New Bankruptcy Case Limits Assertion of Post-Bankruptcy Construction Liens

SUMMARY

On March 30, 2017, the United States Court of Appeals for the Third Circuit issued a decision that curtails the rights of suppliers to lien non-debtor third-party property following the bankruptcy filing of a construction contractor. Generally, if a supplier sells materials on credit to a construction contractor and the contractor incorporates those materials into property owned by a third party (the “Owner”) without paying the supplier, the supplier can file a lien (i.e., a construction lien or mechanics lien) on the property of the Owner and collect the debt owed to the supplier directly from the Owner using sums that would have otherwise been paid to the contractor. Under Linear, however, the ability to file such liens may be limited after the contractor files for bankruptcy.

Factual Background

In Linear, certain electrical suppliers (the “Suppliers”) sold materials to Linear Electric Co., Inc. (the “Debtor”), which the Debtor incorporated into several construction projects. Because the Owner of the property had not fully paid the Debtor for its work on these projects, the Debtor in turn had not fully paid the Suppliers for their materials as of the date of its bankruptcy filing.

On July 1, 2015, the Debtor filed a voluntary bankruptcy petition under chapter 11 of the Bankruptcy Code. After that filing, the Suppliers filed construction liens on the Owner’s property. In response, the Debtor filed a motion with the Bankruptcy Court to discharge the liens as violating the automatic stay.

The Suppliers argued that their liens did not violate the automatic stay because the liens attached to the property interests of the Owner and did not lien the Debtor’s property. Typically, the filing of a bankruptcy petition automatically stays any act to create or perfect a lien against a debtor’s property, and does not stay any act against the property of a non-debtor third party, such as an Owner. For this reason, the Suppliers argued that their construction liens attached to the interests of the Owner and did not constitute a post-bankruptcy lien against property of the Debtor, in violation of the automatic stay.

The Debtor argued, in contrast, that the assertion of the liens against the Owner resulted in a stay violation since such liens were designed to collect money from the Owner that would otherwise constitute the Debtor’s accounts receivable. The Debtor thus argued that the assertion of the liens was an act against the Debtor’s property, in violation of the automatic stay.
**The Court’s Ruling**

The Third Circuit (and the lower courts) agreed with the Debtor. The Court held that because the lien payment process provided for under New Jersey law allowed the Suppliers to collect outstanding amounts only by subtracting such amounts from the Debtor’s accounts receivable from the Owner, the liens were not against third-party property but the Debtor’s accounts receivable, in violation of the automatic stay. Indeed, the Court reasoned that because the amount that the Debtor was owed by the Owner would be reduced to the extent the Suppliers were fully paid, the lien payment process “would transfer a portion of an [estate] asset” to the Suppliers. The Court explained that “[w]here, as here, a lien will be paid by transferring part or all of an asset from the bankruptcy estate to the lien holder, the lien is against the property of the bankruptcy estate.” As such, the Court held that the Suppliers’ post-petition assertion of their liens violated the automatic stay.

Notably, in so holding, the Third Circuit acknowledged a distinction between New Jersey’s lien law and other state laws that provide for liens to “relate back” to the commencement of work, and that may, therefore, be an exception to the automatic stay.

**The Practical Result**

In the past, suppliers and subcontractors could rest assured that construction lien laws protected their rights to assert liens against non-debtor property owners, even where a general contractor filed for bankruptcy. As a result of this assurance, suppliers and subcontractors were likely encouraged to extend credit and otherwise hold off on immediately asserting construction or mechanics liens to avoid the potential effect of driving a contractor to close (or lose) a job or decline into bankruptcy. After **Linear**, however, at least in states with lien laws similar to the New Jersey statute, suppliers and subcontractors may be compelled to “use it or lose it” and assert liens immediately to avoid any risk of nonpayment, even from a non-debtor property owner.

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