

# Enforcing Lien Rights When a Party in the Construction Supply Chain Files for Bankruptcy

Presented by:

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**Tucker  
Ellis | LLP**  
Lead by example.

**Chris Ring**

National Sales Representative

NACM's Secured Transaction Services

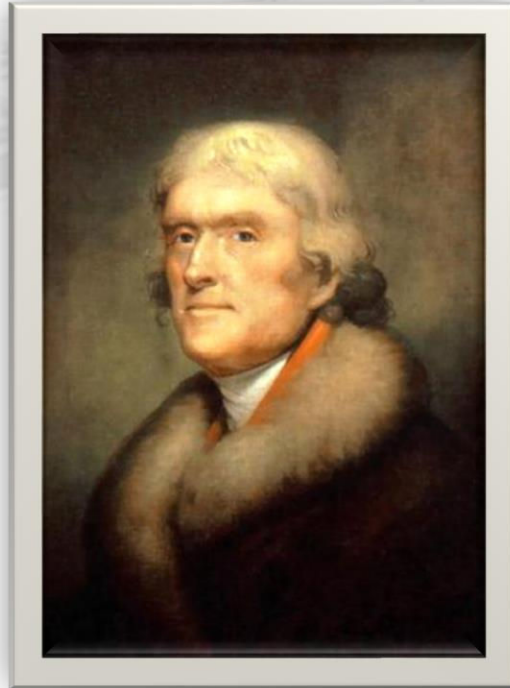
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*Driving results*

Thomas Jefferson wrote the first Mechanic's Lien Statute for Maryland in 1791



Jefferson frequently used the word  
*“Encourage”*.

# Five Cs of credit

- **Character**

The creditability of your customer.

- **Capacity**

Your customer's ability to manage their business.

- **Conditions**

The internal and external forces that we need to know about that affect the customer's business.

- **Capital**

The customer's worth.

- **Collateral**

Property pledged as a security to pay an obligation or loan.

*If you reduce risk, you can sell more*


**\$5,000 credit line**  
**14% Interest rate**



**\$500,000 credit line**  
**4% Interest rate**





The background of the slide is a collage of various US dollar bills, including \$100, \$50, and \$20 bills, scattered across the frame. The bills are slightly faded and overlapping, creating a textured, financial theme. Two text boxes are overlaid on this background: a green one at the top and a red one in the center.

**\$15,000 write off on an order with 3% margin**

**Sales has to generate \$500,000 in new business to offset that loss**



### JOB INFORMATION SHEET

Customer: \_\_\_\_\_ Phone: \_\_\_\_\_ Email: \_\_\_\_\_  
 Street Address: \_\_\_\_\_  
 City: \_\_\_\_\_ State: \_\_\_\_\_ ZIP: \_\_\_\_\_  
 Customer:  Owner  General Contractor  Subcontractor  Material Supplier  Leasehold Interest  
 Supplier to Supplier  Public/Private Partnership (P3)  Sub-subcontractor  Commercial Useful Function Verified

#### PROJECT INFORMATION

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_  
 SCR Number \_\_\_\_\_ MNLN Number \_\_\_\_\_  
(BY REGISTRATION ONLY) (BY REGISTRATION)  
 Registry Number \_\_\_\_\_  
(PA and HQ)

#### PROPERTY OWNER/AWARDING AUTHORITY

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

#### PROPERTY LEASEHOLDER

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

#### LENDER - (CA & AZ Projects Only)

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

#### ARCHITECT

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_

#### ARCHITECT (continued)

PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

#### PRIME CONTRACTOR

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

#### PRIME'S BONDING COMPANY Is this a private bonded job?

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

#### SUBCONTRACTOR (if other than customer)

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

#### SUB'S BONDING COMPANY

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

Estimated Quantity: \_\_\_\_\_ Estimated Dollar Value: \_\_\_\_\_  
 Rental: Estimated Monthly Fee: \_\_\_\_\_ Estimated Term of Rental: \_\_\_\_\_  
 This job will have:  One furnishing  Several furnishings First furnishing date: \_\_\_\_\_ Last furnishing date: \_\_\_\_\_  
 Tax Exempt - Send exemption certificate with job sheet.  
 Signature: \_\_\_\_\_ Date: \_\_\_\_\_ Company: \_\_\_\_\_



Driving results

# Construction Credit has unique terminology

**Retainage**

**Back Charge**

**Pay if Paid**



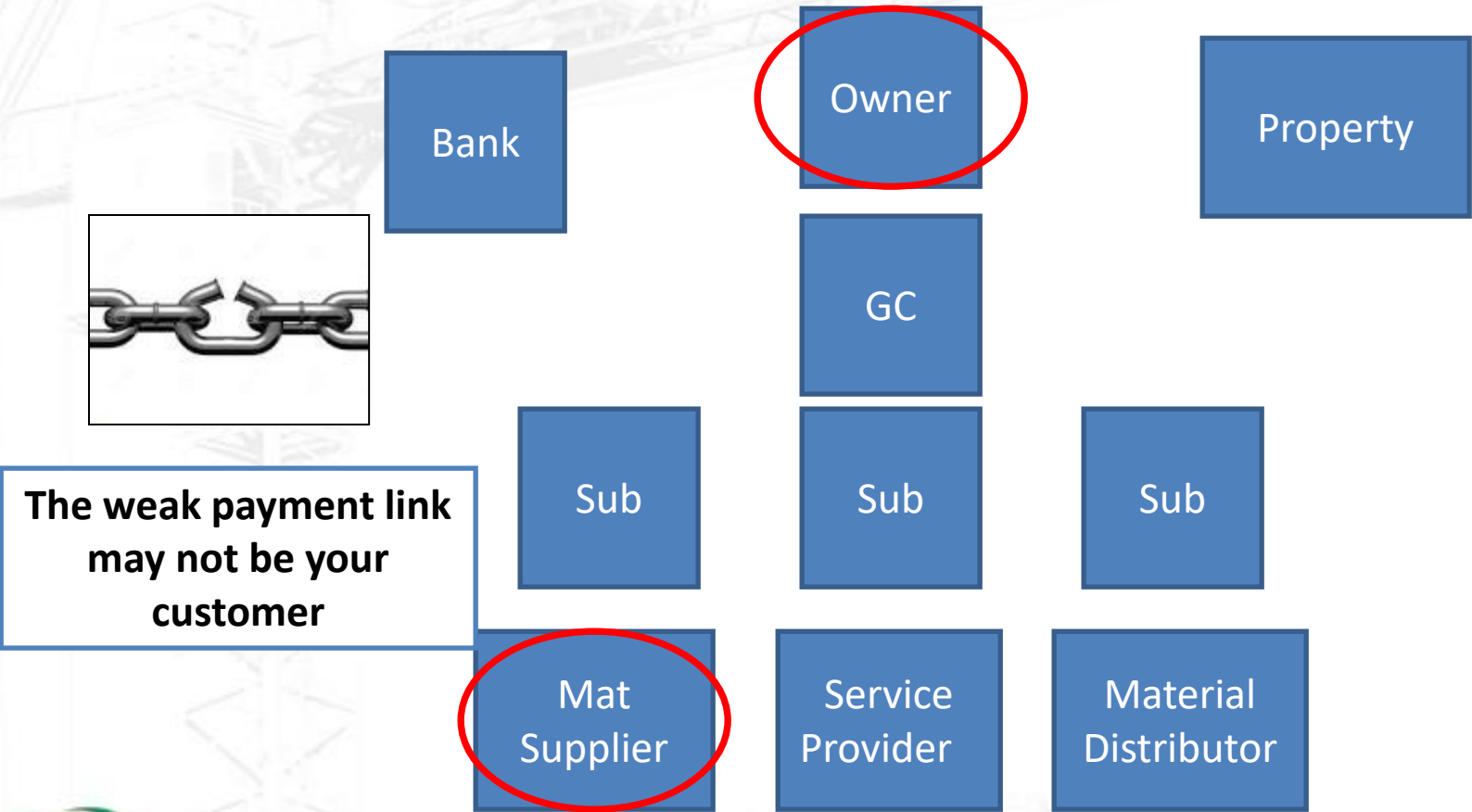
# Unique Collection Objection



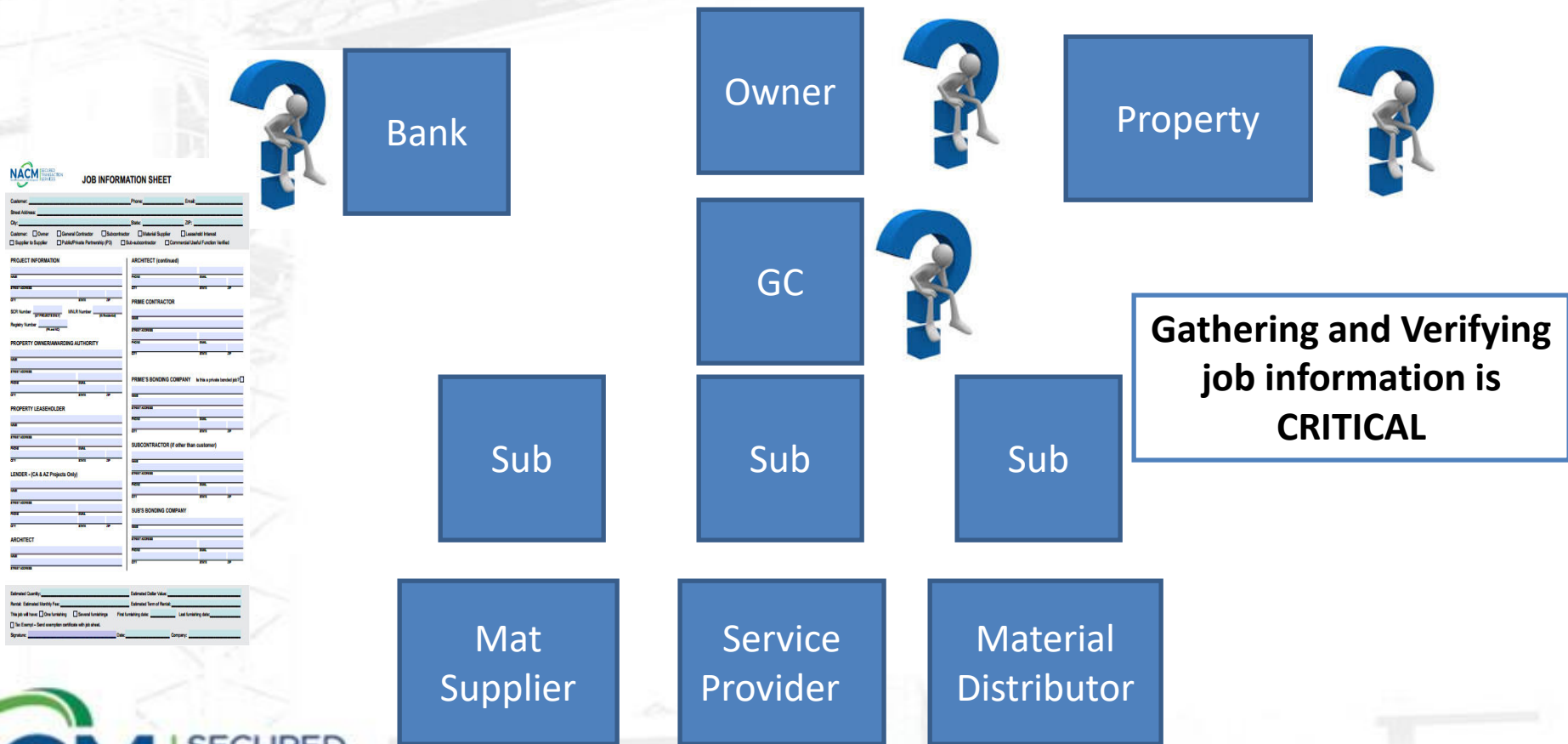
Can't pay you, I haven't been paid!



# Construction Credit is Unique



# Construction Credit is Unique



### JOB INFORMATION SHEET

Customer: \_\_\_\_\_ Phone: \_\_\_\_\_ Email: \_\_\_\_\_  
 Street Address: \_\_\_\_\_  
 City: \_\_\_\_\_ State: \_\_\_\_\_ ZIP: \_\_\_\_\_  
 Customer:  Owner  General Contractor  Subcontractor  Material Supplier  Leasehold Interest  
 Supplier to Supplier  Public/Private Partnership (P3)  Sub-subcontractor  Commercial Useful Function Verified

**PROJECT INFORMATION**

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_  
 SCR Number \_\_\_\_\_ (DI/PRO/SEC/ONLY) MNLN Number \_\_\_\_\_ (A/RES/COM)  
 Registry Number \_\_\_\_\_ (PA and HQ)

**PROPERTY OWNER/AWARDING AUTHORITY**

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

**PROPERTY LEASEHOLDER**

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

**LENDER - (CA & AZ Projects Only)**

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

**ARCHITECT**

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_

**ARCHITECT (continued)**

PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

**PRIME CONTRACTOR**

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

**PRIME'S BONDING COMPANY** Is this a private bonded job?

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

**SUBCONTRACTOR (if other than customer)**

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

**SUB'S BONDING COMPANY**

NAME \_\_\_\_\_  
 STREET ADDRESS \_\_\_\_\_  
 PHONE \_\_\_\_\_ EMAIL \_\_\_\_\_  
 CITY \_\_\_\_\_ STATE \_\_\_\_\_ ZIP \_\_\_\_\_

Estimated Quantity: \_\_\_\_\_ Estimated Dollar Value: \_\_\_\_\_  
 Rental: Estimated Monthly Fee: \_\_\_\_\_ Estimated Term of Rental: \_\_\_\_\_  
 This job will have:  One furnishing  Several furnishings First furnishing date: \_\_\_\_\_ Last furnishing date: \_\_\_\_\_  
 Tax Exempt - Send exemption certificate with job sheet.  
 Signature: \_\_\_\_\_ Date: \_\_\_\_\_ Company: \_\_\_\_\_

**Who Gathers the job information**

**Who VERIFIES the job information**

## **Recent Poll:**

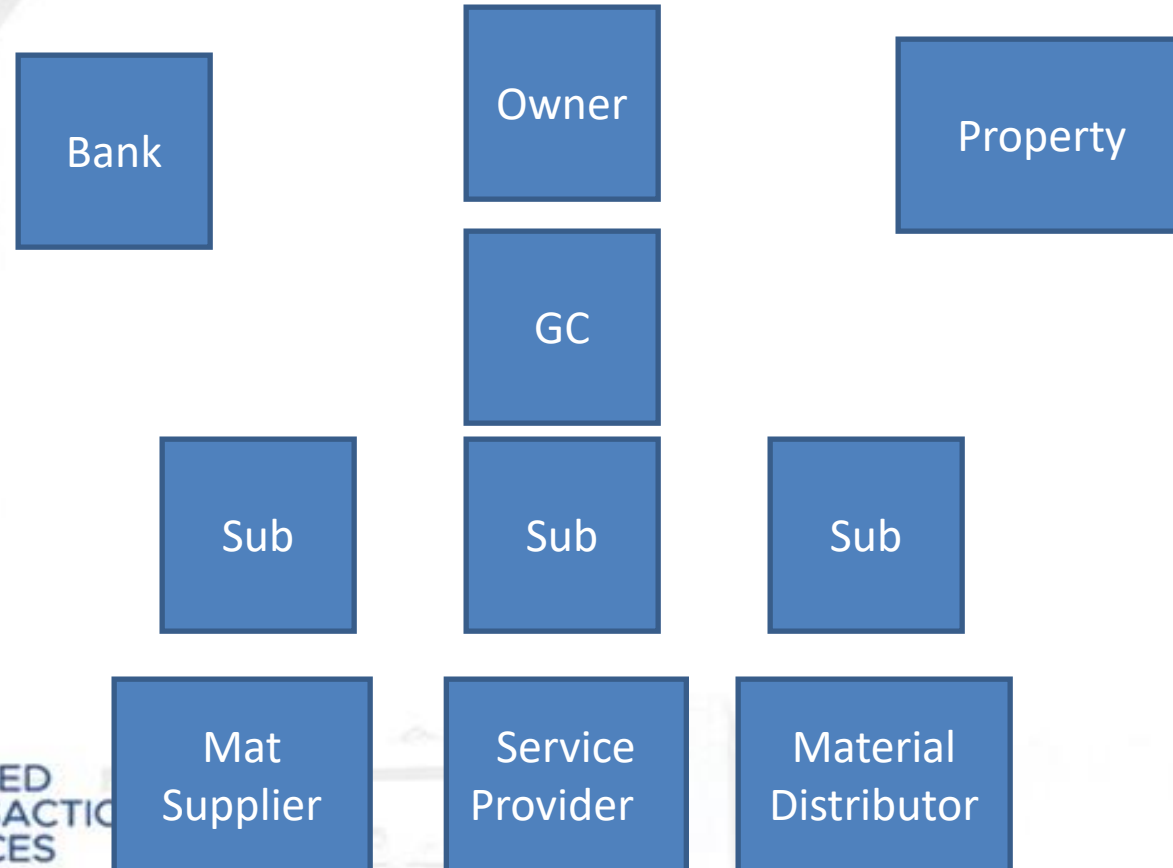
**71% Sales gathers information**

**18% Credit gathers information**

**11% Combined effort of sales and credit**



# How do you tame this animal?



# After you process the Credit Application

**\$40,000 job order**

**Customer is worthy of a \$5,000 credit line**

**CREDIT APPLICATION AND AGREEMENT EXHIBIT**  
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Date \_\_\_\_\_

**A. APPLICANT**

Bank Name \_\_\_\_\_

Property \_\_\_\_\_

Officer Contact \_\_\_\_\_ Acct. No. \_\_\_\_\_ Type of Acct. \_\_\_\_\_  
Acct. No. \_\_\_\_\_ Type of Acct. \_\_\_\_\_

I hereby authorize bank named above to release information requested for the purpose of obtaining and/or reviewing credit.

Signature \_\_\_\_\_ Date \_\_\_\_\_

**D. TRADE REFERENCES** (Please provide three references)

Name	Contact	Address
1. _____	_____	_____
2. _____	_____	_____
3. _____	_____	_____

The preceding information is for the purpose of obtaining credit and is warranted to be true. I/We hereby authorize [Your Company Name Here] to investigate all references and customary credit information sources including consumer credit reporting repositories (see Consent to Obtain Consumer Credit Report below) regarding my/our credit and financial responsibility for the purpose of obtaining credit and for periodic review for the purpose of maintaining

**You're justifying the \$40,000 order against the property value**



**Property is worth \$40,000,000**

Owner

C

Sub

Sub

Mat  
Supplier

Service  
Provider

Material  
Distributor

# Liens are a defined right

1. Be within 3 tiers of the owner.
2. Goods must be affixed, nailed, glued, bolted, painted on, etc.
3. No suppliers to suppliers.



**Today we're focusing on Mechanics' Liens on "Private" construction. The playbook is different for "Public" construction and Payment Bonds.**

Owner

Private = Lien  
Residential  
Commercial

Public = Bonds  
City  
State  
County  
Municipality

**You've gone through all the diligence to maintain and enforce your lien rights.... then**



June 1, 2023

## Commercial Bankruptcies Hit 2010 Level

Jamilex Gotay, editorial associate

Commercial bankruptcies have skyrocketed since the historical lows during the height of the pandemic. At 236 corporate bankruptcy filings so far this year, the number is higher than the first four months of any year since 2010 and more than double 2022 levels, according to [S&P Global Market Intelligence](#). They forecast that the U.S. default rate will rise to 4.25% by the beginning of next year, up from 2.5% currently—or to 6.5% if there is a serious recession.

In mid-May, Vice Media Group joined many of major companies to file for bankruptcy this year. "Vice's bankruptcy documents tell the story in painstaking detail of what happens when the easy-money era comes to an end," reads an article from *Axios*. "The first thing that happens when the ultra-easy access to funding dries up is the spigot stops for the companies that maybe shouldn't be borrowing more anyway."

Retail companies are some of the hardest hit in the current economic environment because they are susceptible to consumer buying changes. Inflationary pressures, high interest rates and supply chain issues are among the primary factors leading U.S. corporations to bankruptcy. And many finance analysts predict an economic downturn in 2023 that will contribute to even more tightening, said Christopher Ng, Esq., managing partner at Gibbs Giden Locher Turner Senet & Wittbrodt LLP (Los Angeles, CA). "Not to mention the weakened real-estate fundamentals where commercial properties are worth less so there is less desire for a bank to loan against these properties."

### The Problem with Subchapter V

Subchapter V bankruptcy filings increased 81% year-over-year in April, according to [Epiq Bankruptcy](#). Subchapter V is a newer modification of Chapter 11 for small businesses, but it places a larger burden on creditors to collect debt. Only small-business debtors whose total debts do not exceed \$7.5 million can file for Subchapter V. The initial debt threshold was roughly \$2.75 million, but the CARES Act increased that limit for another two years—and the expectation is that the \$7.5 million threshold will become permanent.

"The intent with Subchapter V is to streamline the process, and make it more efficient and less expensive for the debtor," Jason Torf, Esq., creditors' rights attorney and partner at Tucker Ellis LLP (Chicago) said during [Subchapter V of the Bankruptcy Code: Its Impact on Trade Creditors](#). "But at the same time, it strips away certain elements of a traditional Chapter 11 that are beneficial to creditors."

Credit professionals may be sitting on a ticking time bomb without even knowing it. In fact, most (40%) creditors do not know what percent of their portfolio is made up of customers who qualify for Subchapter V bankruptcy, according to an *eNews* poll—and the 31% who do know the answer say 10% or more of their portfolio qualifies for Subchapter V.

Creditors must be aware of how many of their customers could file using this subchapter because it makes it much more difficult to collect debt. You might even consider placing eligible customers in a higher risk category "because there will be a lot more factors working against the creditor if the customer files," Torf explained. "There is an additional layer of risk with Subchapter V that does not exist in the traditional Chapter 11 route, and debt recovery is not as successful."

### How to Protect Your Company

From a creditor's perspective, the key is mitigating risk immediately, especially when you know a customer is insolvent. "When they file for bankruptcy, there is a long checklist to follow," Ng said. "Learn how to defend yourself in preference claims and make sure that you have as much security as possible with accounts, especially high risk accounts. In those cases, make sure you get alerts or that there's a way for you to discern when a customer is building up inventory after years of not buying much."

Revisit your credit policy and credit agreements, tighten your terms and try to secure collateral where possible using letters of credit, security deposits and secured interest. "Monitor your accounts receivable (AR) closely," said Mike Mandell, corporate collection manager at Ryder Truck Rental, Inc. (Miami, FL). "For a Subchapter V, I recommend people talk to the trustee. I would try to see who some of the other unsecured creditors are to band together to look at how you can get better oversight in the case. I would encourage people to go to different organizations where us as unsecured creditors can all band together. There, you can lobby to get some of the rules changed on Subchapter V because it has not gone well for unsecured creditors."

# Creation of Mechanics' Lien Rights

- Attachment or Creation of Mechanics' Lien Rights Depends on State Law
  - Some states provide that the lien is created when creditor first provides materials or services
  - Other states require that creditor files or serves notice of right/intention to file lien in prescribed manner
  - Other states provide that the lien is created when recorded in real property records of county or with locality where improved property is located



# Perfection and Enforcement of Mechanics' Lien Rights

- Perfection of Mechanics' Lien Rights Require Recording of Lien in Real Property Records
  - Key question – does state law allow perfection to relate back to when lien arose?
- Those States that Allow Recorded Lien to Relate Back to Attachment or Creation of Lien Rights Have Different Deadlines for Perfection
- Once Lien Rights Arise and are Perfected, Lien Claimant Has Limited Period of Time to Commence Suit to Foreclose on its Lien
  - Depends on state law

# Mechanics' Liens and Bankruptcy Code

- The Bankruptcy Code Defines a “Statutory Lien As Arising by Statute, But Does Not Include a Security Interest or Judicial Lien
  - A mechanics’ lien is a statutory lien
- General Bankruptcy Rule – Liens Filed Post-Petition Are Null and Void – Violating Automatic Stay
  - 11 U.S.C. § 362(a)(4) prohibits “any act to create, perfect or enforce any lien against property of the estate” after bankruptcy filing
- Per 11 U.S.C. § 545, a Debtor or Trustee May Avoid the Filing of a Statutory Lien on Property of Debtor to Extent Lien First Becomes Effective Against Debtor When Bankruptcy is Filed

# Mechanics' Liens and the Bankruptcy Code – Automatic Stay Exception

- Automatic Stay Exception: 11 U.S.C. § 362(b)(3): Bankruptcy Filing Does Not Stay Any Act to Perfect or to Maintain or Continue the Perfection of an Interest in Property to the Extent the Trustee is Subject to Such Perfection Under Section 546(b)
- 11 U.S.C. § 546(b)(i) Creates An Exception to the Automatic Stay Based on Applicable Law That Permits Perfection of an Interest in Property to Be Effective Against an Entity that Acquires Rights in Such Property Before Date of Perfection
  - Depends on whether state allows a perfected mechanics' lien to relate back to the date of commencement of work and/or provision of materials and/or services
  - Bottom Line: Timely Post-Petition Perfection of Mechanics' Lien OK if Liened Property is In State Where Lien Relates Back to Pre-Petition Event (e.g., - Commencement of Work)

# Mechanics' Liens and Bankruptcy

- Alternative: Creditor Can Preserve Its Mechanics' Lien Rights by satisfying 11 U.S.C. § 546(b)(2)'s Notice Requirement

“If – (A) a law...requires...commencement of an action to accomplish such perfection, or maintenance or continuation of perfection of an interest in property; and (B)...such an action has not been commenced before the date of the filing of the petition; such interest in such property shall be perfected, *or perfection of such interest shall be maintained or continued*, by giving notice within the time fixed by such law for...such commencement.”



# Mechanics' Liens and Bankruptcy

- An 11 U.S.C. § 546(b)(2) Lien Preservation Notice States That a Mechanics' Lienholder Intends to Perfect or Maintain and Enforce its Mechanics' Lien
  - Notice should be filed with the bankruptcy court and properly served prior to expiration of state law deadline for commencing action to enforce lien rights

Mechanics' Liens and Bankruptcy

- What If Real Property Subject to Mechanics' Lien Rights is Located in State Without a Relation Back Provision?

# Mechanics Lien and Bankruptcy Code – *In re Linear Electric Company Inc.*

- New Jersey Lien Law: New Jersey Construction Lien Law, N.J.S.A. 2A: 44(A)-1, et seq.:
  - “Any 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 material or equipment furnished in accordance with the contract and based on the contract price . . .”
- Problem: Construction Liens Arising Under New Jersey Lien Law, Are Only Effective on Date of Filing of the Lien
  - New Jersey lacks any retroactive perfection of mechanics’ lien rights

# Mechanics Lien and Bankruptcy Code – *In re Linear Electric Company Inc.*

- Creditors Sold Electric Materials to the Debtor – Linear Electric Co., An Electrical Contractor
- Linear Used These Materials on Various Construction Projects in New Jersey
  - Filed chapter 11 in New Jersey Bankruptcy Court on 7/1/015
  - Owed two creditors approximately \$1.4 million on petition date
- Two Weeks Later, the Creditors Filed Liens Against the Projects
  - Argued post-petition lien filings did not violate the automatic stay because filed against non-debtor owned projects/real property
- Linear Moved to Discharge the Liens As Violating Automatic Stay

# Mechanics Liens and Bankruptcy Code – *In re Linear Electric Company Inc.*

- Bankruptcy Court, District Court and U.S. Court of Appeals for Third Circuit All Ruled: Mechanics' Liens Filed Post-Petition Violated Automatic Stay
- Mechanics' Liens Governed by New Jersey Lien Law – Do Not Relate Back to Pre-Bankruptcy Event
- Mechanics' Liens Attached to Property of Linear's Bankruptcy/Estate – Linear's Accounts Receivable Owed by Project Owners For Linear's Work on the Projects
  - Post-petition lien filing enabled creditors to collect Linear's A/Rs owing on the projects
  - Didn't matter that lien was filed against non-debtor owned projects



# Mechanics Liens and Bankruptcy Code – *In re Linear Electric Company Inc.*

- The Third Circuit Distinguished the New Jersey Lien Law From Pennsylvania Lien Law Where Supplier's/Subcontractor's Lien Relates Back to Date Work on Project First Began
  - *In re Yobe Electric Inc.* – 3<sup>rd</sup> Circuit – 1984 – Per Pennsylvania lien law, construction lien timely filed post petition deemed to have related back to when lien attached pre-petition and, therefore, automatic stay did not apply

# Mechanics' Liens and Bankruptcy Code – *In re Construction Supervision Services*

- North Carolina General Statute § 44A-18 – Subcontractor that furnishes labor, common materials or rental equipment on construction project can assert lien on monies owed on that project
- 2 different types of lien rights
  - All subcontractors have lien on funds acquired by party directly above them in contract chain
  - Second and third lien subcontractors also have a lien on funds owed to entities in the contract chain above the party with whom second and third tier contractor had contracted
- Liens in Project Funds Arise When Subcontractor Provides Materials, Labor or Rental Equipment to Contractor on Project
- Lien Perfected When Subcontractor Gives Written Notice of Lien To All Parties Above Subcontractor in Lien Chain, Including Higher Tiered Subcontractors, General Contractor and Owner

# Mechanics' Liens and Bankruptcy Code – *In re Construction Supervision Services*

- U.S. Court of Appeals for 4<sup>th</sup> Circuit, in *In re Construction Services Inc*, Ruled that Subcontractors' Postpetition Perfection of Their Lien Rights In Project Proceeds Did Not Violate Automatic Stay
  - North Carolina law allowed relation back of post-petition perfected lien to pre-petition creation/attachment of lien (subcontractors' pre-petition delivery of goods)

# Mechanics' Liens and Bankruptcy

- Automatic Stay Bars Mechanics' Lien Creditors from Enforcing (e.g., Foreclosing on) Lien Rights Unless Creditor Obtains Relief From Stay
  - 11 U.S.C. § 362(d) – grounds for lifting stay
    - (d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—
      - (1) for cause, including the lack of adequate protection of an interest in property of such party in interest;
      - (2) with respect to a stay of an act against property under subsection (a) of this section, if—
        - (A) the debtor does not have an equity in such property; and
        - (B) such property is not necessary to an effective reorganization;

# Priority of Mechanics' Lien Rights

- Need to Review DIP Financing Use of Cash Collateral Order to Protect Against Subordination of Lien Rights
- Priority Disputes Might Also Arise in Context of Section 363 Sales in Bankruptcy Cases
- 11 U.S.C. § 363 states:
  - (b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary court of business, property of the estate...
  - (e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest...[Invoked to protect lien rights]



# Priority of Mechanics' Lien Rights

- 11 U.S.C. § 363 Also States

(f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—

- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
- (2) such entity consents;
- (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

# Priority of Mechanics' Lien Rights in Section 363 Bankruptcy Sales

- Order of Filing of Liens
- Exception for Mechanics' Liens in States Where Perfection Relates Back to Attachment/Creation of Lien Rights
- Governed by Bankruptcy Court Order (e.g., DIP Financing/Use of Cash Collateral Order)
- Can Be Priority Between Different Mechanics' Liens?

# Mechanics' Liens and Bankruptcy Code – Preference Risk Issues

## Elements of Preference Claim

- Any Transfer of an Interest of the Debtor in Property;
- To or for the Benefit of a Creditor;
- On Account of an Antecedent Debt Owed by Debtor Before Transfer;
- Made While the Debtor was Insolvent;
  - On or within 90 days before bankruptcy filing; or
  - Between 90 days and one year before bankruptcy filing for transfers to insider creditors; and

# Mechanics' Liens and Bankruptcy Code – Preference Risk Issues

## Elements of Preference Claim

- That Enables Such Creditor to Receive More Than Such Creditor Would Receive if:
  - The case were a Chapter 7 case;
  - The transfer had not been made; and
  - Such creditor received payment to the extent provided by other provisions of Title 11.
  - The greater than liquidation recovery requirement

# Mechanics' Liens and Bankruptcy Code – Protection from Preference Risk

- Greater Than Liquidation Requirement Not Satisfied
- Creditor Fully Secured by Debtor's Assets or Paid from Collateral Proceeds Not Subject to Preference Risk
  - E.g., Mechanics' Lien Fully Secured by Debtor Property
- “Inchoate Lien Rights: Greater than Liquidation Requirement Satisfied Despite Absence of Lien Filing Where Creditor Has Right Under State Law to Record a Fully Secured Mechanics Lien On Debtor's Property that Relates Back to Pre-Petition Creation or Attachment of Lien



# Mechanics' Liens and Bankruptcy Code – Protection from Preference Risk

- Contemporaneous Exchange For New Value Defense – 11 U.S.C. § 54(c)(1)
- Transfer was *Intended* by Debtor and Creditor to be Contemporaneous Exchange for New Value; and
- Transfer was Substantially Contemporaneous Exchange
- Examples:
  - Release of mechanics' lien in debtor's property in exchange for preference payment, provided value of released lien rights is not less than the payment
  - Beware of conditional release of lien rights and bounced check/ACH payment

# Mechanics' Liens and Bankruptcy Code – Protection from Preference Risk

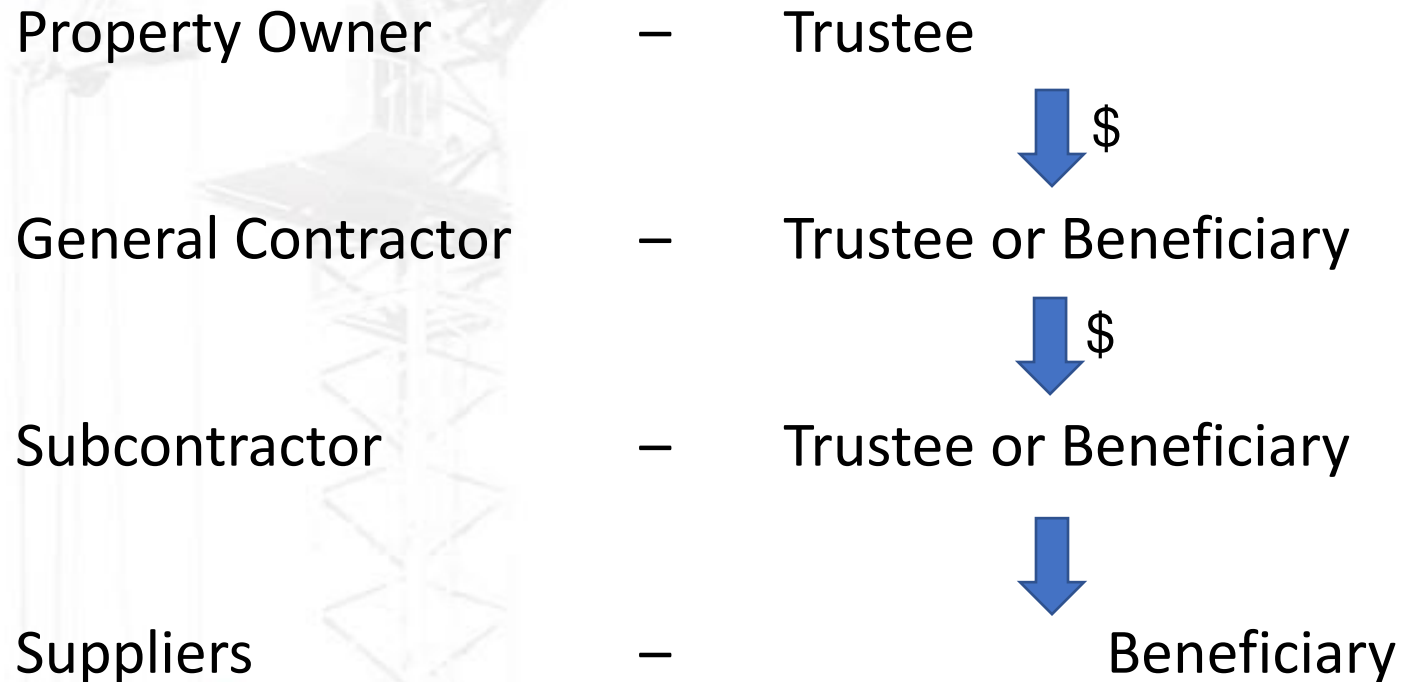
- New Value Defense – 11 U.S.C. § 547(c)(4)
- New Value Defense Can Apply to Release of Lien Rights In Debtor's Property With Value of at Least the Amount of the Preference Payment
- Section 547(c)(6) – No Preference If Transfer is Filing of Statutory Lien Not Avoidable Under Section 545

# Builders/Construction Trust Fund Protection

- Certain States Have Enacted a Builders or Construction Trust Fund Statute
  - Typically provide that all accounts receivable owing on a construction project by an owner to a contractor and/or by the owner or contractor to a subcontractor will be held in trust by the contractor or subcontractor
  - Arises automatically – no notice/filing requirements
- Trust Fund Rights Could Also Be Created By Contract

# How Does the Builders/Construction Trust Fund Work?

## Construction Project



# States That Have Construction/Builders Trust Fund Statutes

- Arizona
- Colorado
- Delaware
- Maryland
- Michigan
- New Jersey
- New York
- Oklahoma
- South Dakota
- Tennessee
- Texas
- Washington
- Wisconsin



# Builders Trust Fund Beneficiaries Can Have Priority Over Trustee's Accounts Receivables Secured Lender

- Funds Held in Trust on a Construction Project Do Not Become Trustee's Property
  - Trust beneficiaries granted first dibs in trust assets in trustee's bankruptcy case
  - Lender's security interest in accounts receivables does not attach until trust fund beneficiaries are paid in full
  - The courts have generally granted priority to trust fund beneficiaries over prior perfected security interest in accounts
- Risk of Commingling of Trust Funds With Trustee's Other Cash that Dissipates the Trust
  - Trust fund beneficiaries have burden of tracing trust fund proceeds into cash

# Builders/Construction Trust Fund Protection

- No Bankruptcy Preference Risk for Builders/Construction Trust Fund Beneficiaries If They Can Show the Alleged Preference Payment Was From Trust Assets;
  - Not property of the debtor (one of the requirements for a preference)
- Key Challenge: Can Builders/Construction Trust Fund Beneficiaries Trace Preference Payment Back to Trust Fund?
  - Risk of commingling of trust and non-trust assets
  - Beneficiaries have the tracing burden

# Misappropriation of Trust Funds

- Construction Trust Fund Statutes Vary Widely By States  
Re: Remedies For Misappropriation of Trust Funds
  - Civil remedies – e.g.,
    - Interest
    - Attorneys' fees
  - Criminal penalties
  - Both
  - Personal liability for officers and directors of contractor/subcontractor
    - Strict liability
    - Officers and directors who controlled disbursement of trust funds

# Non-Dischargeability Re Misappropriation of Trust Funds

- Misappropriation of Trust Funds in States Where Construction Trust Fund Statutes Create Trust Obligation and/or Require Contractor/Subcontractor to Segregate and Keep Detailed Records Is a Ground Supporting Non-Dischargeability of Claim

# Enforcing Lien Rights When a Party in the Construction Supply Chain Files for Bankruptcy

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