

Subcontractors and Suppliers Win Support for Lien Perfection During North Carolina Bankruptcies

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Richard A. Prosser

Lisa P. Sumner

By order issued on February 23, 2012, the United States District Court for the Eastern District of North Carolina vacated the bankruptcy court's decision in *In re Mammoth Grading, Inc.* This decision and the companion decision in *In re Harrelson Utilities, Inc.* held that the lien rights of construction subcontractors and suppliers cannot be perfected once a bankruptcy petition is filed by a party higher in the contract chain.

Prior to these decisions, it had been common practice in the Eastern District of North Carolina for subcontractors to perfect their liens post-petition. This approach was consistent with industry practice and the general reluctance of subcontractors to perfect their liens except as a matter of last resort. Without the ability to perfect their liens post-petition, subcontractors are compelled to perfect their liens earlier and more often to avoid losing their rights. The result has been controversy in the construction industry, as practitioners and industry groups expressed concerns over the heightened costs associated with more lien filings and the potential disruptions in construction project flow. These concerns ultimately spilled over into a legislative effort to revise North Carolina's lien law. Now it appears, however, that the construction industry may not have to rely solely on the legislature for a solution.

In the *Mammoth Grading* case, the district court took aim at the bankruptcy court's interpretation of North Carolina lien law and acknowledged the negative impact the bankruptcy court's ruling has had on the construction industry. Because of the posture of the appeal, the district court was unable to consider the issues on the merits. The claims of all but one of the subcontractors had been settled, and the remaining claim had been satisfied, requiring the district court to dismiss the appeal and vacate the underlying decision. This did not stop the court from commenting on the bankruptcy

court's rulings, though, noting that the lower court's decisions had "turned the construction industry's standard operating procedure on its head."

The bankruptcy court decisions in *Mammoth Grading* and *Harrelson Utilities* were predicated on a ruling that the unperfected lien rights of subcontractors are merely an "entitlement" and not an "interest in property" within the meaning of the automatic stay provisions of the Bankruptcy Code. The district court questioned whether the bankruptcy court's interpretation was in accord with North Carolina statutory law and the protections afforded laborers and materialmen under North Carolina's Constitution.

Although it lacks precedential value, the district court's order is causing waves. The order offers encouragement to advocates for the construction industry, but causes concern for debtors and secured lenders whose reliance on the accounts receivable of companies subject to liens on funds may be jeopardized. These lien perfection issues are presently before the bankruptcy court in at least one other case pending in the Eastern District of North Carolina, and the effort to enact a legislative solution remains active. Thus, anyone grappling with these issues should stay tuned for additional developments in the near future.



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