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RECENT RULINGS BY BANKRUPTCY JUDGES HAVE AFFECTED CHAPTER 44A LIEN RIGHTS

Collections have never been as important — or as challenging — as now. North Carolina construction industry vendors have long held an advantage over other goods and services providers because they can impose liens upon real property improved by their efforts or upon funds in the contract stream. Three recent cases from the Bankruptcy Court of the Eastern District of the North Carolina have exposed limits to these rights and re-emphasized the importance of creditor diligence and proactivity.

William C. Smith

William C. Smith is a partner at **Manning Fulton & Skinner PA**. He has a diverse litigation practice, representing small and large businesses and individuals in litigation and administrative law matters including contract disputes, debt collection, real estate, bankruptcy, employment and professional negligence. He is a graduate of UNC Chapel Hill's School of Law.

Labor and materialman's liens in North Carolina

The rights of laborers and materialmen to assert liens are provided in Chapter 44A of the N.C. General Statutes. In most cases, persons who improve real property have lien rights. Improvement is broadly defined, encompassing engineering, building, demolishing and excavating structures or the land itself. Chapter 44A provides three distinct lien rights to general contractors and subcontractors.

Direct lien. A person contracting directly with an owner of real property may file a lien against the property for payment, filing it with the clerk of superior court within 120 days of furnishing labor or materials to the property. A significant benefit of the direct lien is that it relates back to the date of first furnishing of labor and materials by the lien claimant.

Lien on funds. Those subcontractors who have no direct contract with the owner (but contracted with the general contractor or upstream subs) are not left out. First-tier subcontractors are entitled to assert a lien upon funds owed by the owner to the general contractor; second-tier subs can lien funds owed by the general contractor to the first-tier sub; and so on. The lien is created upon giving notice of the claim, in writing, to the parties upstream [called "Obligors"]. There appears to be no statutory deadline for this notice. It is required that funds are owed to the entity with which the lien claimant contracted. Once the Obligor receives the notice from a subcontractor downstream of the contractor with whom it dealt, it is obligated to withhold enough funds from payment to its contractor to satisfy the lien. If it doesn't, it is liable to the lien claimant for this payment, and if the obligor is the owner of the real property, the subcontractor is entitled to claim a lien on it.

Subrogation lien. Certain higher-tiered subcontractors entitled to a lien on funds are also subrogated to the liens on funds and on the real property available to subcontractors and the general contractor in the chain above it. Subs who have not been paid often serve their claim of lien on funds and their subrogation claim of lien on real property at the same time to ensure their full spectrum of possible lien rights are covered.

The Bankruptcy Code and state lien law

The primary protection of a debtor in bankruptcy is the "automatic stay" created by 11 U.S.C. § 362. This statute prohibits creditors from undertaking "any act to create, perfect, or enforce any lien against property of the estate." Real property owned by a debtor is obviously "property of the estate," as are funds owed to a bankrupt general contractor or subcontractor. Any actions in violation of the automatic stay are void. In addition, creditors seeking to assert impermissible liens could be sanctioned by the Bankruptcy Court, including being required to pay monetary penalties, if the stay is violated, even unwittingly.

Luckily, at least for direct liens, the Bankruptcy Code provides a specific exception and does not stay "any act to perfect or to maintain or continue the perfection of" certain liens. Therefore, at least with respect to direct liens on real property relating to pre-bankruptcy work, acts to perfect them do not violate the automatic stay.

Clarification arises from three cases

Until recently, lien claimants and their lawyers have treated the direct liens, the lien upon funds and subrogation liens the same with respect to their assumption that all were exceptions to the automatic stay and could be created, filed and perfected after the obligor's bankruptcy petition. However, in *In re Shearin Family Investment, LLC, 08-07082-8-JRL, In re Harrelson Utilities, Inc., 09-02815-8-ATS, and In re Mammoth Grading, Inc., 09-01286-8-ATS*, two bankruptcy judges in the Eastern District recently held that the serving of a notice of claim of lien on funds upon a bankrupt Obligor was in violation of the automatic stay, and was void and ineffective to create a lien.

In Shearin, the bankrupt entity or “Debtor” owned real property and hired Centurion Construction as general contractor before the bankruptcy. After the Debtor filed bankruptcy, several subcontractors served notices of claim of lien on funds owed to Centurion. As part of the approved bankruptcy plan, Centurion was paid a significant sum by the Debtor for its work before the bankruptcy. The subcontractors claimed those funds were subject to their liens.

The Debtors in Harrelson and Mammoth were general contractors for various owners on various jobs. Both contracted with a number of subcontractors for these jobs. After Harrelson and Mammoth filed bankruptcy, many subs served their notice of claim of lien on funds upon the Debtors and owners, seeking to intercept payments to the Debtors. The court held that those accounts receivable were “property of the estate” subject to the automatic stay, voiding the lien claims.

The rulings caught many by surprise. Contractors and their attorneys assumed that their lien on funds related back to their first furnishing of labor or materials on the property, and the act of sending the notice of claim of lien merely perfected a pre-existing lien right. Both judges disagreed. These judges held, based on a careful and literal reading of the applicable statues, that subcontractors had no post bankruptcy petition ability to serve a notice of lien on funds. They held that the claim of lien on funds is created, not merely perfected or maintained, by the service of the notice. Therefore, if the notice is not served before the Obligor’s bankruptcy, it cannot be served afterwards, because it would be the first act necessary to create a lien against estate property. Although in each case the judge declined to punish the lien claimants, future lien claimants or their attorneys who violate this rule may not be so lucky.

Conclusion

Lawyers for lien claimants have predicted that the Shearin, Harrelson and Mammoth holdings will result in chaos, potentially shutting down construction funding. They say subcontractors will be forced to serve and file claims of lien right along with their invoices. The flow of funds throughout the owner-general contractor-subcontractor chain will grind to a halt, they fear. It appears unlikely the effect will be that drastic. Subcontractors with only lien rights upon funds (and subrogation lien rights) are always at the mercy of the arrangement between the owner and the general contractor, the general contractor and first-tier subs, etc. If payment already had been made to claimant’s Obligors before the notice was served or if the Obligor’s contract party was entitled to deny payment due to quality or quantity of work issues, there were no lien rights available to the subcontractors anyway. The moral should simply be for subcontractors to keep a close eye on contractors and owners up the chain and to serve notices of their claims of lien if it appears an upstream bankruptcy is likely.

There are typically weeks and perhaps months between the first signs of trouble and the ultimate bankruptcy of an entity. Subcontractors should be prepared to move quickly if the need to serve and file liens arises. When working with contractors or owners who show any signs of stress, joint check arrangements should be considered. Even if invoices are served with notices of claim of lien on funds, such action should not necessarily put impossible burdens on owners or contractors.