 546(b)(1) permits the post-petition perfection of a property interest, that arose prior to a debtor's

bankruptcy filing, to be effective against any third party that acquired rights in the property prior to the date of perfection.

The automatic stay, therefore, does not prevent a mechanic's or materialman's lien creditor, whose lien arose prior to bankruptcy, from perfecting its lien post-petition. This is conditioned on state law that permits a creditor's perfected lien rights to relate back to their creation and have priority over any other entity acquiring rights in the property prior to perfection, such as the debtor's secured lender with a perfected pre-petition security interest in the same asset.

The Fourth Circuit, in the *Construction Supervision Services* case, ruled that "inchoate" unperfected mechanic's or materialman's lien rights in North Carolina are "interests in property" that could be perfected post-petition and have priority over pre-petition perfected security interests under the North Carolina Lien Law. As such, the subcontractors in that case are not barred by the automatic stay from perfecting their pre-petition unperfected "inchoate" lien rights during the debtor's bankruptcy case by dispatching notices of lien.

North Carolina's Lien Law: Chapter 44(A)

The North Carolina lien statute at issue in the *Construction Supervision Services* case, North Carolina General Statute §44A-18, addresses the lien rights of subcontractors who dealt with someone other than the owner of real property.

According to North Carolina General Statute §44A-18, a subcontractor that furnishes labor, common materials or rental equipment on a construction project can assert a lien on the monies owed on that project. Subcontractors have two different types of lien rights. First, all subcontractors have a lien on the funds owed by the party directly above them in the contract chain. Additionally, second and third tier subcontractors have a lien on the funds owed to entities in the contract chain above the party with whom the second or third tier subcontractor had contracted.

This lien in project funds arises when a subcontractor provides material, labor or rental equipment to the contractor on the project. The lien is then perfected when the subcontractor gives written notice of its lien to all parties above the subcontractor in the lien chain, including all higher tiered subcontractors, the general contractor and the owner of the property.

Finally, North Carolina General Statute §44A-22 contains the priority rules governing creditors whose liens in project funds arise under the North Carolina Lien Law. Those lien claimants that perfect their lien rights have priority over creditors with security interests and other lien rights in the funds.

The Facts of the Construction Supervision Services Case
Construction Supervision Services (CSS) was a full-service construction company that acted as a general contractor or a

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first-tier subcontractor on various construction jobs. CSS had placed orders with several first-tier and second-tier suppliers (the Subcontractors) to purchase stone, concrete and fuel to run equipment and furnish rental equipment on various construction projects (the Projects). The Subcontractors delivered goods to CSS, for use on the Projects, on open account and later invoiced CSS for the amounts owed the Subcontractors.

CSS filed a Chapter 11 bankruptcy petition in January 2012. When CSS had filed its Chapter 11 case, the Subcontractors had unperfected “inchoate” lien rights under the North Carolina Lien Law in the proceeds of the Projects for which they had provided goods. However, the Subcontractors had not perfected their lien rights pre-petition.

Branch Banking and Trust (BB&T) was CSS’ secured lender when CSS had filed its Chapter 11 case. CSS owed BB&T in excess of \$1 million. BB&T’s claim against CSS was secured by, among other assets, CSS’s accounts receivable, including the Project funds that the Subcontractors claimed were subject to their lien rights.

All subcontractors have a lien on the funds owed by the party directly above them in the contract chain.

After CSS’s bankruptcy, the Subcontractors had sought to serve notice of and thereby perfect their lien rights on funds third parties owed CSS on the Projects. The Subcontractors sought an order from the bankruptcy court declaring that they were not barred by the automatic stay from perfecting their lien rights post-petition in Project funds. The Subcontractors invoked Section 362(b)(3)’s stay exception applicable to pre-petition property interests the post-petition perfection of which would be effective against third parties who acquired a perfected pre-petition interest in this property. The Subcontractors claimed their liens arose pre-petition and once perfected (even post-petition) would be effective against all third parties, like BB&T with a valid and perfected pre-petition security interest in Project funds.

BB&T argued that the automatic stay prevented the Subcontractors from perfecting their lien rights post-petition. According to BB&T, the Subcontractors could not invoke Section 362(b)(3)’s stay exception because their unperfected lien rights in project proceeds were not an “interest in property” of CSS.

The bankruptcy court ruled in favor of the Subcontractors. The court held: (a) the Subcontractors’ unperfected “inchoate” lien rights were “interests in property” of CSS because their lien rights arose upon their delivery of goods for the Projects (*i.e.*, before lien notice and perfection) and (b) once perfected, their liens related back to their creation pre-petition. This satisfied Section 362(b)(3)’s exception to the automatic stay and thereby enabled the Subcontractors to perfect their lien rights post-petition by serving their lien notices.

BB&T appealed to the District Court. The District Court, affirming the bankruptcy court, also held that the Subcontractors’ post-petition notice and perfection of their lien rights did not violate the automatic stay.

That led to BB&T’s appeal to the Fourth Circuit.

The Fourth Circuit’s Decision

The Fourth Circuit ruled that Section 362(b)(3)’s automatic stay exception permitted the Subcontractors to provide notice of and thereby perfect their lien rights in funds generated by the Projects subsequent to CSS’ bankruptcy filing. The court held the Subcontractors’ “inchoate” unperfected lien rights that arose pre-petition were an “interest in property.”

The court relied on North Carolina General Statute §44A-18 that grants a subcontractor a lien upon funds owed to the contractor or subcontractor with whom the subcontractor had dealt, arising out of the improvements on which the subcontractor had worked or furnished materials. Section 44A-18 further states that a lien on funds created “under this section shall secure amounts earned by the lien claimant as a result of having furnished labor, common materials or rental equipment at the site of the improvement under the contract to improve real property....” As a result, the Subcontractors’ lien rights arose upon the delivery of their goods and equipment to the construction project prior to the commencement of CSS’ bankruptcy case.

The Fourth Circuit held that the Subcontractors’ perfected “inchoate” lien rights were an “interest in property.” There was no dispute that, before CSS’ bankruptcy, the Subcontractors had delivered materials and equipment to CSS for its numerous construction projects. Under the North Carolina Lien Law, the Subcontractors’ lien rights, therefore, arose pre-bankruptcy upon delivery of the materials and equipment for use on the Projects.

The Fourth Circuit also noted that according to Section 362(b)(3), the automatic stay does not apply to the post-petition perfection of lien rights as long as this constitutes an “act to perfect. . . , an *interest in property* to the extent that the trustee’s rights and powers are subject to such perfection under section 546(b)...” Section 546(b), in turn, subjects a bankruptcy trustee’s rights and powers to generally applicable law that “...permits perfection of an *interest in property* to be effective against an entity that acquires rights in such property before the date of perfection....”

Applying both Sections 362(b)(3) and 546(b), the Fourth Circuit concluded that the Subcontractors’ lien rights arose prior to CSS’ bankruptcy filing when they had delivered goods for the Projects, and were, therefore, an interest in property of CSS. In addition, pursuant to the North Carolina Lien Law, once the Subcontractors had perfected their lien rights post-petition by providing the requisite notices, their lien rights related back to their pre-petition delivery of goods. As a result, the Subcontractors had satisfied Section 362(b)(3) and were

not barred by the automatic stay from noticing (*i.e.*, perfecting) their pre-petition inchoate lien rights (*i.e.*, their interest in property) post-petition.

The Fourth Circuit relied on the Seventh Circuit Court of Appeal's decision in *In re AR Accessories Group, Inc.* In that case, a government agency, invoking Wisconsin law, asserted a statutory wage lien on the property of an employer that

The agency timely perfected its wage lien post-petition when it had filed a verified petition claiming the lien.

failed to pay its employees. The Seventh Circuit held the wage lien arose and was an interest in the employer's property prior to the employer's bankruptcy filing when the employees performed their last unpaid services. The agency timely perfected its wage lien post-petition when it had filed a verified petition claiming the lien. The court noted that the agency's post-petition perfection of its lien rights did not violate the stay because the lien arose pre-petition, and, under Wisconsin law, was granted superpriority rights over the rights of the employer's secured lender and other creditors.

The Fourth Circuit also rejected recent decisions by the United States Bankruptcy Court for the Eastern District of North Carolina that subcontractors' lien rights in project funds could not be perfected post-petition because their unperfected "inchoate" lien rights were not an "interest in property." The Fourth Circuit relied on a recent amendment to the North Carolina

Lien Law (§44A-18) that entitled a subcontractor to a lien on project funds as soon as goods and services are delivered.¹

Conclusion

The Fourth Circuit's decision is great news for creditors providing goods and/or services on construction projects in North Carolina and elsewhere. Once a subcontractor obtains a perfected lien in funds derived from a North Carolina construction project for which the subcontractor had provided goods and/or services, the subcontractor has a priority right to the project funds that is ahead of its customer's secured lender with a prior perfected security interest in the customer's accounts. Perfection and this priority occur notwithstanding the customer's bankruptcy filing and the resulting automatic stay. What a nice automatic stay exception to contend with! ▀

1. The court considered the amendment to the North Carolina Lien Law, even though the amendment became effective after the Subcontractors' claims arose, because the North Carolina legislature considered it a clarifying amendment.

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