

How **BANKRUPTCY** affects **MECHANICS LIENS**

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BANKRUPTCY

- Bankruptcy is the word we all hate to hear, but it does not mean you should throw the account in the trash.
- The rules in 11 USC 362 relevant to mechanics liens provides:
 - The filing of bankruptcy operates as a stay, applicable to all entities, of any act to create, perfect, or enforce any lien against property of the estate
 - While the language of the rule says you cannot create or perfect a lien, the Courts have helped carve out lots of exceptions with creative rulings to benefit mechanics lien claimants.

THE FIRST STEP

- The most important first step is understanding who filed bankruptcy and where.
- Different rights exist depending on who filed bankruptcy and the state they filed in.
 - Customer
 - General Contractor
 - Owner
 - Lender



TYPES OF BANKRUPTCIES

There are different types of bankruptcy, and each operates its own way. The normal bankruptcies you will see for are:

- Chapter 7
- Chapter 11
- Chapter 13



MECHANICS LIEN RULES

- The mechanics lien process is similar in most states.
 - It starts with a preliminary notice
 - You record your lien once you have completed work and have not been paid
 - You file your lawsuit to foreclose on your mechanics lien within a certain period of time after you have recorded your mechanics lien

MECHANICS LIEN RIGHTS WHEN BANKRUPTCY IS FILED

- Just because someone files bankruptcy does not mean you need to write off that account PROVIDED you have your mechanics lien rights.
- Depending on who files for bankruptcy, you may still have the ability to:
 - Record a mechanics lien
 - File your lawsuit to collect your mechanics lien

YOUR CUSTOMER FILES BANKRUPTCY

- When your customer has filed bankruptcy, you are precluded from taking any steps to collect from your customer.
- You are not prevented from enforcing your mechanics lien rights against the owner of the property because the property is not part of the bankruptcy.

BANKRUPTCY

YOUR CUSTOMER FILES BANKRUPTCY

- This may be different if your customer is also the general contractor or if you name your customer because they have some interest in the property
 - Some states require you to name all other mechanics lien claimants in your lawsuit to foreclose on your lien



THE GENERAL CONTRACTOR FILES BANKRUPTCY

- Like your customer's bankruptcy, the general contractor filing for bankruptcy generally has little impact on your ability to record your mechanics lien or file your lawsuit to foreclose on your mechanics lien.
- The primary exception is states that require you to name all other mechanics lien claimants as part of your mechanics lien foreclosure action.
 - Arizona requires you to name all lien claimants, but has carved our special rules for bankruptcy.

THE GENERAL CONTRACTOR FILES BANKRUPTCY

- While you may be able to file your mechanic lien foreclosure action, some states limit the amount of the mechanics lien to the amount due the general contractor, in those situations the general contractor's bankruptcy could have a direct impact on your ability to pursue your mechanics lien foreclosure action.
 - This is because there may be a dispute between the owner and the general contractor as to what is owed. That dispute is stayed by the general contractor's bankruptcy and your mechanic lien foreclosure action is similarly stayed until a determination can be made as to what is, or what is not, owed.

THE OWNER FILES BANKRUPTCY

After You Record Your Mechanics Lien

- In many states your mechanics lien is unaffected by the bankruptcy, but the automatic stay precludes you from filing your lawsuit to foreclose
 - California, Nevada and Colorado are examples
- In most of these states, the statute of limitations to file your lawsuit is tolled until the property is released from the bankruptcy, then it starts to run.
 - Some states provide whatever time is left based on when the mechanic lien was recorded and when the statute of limitations runs – California
 - Some give you a set amount of time after the bankruptcy is terminated – Colorado
- The other option is to file a notice of enforcement in the Bankruptcy Court. This notice of enforcement acts like you filed a lawsuit for statute of limitations purposes. So long as you file this notice within the time to file your lawsuit and foreclose on your lien, you have met the statute of limitations – Nevada requires this.

THE OWNER FILES BANKRUPTCY

- In some states, if the owner files bankruptcy you may still record your mechanics lien and file your lawsuit to foreclose
 - Arizona is a good example



- The key is understanding the rules in your state, because each state is different and the time limits may, or may not, be impacted depending on your state.

THE OWNER FILES BANKRUPTCY

Pioneer Construction v. Global Investment (CA)

- Pioneer performs work and is not paid
- April 17, 2008 records a mechanics lien
- June 13, 2008 Owner files bankruptcy
- January 29, 2009 Pioneer records a second lien
- August 25, 2009 property is sold in a trustee's sale by the bank
- November 12, 2009 Pioneer files its complaint to foreclose



THE OWNER FILES BANKRUPTCY

Pioneer Construction v. Global Investment (CA)

- Owner argues:
 - Second lien is unenforceable because it was recorded while bankruptcy was pending in violation of the stay
 - Second Lien was not foreclosed on in time because more than 90 days had run since it was recorded
- Court Disagrees
 - Bankruptcy code allows a lien to be recorded during pendency of a bankruptcy
 - The time that automatic stay is in effect is not counted against the limitations period

THE OWNER FILES BANKRUPTCY

Before You Record Your Mechanics Lien

- Virtually all states allow a lien claimant to record their mechanics lien after the owner has filed bankruptcy to preserve their mechanics lien rights
 - Most courts have come to the conclusion that the statutory language of the automatic stay does not apply to recording mechanics liens because liens relate back to when the work first commenced, which is before the owner filed bankruptcy.
 - California, Arizona, Colorado, New York, Texas, Nevada

THE LENDER/BANK FAILS

- While not common now, in 2007-2008 this was a common situation.
 - Studies shows more than half the projects ongoing at any one time were never finished because of lack of funding.
- The lender's bankruptcy, or getting taken over by the FDIC has no impact on your mechanics lien rights.
- But consider the impact on the likelihood you will be paid, or that the project will continue and the owner will stay afloat if a lender runs out of money.
 - This is a good example of why timely and proper mechanics lien recording is imperative.

PREFERENCE PAYMENTS

- If you are paid within 90 days by a party who thereafter files bankruptcy, the bankruptcy trustee can claw back that payment or payments.
- Releasing a mechanics lien, or giving up mechanics lien rights is a complete defense to a preference claim.



THANK YOU

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