LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist™

Volume XX, Number 9 • July 2003

Lien Creation and Lien Perfection: What's the Difference?

Mechanics' Liens and the Automatic Stay

By Adam L. Rosen and Lon J. Seidman

It is generally understood that materialmen, contractors, subcontractors and others (collectively called "contractors") who perform labor or furnish materials on construction projects are entitled under state law to assert a mechanics' lien against real property for the value of the labor or materials they provide. What is less clear is the effect of a bankruptcy petition that is filed before the contractor has taken the necessary steps to create or perfect its rights.

It is not necessarily correct that Bankruptcy Code section 362(b)(3), which permits a contractor to take steps to perfect a mechanics' lien after a bankruptcy petition has been filed, provides a blanket exception to the automatic stay for any steps a contractor might take to advance its lien rights.

As explained below, there are important differences between lien *creation*, which is proscribed by the automatic stay, and lien *perfection*, which is sometimes excepted from the automatic stay, depending upon applicable state law. The Bankruptcy Code permits post-petition perfection on the theory that a lien holder should not lose

continued on page 5

Sigh of Relief: Derivative Actions Safe for Now

By Scott D. Cousins and Luis Salazar

Much to the relief of many in the Third Circuit, its long-awaited *en banc* ruling in the *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery, (en banc) No. 01-3805 (May 29, 2003)* disagreed with the decision of one of its panels and upheld the right of parties other than a debtor or trustee to pursue avoidance actions under the Bankruptcy Code on a derivative basis. In doing so, the court supported the well-established practice allowing these derivative actions, and eschewed a slavish plain-language interpretation of Section 544(b) in favor of a broader, multi-section reading.

The Circuit's analysis of that Section employs a "holistic" approach that is arguably quite at odds with the now decade-old Supreme Court trend of plain-language interpretation. In fact, the circuit court took great pains to demonstrate why the plain-language holding of *Hartford Underwriter Ins. Co. v. Union Planters Bank* — a case appellees and the dissent argued was controlling — was inapplicable. With the rumored retirement of Chief Justice Rehnquist, plain-language's champion, will *Cybergenics* signal the end of an era, or merely a narrow exception created by necessity? Or, if appealed to the Supreme Court, will it offer a final, conclusive opportunity to establish plain language as the sole interpretive mechanism for the Code?

Summary of the Case

The facts confronting the circuit in the *Cybergenics* appeal are really quite common within the bankruptcy practice. In that Chapter 11 case, the Official Committee of Unsecured Creditors sued to reverse certain transactions as fraudulent transfers under Section 544(b). Initially, the Committee asked Cybergenics, the debtor-in-possession, to prosecute the fraudulent transfer claims, but Cybergenics refused. The Committee then obtained court authorization to bring the claims derivatively for the benefit of the estate. In due course, the Committee sued the debtor's principal and several entities, seeking to recover millions of dollars that the Committee alleged were fraudulently transferred. Eventually, these defendants moved to dismiss on various grounds, including the Committee's lack of capacity to assert a Section 544(b) claim.

continued on page 2

IN THIS ISSUE

SC

191

PERIODICALS

Lien Creation

continued from page 1

its ability to perfect its lien under state law merely because the automatic stay intervenes. It does not, however, permit post-petition creation of liens.

The Section 362(b)(3) Exception

Section 362(a)(4) stays "any act to create, perfect, or enforce any lien against property of the estate." Section 362(b)(3) contains a limited exception, providing that:

"the filing of a petition ... does not operate as a stay ... of any act to perfect an interest in property to the extent that the trustee's rights and powers are subject to such perfection under Section 546(b) ..."

Section 546, in turn, preserves the protections given to creditors under applicable state law if a bankruptcy petition is filed *between the date a lien is created and the date it is perfected.* Section 546(b) provides that the trustee's avoiding powers under sections 544, 545 and 549 are "subject to any generally applicable 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."

Taken together, sections 362(b)(3) and 546 provide that if a contractor possesses a pre-petition interest in property (*ie*, a mechanics' lien), and "generally applicable law" authorizes perfection of the lien within a certain period of time after another party has acquired an interest in the property, the mechanics' lien can be perfected post-petition without violating the automatic stay. The key is that the lien must exist under state law *before* the case is filed.

Mechanics' Liens under New York Law

In New York, the "generally applicable law" governing mechanics' liens is the New York Lien Law. Under section 3 of the Lien Law, a mechanics' lien arises "from the time of filing a notice of such lien." The time for filing a notice of lien is prescribed by section 10 of the Lien Law, which provides that the notice of lien may be filed at any time during the progress of the work or the furnishing of materials, but must be filed within 8 months of the completion of the contract or the final performance of the work. Section 11 of the Lien Law provides that within 5 days before or 30 days after the filing of the notice of lien, the lienor must serve a copy of the notice upon the owner. Section 11 then requires that the lienor file proof of such service within 35 days of the filing of the notice of lien. Assuming a contractor complies with the above requirements, section 13 of the Lien Law provides that, with certain exceptions, the mechanics' lien will have priority over other claims that were not recorded, docketed or filed before the notice of mechanics' lien was filed.

A Thorny Question

Under New York law, may a contractor file a notice of mechanics' lien post-petition, so long as the filing occurs within 8 months of the completion of the work? Few cases address this question squarely. Two Bankruptcy Code provisions, however, strongly suggest that the answer is "no."

First, the automatic stay of section 362(a)(4) prohibits "any act to *create, perfect, or enforce* any lien against property of the estate." (Emphasis added.) The limited exception contained in section 362(b)(3), however, is narrower; it only excepts acts "to *perfect* an interest in property to the extent that the trustee's rights and powers are subject to such perfection under section 546(b) ... " (Emphasis added.)

Section 362(b)(3) does not permit the post-petition creation of a lien. Lien creation and lien perfection are, of course, two separate things. As mentioned, in New York, a mechanics' lien is created at the time the notice of lien is filed. *See* NY Lien Law § 3; Robert H. Bowmar, *Mechanics' Liens in New York* § 8.1 (Lawyers Coop. 1992 & Supp. 2001) ("The filing of a notice of lien is a condition precedent to the existence of the lien"). As of the date of filing, the lien becomes enforceable against the debtor. The perfection of a mechanics' lien often occurs later, *ie*, when the lienor serves notice of the filing of the lien and files proof of such service. *See* NY Lien Law § 11. After these two additional requirements are met, the lien takes priority over the rights of intervening creditors who acquired rights after the notice of mechanics' lien was filed but before the lien was perfected. *See Klein v. Civale & Trovato, Inc. (In re Lionel Corp.)*, 29 F.3d 88, 93 (2d Cir. 1994) (where notice of mechanics' lien was filed pre-petition, lienor's post-petition acts of serving notice of the filing and filing proof of such service were acts that perfected the lien and, thus, were excepted from the automatic stay).

Thus, applying the plain language of section 362(b)(3), a contractor should not be permitted to file a mechanics' lien post-petition against a debtor's property located in New York. It should be noted, however, that at least two Bankruptcy Court decisions have permitted mechanics' liens to be created post-petition, but they have done so without analyzing the plain language of section 362(b)(3). *See In re Severson Acres Development Corp.*, 142 B.R. 59, 60 (N.D.N.Y. 1992); *In re Fiorillo & Co.*, 19 B.R. 21, 23 (S.D.N.Y. 1982).

The 'Interest in Property' Requirement

Second, sections 362(b)(3) and 546(b) authorize the post-petition perfection of an "interest in property." As explained above, under New York law, a contractor does not have any interest in the debtor's property capable of being perfected until the notice of lien is filed. *See Tisdale Lumber Co. v. Read Realty Co.*, 154 A.D. 270, 138 N.Y.S. 829 (2d Dep't 1912) ("There is no such thing as an 'inchoate' mechanic's lien. The sole right given by the statute is to create a lien, which has no existence, inchoate or otherwise, until the notice is filed ... "). Thus, if the notice of lien is not filed by the time the automatic stay comes into existence, the stay prohibits any further act by the contractor.

Similar analyses conducted in the context of tax liens and attachment liens have yielded similar results, *ie*, that post-petition attempts to "perfect" such liens would violate the automatic stay. *See Makaroff v. City of Lockport*, 916 F.2d 890, 895-96 (3d Cir. 1990) (under New York law, tax assessments made post-petition violated the automatic stay because the taxing authority

continued on page 6

Adam L. Rosen is a partner with the Uniondale, NY, law firm of Scarcella Rosen & Slome LLP, and **Lon J. Seidman** is counsel to the firm.

Derivative Actions

continued from page 2

Section 503(b)(3)(B). That Section allows for the priority payment of the expenses of "a creditor that recovers, after the Court's approval, for the benefit of the estate any property transferred or concealed by the debtor." The circuit court rejected appellee's arguments that this Section should be narrowly interpreted, favoring instead what it called the Section's "natural meaning." That is, Section 503(b)(3)(B) allows a court to compensate a creditors' committee pursuing derivative actions on behalf of a debtor's estate. By implication, therefore, the pursuit of those types of actions is authorized by Congress and the Bankruptcy Code.

Pulling all these Sections together, then, the circuit court ruled that the "most natural reading" of the Code is that Congress recognized and approved a derivative standing for creditors' committees, as part of their "robust and flexible role" in representing the bankruptcy estate, even in adversarial proceedings. As further support for its holding, the court cited both Second and Seventh Circuit cases that reached this very same conclusion.

But this textual conclusion alone was not enough. In the Circuit's view, the missing component was the court's inherent equitable power to craft flexible remedies in situations where the Code's causes of action failed to achieve their intended purpose. The court reviewed approvingly the long-held notion that bankruptcy courts were courts of equity, and thus empowered to craft remedies to promote the Bankruptcy Code's goals. And the Circuit's analysis of all the relevant non-textual factors supported an "equitable solution" empowering creditor committees to pursue derivative actions where a debtor unjustifiably refuses. For one thing, the practice itself traced its roots back into the pre-Code period. For another, other available options asserted by appellees — such as the appointment of a trustee or an examiner with additional powers, or the conversion of the case — were simply not as attractive, nor did they support Congress' intention to make the committee's role in Chapter 11 cases meaningful.

Therefore, the circuit court ruled in favor of the Committee, and reversed the district court's dismissal for lack of standing under Section 544(b). But the case will not return immediately to the district court, as the circuit court directed the original appellate panel to consider the Committee's appeal of the five other grounds for the complaint's dismissal.

Conclusion

The circuit court's decision certainly generated an audible sigh of relief from many practitioners, but it should also generate some questions about the future of Bankruptcy Code interpretation. Just as *Cybergenics* supports the creditors' committee's "robust and flexible" role in the Chapter 11 process, so has it reopened the door to the courts' robust and flexible analysis of the Bankruptcy Code. Looming on the horizon is a potential appeal to the Supreme Court that will leave that door ajar or shut it firmly.

—❖—

Lien Creation

continued from page 5

did not have an "interest in [the assessed] property" prior to the bankruptcy filing); *But see In re Parr Meadows Racing Ass'n. Inc.*, 880 F.2d 1540 (2d Cir. 1989) (holding that under New York state tax law, taxing authority possessed an "interest in property" as of the date that taxes were assessed, even though lien did not attach until after the bankruptcy filing). See also *In re Minton Group, Inc.*, 28 B.R. 774, 779-80 (Bankr S.D.N.Y. 1983) (creditor did not have prejudgment attachment lien capable of post-petition perfection since it did not complete the Connecticut statutory prerequisites of causing the town clerk to record the certificate of attachment until after the bankruptcy petition was filed).

Unlike New York law, some state laws provide that mechanics' liens can be created earlier than the date the lienor files a notice of its lien or claim. For example, under Pennsylvania law, a mechanics' lien arising out of the construction of an improvement is created upon the visible commencement of the work. *See Matter of Yobe Elec., Inc.* 30 Bankr. 114, 117 (Bankr. W.D. Pa. 1983). Similarly, in Illinois, a mechanics' lien can be created upon the execution of the underlying contract. *See FirstSouth, F.A. v. LaSalle Nat'l Bank*, 766 F. Supp. 1488, 1489 (N.D. Ill. 1991). Hence, a post-petition filing of a mechanics' claim in those jurisdictions generally would not violate the automatic stay.

However, other states, such as New Jersey, Michigan, Texas and California, have laws similar to New York's in that they require the contractor to make some type of filing in order for a mechanics' lien to be created. *See Citicorp v. Klauder & Nunno Enterps., Inc.*, 260 N.J. Super. 333, 616 A.2d 939, 941 (N.J. Super. Ct. App. Div. 1992) (requiring either the filing of mechanics' "notice of intention" or the filing of the construction contract); *J. Altman Cos., Inc. v. Saginaw Plumbing & Heating Supply Co.*, 202 N.W.2d 707, 711 (Mich. Ct. App. 1972) (requiring filing of proof of service of notice of intention to claim a lien); *Trinity Nat'l Bank of Dallas v. Criswell*, 1991 WL 141444, *3 (Tex. Ct. App. July 31, 1991) (requiring filing of affidavit); *Barr Lumber Co., Inc. v.Old Ivy Homebuilders, Inc.*, 40 Cal. Rptr. 2d 717 (Cal. App. Dep't Super Ct.1995) (requiring filing of preliminary notice of lien).

Conclusion

Contractors should carefully consider when mechanics' liens are created under applicable state law before taking steps to "perfect" post-petition. Although sections 362(b)(3) and 546(b) permit contractors to utilize applicable state law and perfect their liens post-petition, this limited exception to the automatic stay does not apply unless, in the first place, there exists pre-petition a lien capable of being perfected.

—❖—

The publisher of this newsletter is not engaged in rendering legal, accounting, financial, investment advisory or other professional services, and this publication is not meant to constitute legal, accounting, financial, investment advisory or other professional advice. If legal, financial, investment advisory or other professional assistance is required, the services of a competent professional person should be sought.