

# One Minute Memo®



## Third Circuit Holds That Post-Petition Filing of NJ Construction Lien Violates the Automatic Stay

By John W. Mills, III

On March 30, the Third Circuit Court of Appeals filed an opinion regarding whether the filing of a mechanic's lien after the commencement of a bankruptcy case violates the automatic stay. Given the frequent involvement of many companies in Delaware bankruptcy cases, you should be aware of the Third Circuit's ruling.

The Third Circuit case, *In re Linear Electric Company, Inc.*, concerns the relationship between New Jersey construction lien law and federal bankruptcy law. Under New Jersey law, any contractor, subcontractor, or supplier who provides work, services, material, or equipment pursuant to a contract is entitled to a lien for the value of the work or services performed or materials or equipment furnished, in accordance with the contract, based upon the contract price. Linear Electric was a contractor to whom two suppliers, Cooper Electrical Supply Co. and Samson Electrical Supply Co., Inc., sold electrical materials that Linear Electric incorporated into several construction projects. On July 1, 2015, Linear Electric filed a petition in bankruptcy under chapter 11 of the United States Bankruptcy Code. As of that date, Linear Electric had not fully paid Cooper and Samson. On July 15, 2015, Cooper and Samson filed construction liens on the developments into which Linear Electric had incorporated the electrical materials supplied by Cooper and Samson. Linear Electric moved to vacate the lien filings as having violated the automatic stay of the Bankruptcy Code, which stays, among other things, any act to create, perfect, or enforce any lien against property of the estate. The bankruptcy court granted the motion, holding the liens to be void *ab initio* for violation of the automatic stay. On appeal, the district court affirmed, and the Third Circuit also affirmed.

The Bankruptcy Code provides an exception to the stay of the filing of liens. Specifically, section 363(b)(3) of the Code provides that the filing of a petition in bankruptcy does not stay any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's or debtor-in-possession's rights and powers are subject to such perfection under section 546(b) of the Code. Section 546(b)(1) in turn provides that the rights of a trustee or debtor-in-possession to avoid a lien are subject to any generally applicable law that (A) 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 (B) 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. Cooper and Samson argued that these sections authorized the post-petition filing of their construction liens.

Cooper and Samson relied upon *In re Yobe Electric, Inc.*, where the Third Circuit affirmed a bankruptcy court's determination that the post-petition filing of a mechanic's lien under Pennsylvania law did not violate the automatic stay. The facts in *Yobe* are analogous to Linear Electric: a subcontractor filed a mechanic's lien after a general contractor filed a bankruptcy case.

However, the Third Circuit distinguished *Yobe* from *Linear Electric*. In *Yobe*, the post-petition lien filed under Pennsylvania law related back to “the date of visible commencement upon the ground of the work of erecting or constructing the improvement,” which, in *Yobe*, occurred prepetition. The construction liens filed by Cooper and Samson under New Jersey law were effective as of their post-petition filing date and did not relate back. The Third Circuit held that if under applicable State law the post-petition filing of a mechanic’s lien would not relate back to a date prior to the filing of the bankruptcy case, then the automatic stay of section 362(a)(4) applies, and the filing is prohibited. If under applicable State law the post-petition filing of a mechanic’s lien would relate back to a prepetition date, then the section 362(b)(3) exception to the automatic stay would apply, and the lien can be filed.

There are two important points discussed by the Court that are not part of its holding. First, under New Jersey law, the construction liens filed by Cooper and Samson attached to the accounts receivable owed by the property owner to the debtor contractor, i.e. they attached to property of the debtor. They did not attach to the non-debtor owner’s real property or improvements. The Court made clear in its discussion that the filing of a mechanic’s lien, or any other lien, that under State law does not attach to a debtor’s property is not barred by the automatic stay. Second, the Court emphasized that its ruling relates to lien creation or perfection and not to enforcement or maintenance.

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