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On Subcontractors And Suppliers



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## IMPACT OF RECENT EASTERN DISTRICT OF NORTH CAROLINA DECISIONS ON SUBCONTRACTORS AND SUPPLIERS

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### *Introduction*

The Bankruptcy Court for the Eastern District of North Carolina has recently entered orders in two separate bankruptcy cases that impact the lien rights of subcontractors when a contractor files for bankruptcy. In both rulings, the bankruptcy court held that a subcontractor must file and serve a notice of claim of lien on funds before a contractor files for bankruptcy or it may lose its lien rights and be treated as an unsecured creditor in the bankruptcy case. Further, the bankruptcy court held that a subcontractor will also lose its subrogation claim if a Notice of Claim of Lien on Funds is not before a contractor files for bankruptcy. These holdings have a significant impact on subcontractors working with a potentially insolvent contractor as their state law lien rights may be lost if the subcontractor does not take action prior to a contractor's bankruptcy filing.

### *Lien Rights Under North Carolina Law*

North Carolina's statutory liens for improvements to real property are set out in Chapter 44A of the North Carolina General Statutes. These statutory liens are often known as "mechanic's liens" or "materialman's liens."

### Claim of Lien on Real Property

North Carolina grants lien rights on real property to any entity who provides material or services for the purpose of making an improvement on real property pursuant to an express or implied contract with the owner of the real property. The lien attaches to the improvement to the property (i.e., the buildings) and to the land on which the improvement is situated (but only to the extent of the owner's interest in the property). N.C.G.S. § 44A-8.

Perfection of lien rights on real property when an entity has a contract directly with the owner involves two steps: (i) filing a claim of lien on real property and (ii) filing a lien enforcement lawsuit. A powerful part of North Carolina's lien law is that the filing of a claim of lien on real property "relates back", i.e., once a claim of lien is perfected, it becomes effective as of the date the contractor first furnishes labor or materials at the site of the improvement. N.C.G.S. § 44A-10. Therefore, the party who first provides labor or materials and properly and timely perfects its lien rights will have complete priority in its lien claims over others who later provided labor or materials, or over a deed of trust which was filed after the party first provided labor or materials to the job site.

### Claim of Lien on Funds.

A claim of lien on real property may only be brought by an entity who contracts directly with a real property owner. Subcontractors do not have direct contracts with property owners and, as such, North Carolina law does not provide them a direct lien on the property as it does to general contractors. Instead, subcontractors and suppliers are provided with two other types of liens. The first is a lien on funds. N.C.G.S. § 44A-18 gives all subcontractors and suppliers a lien upon any funds which are earned by the subcontractor as a result of having furnished labor or materials to a job site, whether or not the amounts are currently due and whether or not performance or delivery is complete. A first tier subcontractor or materials supplier is entitled to a lien on any funds which are owed by the owner to the general contractor with whom the first tier subcontractor contracted. Likewise, a second tier subcontractor is entitled to a lien on funds which are owed by the general contractor to the first tier subcontractor with whom the second tier subcontractor contracted. Each successive tier of subcontractor is entitled to a lien on funds which are owed to the subcontractor with whom the subcontractor contracted.

A lien on funds is perfected by serving a written notice of claim of lien on funds to the person or company who owes the funds. The notice must be served either by hand delivery or by certified mail, return receipt requested.

### Subrogation Lien Upon Real Property

In addition to a claim of lien on funds, North Carolina allows a first, second or third tier subcontractor who gives proper notice to perfect and enforce the lien of the general contractor who has a contract with the owner and may have a direct lien on the property. In order to perfect a subrogation lien, the subcontractor must perfect both the lien of the general contractor by filing of claim of lien on real property and perfect its own lien by serving all parties above it in the contractual chain with a notice of claim of lien on funds.

### *The Mammoth Grading, Inc. and Harrelson Utilities, Inc. Bankruptcies*

Mammoth Grading, Inc. (“Mammoth”), a site development contractor, filed for chapter 7 bankruptcy on February 18, 2009 (Case No. 09-01286). The bankruptcy court appointed a trustee (the “Trustee”) to represent the interests of the debtor’s bankruptcy estate. Harrelson Utilities, Inc. (“Harrelson”) is a utilities contractor. It filed Chapter 11 bankruptcy on April 6, 2009 and continues to operate its business as a debtor-in-possession.

At the time Mammoth and Harrelson each filed their respective bankruptcy petitions, each contractor had a number of unpaid subcontractors. The subcontractors, after the bankruptcies were filed, served notices of claims liens on funds due to Mammoth and Harrelson and filed notices claiming, via subrogation, liens against the real property on which Mammoth and Harrelson and the subcontractors did work. Both Harrelson and the Trustee opposed these actions and argued that the subcontractors violated the automatic stay imposed by the Bankruptcy Code, rendering their liens invalid. The subcontractors, on the other hand, argued that their actions were consistent with North Carolina lien law and long-standing practices within the construction industry and that their actions fit within an exception to the automatic stay.

When a debtor files bankruptcy, it gets the benefit of an “automatic stay” which prohibits creditors and others from taking or continuing any actions against the debtor on account of pre-bankruptcy obligations. In addition, creditors are prohibited from taking any action affecting a debtor’s property including “any act to create, perfect, or enforce any lien against property of the estate.” 11 U.S.C. § 362(a)(3). A debtor’s estate includes “all legal or equitable interests of the debtor in property” and “proceeds...or profits of or from property of the estate.” 11 U.S.C. § 541(a).

However, the Bankruptcy Code provides certain exceptions to the automatic stay. One such exception is “any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee’s rights and powers are subject to such perfection under 546(b).” 11 U.S.C. § 362(b)(3). Bankruptcy Code § 546(b) provides that a trustee’s powers are subject to any law that “permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection or provides for the maintenance or continuation of perfection of an interest in property to be effective against an entity that acquires rights in such property before the date on which action is taken to effect such maintenance or continuation.” In other words, for the exception under Bankruptcy Code § 362(b)(3) to apply, a creditor must have had some pre-petition interest in the property and perfection of this interest must be effective against an entity that acquires rights in the property prior to the date of perfection.

### *The Bankruptcy Court’s Analysis*

In its *Order Determining that the Automatic Stay was Violated* entered in the Harrelson bankruptcy, the bankruptcy court held that (i) serving a notice of claim of lien on funds due to a debtor post-bankruptcy violates the automatic stay and, as such, those liens are invalid and (ii) since liens filed by subcontractors against real property must be supported by a valid lien on funds, and since those liens are invalid, the subrogation liens are invalid as well.

In its analysis, the bankruptcy court first noted that in order to determine whether the automatic stay exception set forth in Bankruptcy Code § 362(b)(3) applies, it must refer to the plain language of Bankruptcy Code § 546(b) and determine “[w]hether the subcontractors had an ‘interest in property,’ the perfection of which could be effective against an entity that acquired rights in the property prior to the date of perfection.” Such an issue must be determined by North Carolina state law.

The bankruptcy court first reviewed the lien rights of general contractors and other such entities that contract directly with the owner of property and noted that North Carolina law explicitly provides that a contractor’s claim of lien on real property relates back to the date of the first furnishing of labor or materials by the person claiming the lien. The bankruptcy court then contrasted this with the rights of subcontractors and noted that the lien laws as applied to subcontractors do not have the same “relation back” language. Rather, N.C.G.S. §44A-18(6) provides that a subcontractor’s lien on funds “is perfected upon the giving of notice in writing to the obligor...and shall be effective upon the obligor’s receipt of notice.” As such, subcontractors with properly perfected liens are given priority in the funds, but they are not given an “interest” in the funds prior to the time they serve a notice of claim of lien on funds.

The bankruptcy court also responded to the subcontractors’ argument that *entitlement* to a lien is created upon the delivery of the materials, and that it is the entitlement that is the interest that is allowed to be perfected under Bankruptcy Code § 362(b)(3). The bankruptcy court reasoned that entitlement is not the same as an interest in property as such an entitlement as no value until a subcontractor gives notice of claim of lien on funds.

Next, the Bankruptcy Court determined whether a subcontractor may file, pursuant to its subrogation rights, a lien on real property. The Court noted that N.C.G.S. § 44A-23(a) provides that “a first tier subcontractor, who gives notice of claim of lien upon funds as provided in this Article, may, to the extent of this claim, enforce the claim of lien on real property of the contractor.” Since the statute is clear that in order to enforce the contractor’s lien on property via subrogation, the subcontractor must first give notice of its own claim of lien on funds, the Court reasoned that a post-petition claim of lien on real property filed by a subcontractor is invalid and unenforceable if the corresponding claim of lien on funds was perfected post-bankruptcy filing.

The bankruptcy court’s *Order Regarding Motions for Relief from Stay* entered in the Mammoth bankruptcy ultimately reached the same conclusion as the order entered in the Harrelson bankruptcy, holding that:

After a thorough analysis of the legal arguments set forth by the parties in both this case and in Harrelson Utilities, the court in an order entered in the Harrelson case...[holding] that serving a notice of claim of lien on funds due to the debtor post-petition violates the automatic stay... Accordingly, post-petition notices filed by the subcontractors in this case violated the automatic stay and are void. As discussed in *Harrelson*, liens filed by subcontractors against the real property must be supported by valid liens on funds due to the contractor, and if the liens on the funds are invalid, so are liens against the real property.

### *Conclusion*

The orders entered by the Bankruptcy Court in the Harrelson and Mammoth bankruptcies muddy the waters for unpaid subcontractors and severely limit the ability of an unpaid subcontractor to perfect and enforce its lien rights under North Carolina law after a contractor files for bankruptcy protection. Without a perfected lien, a subcontractor becomes another general unsecured creditor and thus has a much smaller chance of receiving much – if any – payment on its claims.

Many of the subcontractors in the Mammoth and Harrelson bankruptcies have appealed the bankruptcy court’s decision; however, unless and until the rulings are overturned, subcontractors need to be aware of this ruling as to avoid violating the automatic stay and thus becoming subject to sanctions and monetary penalties.