Navigating Lien and Trust Fund Rights When a Party in the Construction Supply Chain Files for Bankruptcy

SUPPLEMENTAL MATERIALS

Presentation For:

NACM Webinar

March 11, 2019 – 1:30 pm - 3:00 pm

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SELECTED TOPIC

Bruce Nathan, Esq. and Eric Chafetz, Esq.

Construction Suppliers Beware: The Bankruptcy Code's Automatic Stay May Bar Post-Petition Perfection of Your Lien Rights

Most states have enacted statutes that allow creditors providing goods and/or services to a contractor on a construction job to file a "mechanics' lien" or "construction lien" directly against a third-party owned construction project in which (a) the creditor provided goods and/or services to the contractor, (b) the contractor used the goods and/or services on the construction project, and (c) the contractor had not paid for the materials or services. Under certain circumstances, the creditor might also be able to benefit from its lien rights by stepping into the contractor's shoes and directly collecting the project owner's indebtedness to the contractor.

Mechanics' or construction lien rights are a powerful collection tool for trade creditors involved in the construction industry. These lien rights, if exercised properly, can potentially elevate an otherwise general unsecured claim that oftentimes recovers only pennies on the dollar to a much more valuable secured claim that in many instances receives full recovery.

Well, what happens if the contractor files bankruptcy? Can the creditor file its mechanics' lien post-petition? The answer depends on the lien law of the state where the construction project is located and whether the lien law allows for the retroactive perfection of lien rights to before the bankruptcy filing.

These lien rights, if exercised properly, can potentially elevate an otherwise general unsecured claim that oftentimes recovers only pennies on the dollar to a much more valuable secured claim that in many instances receives full recovery.

The Third Circuit Court of Appeals, in *In re Linear Electric Company Inc.*, recently dealt with New Jersey's construction lien statute, N.J.S.A. § 2A: 44A. The court held that two creditors that sold goods to an electrical contractor for use in several construction projects had violated the automatic stay that arose in the contractor's bankruptcy case by filing construction liens against the owner's interest in the projects after the bankruptcy filing. The court concluded the creditors had violated the stay because, under New Jersey's lien law, the creditors had obtained post-petition liens in the contractor's assets consisting of accounts receivable the owners owed to the contractor on the projects into which the contractor had incorporated the creditors' goods. It did not matter that the creditors had also obtained their post-petition lien rights against the property interests of the nondebtor project owners, which were not property of the contractor's bankruptcy estate.

The Third Circuit's decision is a warning to suppliers of goods and/or services on construction projects in New Jersey and other states with similar lien laws to quickly file their mechanics' or construction liens. Significantly, the outcome might have been different in other states whose lien laws grant creditors additional time to file their liens by providing for the retroactive perfection of lien rights to before the bankruptcy filing when, for example, the lien arose (i.e., when the creditor had furnished goods or services for the project).

The New Jersey Construction Lien Law

Pursuant to the New Jersey Construction Lien Law, N.J.S.A. § 2A: 44A (the "NJ Lien Law"), "[a]ny contractor, subcontractor or supplier who provides work, services, material or equipment pursuant to a contract, shall be entitled to a lien for the value of the work or services performed, or materials or equipment furnished. … " The lien arising under the NJ Lien Law attaches to the "interest of the owner or unit owner of the real property development … " and is "limited to the amount that [the owner] agreed in writing to pay … ," less amounts paid by the owner prior to the filing of the lien.

There are various limitations on construction liens under the NJ Lien Law. For example, there generally is no lien if the property owner is no longer indebted to the contractor when the lien was filed. In addition, a lien claimant cannot receive more than (a) the amount the owner had agreed to pay the contractor less payments by or on behalf of the owner prior to the filing at the lien, and (b) the unpaid portion of the contract price owing to the lien claimant.

Significantly, construction liens arising under the NJ Lien Law are only effective as of the date of the filing of the lien. This is in contrast to other states' lien laws where a timely filed lien relates back to an earlier date, such as when the lien arose under state law.

The Impact of a Contractor's Bankruptcy Filing on State Law Lien Rights

According to Bankruptcy Code section 362(a), a debtor's bankruptcy filing triggers an automatic stay that bars a wide variety of creditor actions against the debtor and/or the debtor's property, unless the bankruptcy court grants relief from the stay. For instance, sections 362(a)(4) and (a)(5) stay a creditor's creation, perfection, or enforcement of a lien against property of the debtor and/or the debtor's estate.

A debtor's bankruptcy filing triggers an automatic stay that bars a wide variety of creditor actions against the debtor and/or the debtor's property, unless the bankruptcy court grants relief from the stay.

Bankruptcy Code section 362(b) creates exceptions to the automatic stay. One such exception is contained in section 362(b)(3). This section permits a creditor to perfect a mechanics' or construction lien subsequent to a contractor's bankruptcy filing to the extent that a bankruptcy trustee's rights and powers are subject to such perfection under section 546(b) of the Bankruptcy Code. Section 546(b)(1), in turn, permits the post-petition perfection of a lien that arose prior to a debtor's bankruptcy filing where applicable nonbankruptcy law permits the perfection to relate back to when the lien arose pre-petition so as to defeat an intervening lien creditor or any other third party that acquired rights in the property prior to perfection. Significantly, the NJ Lien Law lacks any such retroactive perfection of construction lien rights.

Factual and Procedural Background

Cooper Electrical Supply Co. ("Cooper") and Samson Electrical Supply Co. Inc. ("Samson") sold electrical materials to an electrical contractor, Linear Electric Co. Inc. ("Linear"). Linear used these materials in various construction projects. The construction project owners had not fully paid Linear for its work on the projects when Linear had filed its Chapter 11 petition in the United States Bankruptcy Court in New Jersey (the " Bankruptcy Court") on July 1, 2015 (the "Petition Date"). Linear, in turn, still owed Cooper $1,234,100.48 and Samson $142,980.17.[1]

Two weeks after the Petition Date, both Cooper and Samson filed construction liens against the projects. They argued that their lien filings did not violate the automatic stay in Linear's bankruptcy case because the liens attached to the projects owned by non-debtors and not to assets of the contractor's bankruptcy estate. Thereafter, on July 20, 2015, Linear filed a motion with the Bankruptcy Court seeking to discharge Cooper's and Samson's post-petition lien filings because they had violated the automatic stay in Linear's Chapter 11 case. The Bankruptcy Court directed Cooper and Samson to discharge their liens, ruling that Cooper and Samson had violated the automatic stay

EXTENDING CREDIT

Mind Your Mannerisms—and Your Manners, Too

There are times when I exchange my suit and tie for a polo shirt and jeans when I go on a customer visit. My customers are farmers, and sometimes their office is a barn. At one dairy farm a customer told me to go ahead and take a seat. The seat was a turned-over five-gallon bucket. It was no problem at all. Adapting to the situation and mannerisms of your customer builds rapport.

Any time you have a downturn in the economy and you have industries under pressure, you are going to be asked to do more location visits. Sometimes the sales staff asks me to do more visits because they are having trouble with first-line collections. Or maybe your customer is trying to establish lines of credit and you need to see what additional things you can do, such as getting a personal guarantee. Salespeople are not always comfortable having that conversation with their customers; they need someone else who is more of an expert in the financial arena.

One of the biggest advantages in doing customer visits is establishing trust with that customer. If they don't know who I am and what I look like I'm just an anonymous person on the phone. But after having that conversation, I'm no longer a faceless person; I'm Kevin. When you've established that rapport with a customer, they are more likely to pick up the phone when they see your name on their Caller ID. They are more likely to pay the person who is asking for money.

I have a customer who lives a few miles from me with whom I've worked for 10 years. We're on a first-name basis and we've formed a tradition. Every 26th of December he goes on a trip, but his account is due at the end of the year. He calls me every Christmas Eve to make sure the account gets paid. He has even come to my house on Christmas Eve and given me Christmas presents. He has my number on his cell phone just so that he can call me on Christmas Eve and get his account paid. He wants to make sure the check is in my hands before the end of the year. That rapport we've established has become an enjoyable tradition every year.

Establishing rapport with customers means matching your mannerisms to them. I have some customers that if I approach their farms in a suit and tie, I'd be thrown out. On one visit, the salesperson handed me a ball cap. I asked what it was for. He told me that the customer would not meet with me without a ball cap on. Otherwise, he would think I was a banker or an insurance salesman.

It's fine by me. Building rapport with your customer will pay you back tenfold. And sometimes you get to wear jeans to work, too.

***Kevin Stinner, CCE, CCRA**, is credit manager at Crop Production Services.*

by filing their construction liens post-petition and the liens were, therefore, void *ab initio*.

Both Cooper and Samson appealed the Bankruptcy Court's orders to the United States District Court for the District of New Jersey (the "District Court"). The District Court affirmed the Bankruptcy Court's decisions and both Cooper and Samson then appealed to the Third Circuit.

The Third Circuit's Decision

The Third Circuit held that the construction liens filed by Cooper and Samson after the Petition Date had violated the automatic stay in Linear's bankruptcy case. The court concluded that due to the procedure Cooper and Samson had followed under the NJ Lien Law, the post-petition payment of Cooper's and Samson's liens from Linear's accounts receivable owed by the project owners reduced Linear's receivables, which were property of Linear's estate.[2]

The Third Circuit noted that construction liens governed by the NJ Lien Law are effective upon filing and do not relate back to prior to the bankruptcy filing when the liens arose. As a result, construction liens in New Jersey are not subject to the exception to the automatic stay contained in section 362(b)(3) and any post-petition filing would violate the stay.

Thus, the key issue in the *Linear* case was whether the construction liens had attached to property of Linear's bankruptcy estate. The Third Circuit concluded that the NJ Lien Law allowed Cooper and Samson to file their construction liens for the value of the materials they had sold to Linear and that Linear had used in the projects. Cooper and Samson had liens both in the projects owned by the nondebtor project owners, which were not property of Linear's bankruptcy estate, and in the accounts receivable the owners owed Linear for its work on the projects, which were property of Linear's estate. Cooper's and Samson's post-petition lien filings violated the automatic stay by enabling them to collect the receivables (Linear's asset) and reduce the amounts the owners owed to Linear by an amount equal to those payments.

The Third Circuit then compared the *Linear* case, governed by the NJ Lien Law, to cases involving analogous facts where the project is located in a state whose construction or mechanics' lien law allows a retroactive perfection of lien rights to a date prior to the bankruptcy filing. In *In re Yobe Electric Inc.,* a case filed in the United States Bankruptcy Court for the Western District of Pennsylvania, a subcontractor (like Cooper and Samson) had filed a mechanics' lien after a general contractor (like Linear) had filed for bankruptcy. However, unlike *Linear*, the subcontractor's lien in *Yobe Electric* was governed by Pennsylvania's lien law which permits a mechanics' lien to relate back to when the subcontractor had provided goods for the project. Accordingly, since the subcontractor/supplier had provided goods prior to the contractor's bankruptcy filing date in *Yobe Electric*, the subcontractor's timely post-petition perfection of the lien did not violate the automatic stay as a result of the relation back provision under Pennsylvania's lien law.

In states with statutes like the NJ Lien Law, the best practice for a construction creditor that learns about a contractor's financial distress is to quickly file its lien prior to the contractor's bankruptcy filing when there is no bankruptcy stay that would otherwise stand in the way.

Conclusion

As the Third Circuit's decision in *Linear* illustrates, mechanics' and construction lien rights vary from state to state and are governed by the lien law of the state where the project is located. A construction lien filing following a contractor's bankruptcy filing in states like New Jersey violates the automatic stay because the lien attaches to property of the contractor's bankruptcy estate (the receivable the project owner owes the contractor), becomes effective post-petition upon the filing of the lien, and does not relate back to an earlier date prior to the bankruptcy filing when the lien arose. That will land the creditor filing the lien in hot water, exposing it to unnecessarily costly and time consuming litigation.

In states with statutes like the NJ Lien Law, the best practice for a construction creditor that learns about a contractor's financial distress is to quickly file its lien prior to the contractor's bankruptcy filing when there is no bankruptcy stay that would otherwise stand in the way. If the contractor files for bankruptcy prior to the creditor's exercise of its lien rights in such states, the automatic stay would preclude any exercise of lien rights, and the creditor would be left with the expensive alternative of moving for relief from the stay to file its lien against the project. However, that would be unnecessary and the creditor would not be barred from timely filing its lien post-petition where the project is located in a state, like Pennsylvania, whose lien law includes a relation back provision.

Aren't lien rights fun!

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1 After the Petition Date, Cooper and Samson were paid $257,026.63 and $15,755.54, respectively. Consistent with the NJ Lien Law, both claimants reduced their claims to reflect the payments.

2 The Third Circuit rejected Cooper's and Samson's arguments that they had not violated the automatic stay because (i) their liens attached to the real property interests of the non-debtor project owners and not to Linear's property (its accounts receivable), and (ii) Linear did not have any interest in the debts owed by the project owners.

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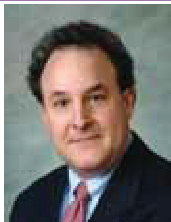

BRUCE NATHAN, ESQ.

Materialman's Lien Rights: Post-Petition Perfection Approved

A mechanic's or materialman's lien is a state law lien granted to secure payment of the claims of creditors that supply goods and/or labor to improve real property. While all states have mechanic's or materialman's lien laws, their lien laws differ in the manner in which these liens arise and are perfected.

Mechanic's and materialman's liens generally attach to the debtor's real property. North Carolina's lien law, contained in Chapter 44(A) of the North Carolina General Statutes, (the North Carolina Lien Law) sets forth the requirements for a contractor and subcontractor on a North Carolina construction project to obtain and perfect their lien rights. Contractors and subcontractors, who deal directly with the owner of real property and satisfy the requirements of the statute, obtain lien rights in the owner's real property. According to Section 44A-18, the provision of the North Carolina Lien Law at issue in the case discussed in this article, a subcontractor, who deals with someone other than the owner of real property and satisfies the statute's requirements, also obtains a lien in funds owed on account of the construction project for which the subcontractor had provided goods and/or services. This lien in project funds arises upon the subcontractor's delivery of goods and/or the provision of services. The lien is perfected upon the creditor's providing written notice of the lien.

The subcontractors invoked an exception to the automatic stay that allows a creditor to perfect its lien rights post-petition.

Recently, the United States Court of Appeals for the Fourth Circuit, in *In re Construction Supervision Services, Inc.,* ruled in favor of the subcontractors who provided goods to their customer on various North Carolina construction projects, prior to the customer's bankruptcy filing, and then sought to perfect their "inchoate" lien rights in project proceeds during the bankruptcy case. The subcontractors argued that they were not barred by the automatic stay from perfecting their lien rights post-petition by giving post-petition notice of their liens. The subcontractors invoked an exception to the automatic stay that allows a creditor to perfect its lien rights post-petition if such rights are an "interest in property" on the bankruptcy filing date and state law allows such perfection to relate back to the creation of the lien and be effective against third parties with a perfected pre-petition interest in the same property.

The Fourth Circuit ruled that the subcontractors satisfied Section 362(b)(3)'s stay exception and could, therefore, perfect their lien rights post-petition. That enabled the subcontractors to obtain priority status in project funds over the rights of the debtor's lender with a perfected blanket security interest in the funds. Quite a nifty little device. Read on to see why!

The Impact of a Contractor's or Subcontractor's Bankruptcy Filing on State Law Lien Rights

According to Bankruptcy Code Section 362(a), a debtor's bankruptcy filing triggers the automatic stay. The automatic stay bars a wide variety of creditor actions against the debtor and/or the debtor's property, unless the bankruptcy court grants relief from the stay. For instance, Sections 362(a)(4) and (a)(5) stay a creditor's creation, perfection, or enforcement of a lien against property of the debtor and/or the debtor's estate. So does the stay bar a creditor from perfecting its lien rights post-petition? Not so fast!

Bankruptcy Code Section 362(b) creates exceptions to the automatic stay. One such exception, contained in Section 362(b)(3), permits a creditor "…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) [of the Bankruptcy Code]…" This stay exception applies to mechanic's and other lien creditors that can satisfy Bankruptcy Code Section 546(b).

Section 546(b)(1) states that a bankruptcy trustee's rights

> "…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 such perfection…."

Section 546(b)(1) permits the post-petition perfection of a property interest, that arose prior to a debtor's

bankruptcy filing, to be effective against any third party that acquired rights in the property prior to the date of perfection.

The automatic stay, therefore, does not prevent a mechanic's or materialman's lien creditor, whose lien arose prior to bankruptcy, from perfecting its lien post-petition. This is conditioned on state law that permits a creditor's perfected lien rights to relate back to their creation and have priority over any other entity acquiring rights in the property prior to perfection, such as the debtor's secured lender with a perfected pre-petition security interest in the same asset.

The Fourth Circuit, in the *Construction Supervision Services* case, ruled that "inchoate" unperfected mechanic's or materialman's lien rights in North Carolina are "interests in property" that could be perfected post-petition and have priority over pre-petition perfected security interests under the North Carolina Lien Law. As such, the subcontractors in that case are not barred by the automatic stay from perfecting their pre-petition unperfected "inchoate" lien rights during the debtor's bankruptcy case by dispatching notices of lien.

North Carolina's Lien Law: Chapter 44(A)

The North Carolina lien statute at issue in the *Construction Supervision Services* case, North Carolina General Statute §44A-18, addresses the lien rights of subcontractors who dealt with someone other than the owner of real property. According to North Carolina General Statute §44A-18, a subcontractor that furnishes labor, common materials or rental equipment on a construction project can assert a lien on the monies owed on that project. Subcontractors have two different types of lien rights. First, all subcontractors have a lien on the funds owed by the party directly above them in the contract chain. Additionally, second and third tier subcontractors have a lien on the funds owed to entities in the contract chain above the party with whom the second or third tier subcontractor had contracted.

This lien in project funds arises when a subcontractor provides material, labor or rental equipment to the contractor on the project. The lien is then perfected when the subcontractor gives written notice of its lien to all parties above the subcontractor in the lien chain, including all higher tiered subcontractors, the general contractor and the owner of the property.

Finally, North Carolina General Statute §44A-22 contains the priority rules governing creditors whose liens in project funds arise under the North Carolina Lien Law. Those lien claimants that perfect their lien rights have priority over creditors with security interests and other lien rights in the funds.

The Facts of the Construction Supervision Services Case

Construction Supervision Services (CSS) was a full-service construction company that acted as a general contractor or a

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first-tier subcontractor on various construction jobs. CSS had placed orders with several first-tier and second-tier suppliers (the Subcontractors) to purchase stone, concrete and fuel to run equipment and furnish rental equipment on various construction projects (the Projects). The Subcontractors delivered goods to CSS, for use on the Projects, on open account and later invoiced CSS for the amounts owed the Subcontractors.

CSS filed a Chapter 11 bankruptcy petition in January 2012. When CSS had filed its Chapter 11 case, the Subcontractors had unperfected "inchoate" lien rights under the North Carolina Lien Law in the proceeds of the Projects for which they had provided goods. However, the Subcontractors had not perfected their lien rights pre-petition.

Branch Banking and Trust (BB&T) was CSS' secured lender when CSS had filed its Chapter 11 case. CSS owed BB&T in excess of $1 million. BB&T's claim against CSS was secured by, among other assets, CSS's accounts receivable, including the Project funds that the Subcontractors claimed were subject to their lien rights.

> All subcontractors have a lien on the funds owed by the party directly above them in the contract chain.

After CSS's bankruptcy, the Subcontractors had sought to serve notice of and thereby perfect their lien rights on funds third parties owed CSS on the Projects. The Subcontractors sought an order from the bankruptcy court declaring that they were not barred by the automatic stay from perfecting their lien rights post-petition in Project funds. The Subcontractors invoked Section 362(b)(3)'s stay exception applicable to pre-petition property interests the post-petition perfection of which would be effective against third parties who acquired a perfected pre-petition interest in this property. The Subcontractors claimed their liens arose pre-petition and once perfected (even post-petition) would be effective against all third parties, like BB&T with a valid and perfected pre-petition security interest in Project funds.

BB&T argued that the automatic stay prevented the Subcontractors from perfecting their lien rights post-petition. According to BB&T, the Subcontractors could not invoke Section 362(b)(3)'s stay exception because their unperfected lien rights in project proceeds were not an "interest in property" of CSS.

The bankruptcy court ruled in favor of the Subcontractors. The court held: (a) the Subcontractors' unperfected "inchoate" lien rights were "interests in property" of CSS because their lien rights arose upon their delivery of goods for the Projects (*i.e.,* before lien notice and perfection) and (b) once perfected, their liens related back to their creation pre-petition. This satisfied Section 362(b)(3)'s exception to the automatic stay and thereby enabled the Subcontractors to perfect their lien rights post-petition by serving their lien notices.

BB&T appealed to the District Court. The District Court, affirming the bankruptcy court, also held that the Subcontractors' post-petition notice and perfection of their lien rights did not violate the automatic stay.

That led to BB&T's appeal to the Fourth Circuit.

The Fourth Circuit's Decision

The Fourth Circuit ruled that Section 362(b)(3)'s automatic stay exception permitted the Subcontractors to provide notice of and thereby perfect their lien rights in funds generated by the Projects subsequent to CSS' bankruptcy filing. The court held the Subcontractors' "inchoate" unperfected lien rights that arose pre-petition were an "interest in property."

The court relied on North Carolina General Statute §44A-18 that grants a subcontractor a lien upon funds owed to the contractor or subcontractor with whom the subcontractor had dealt, arising out of the improvements on which the subcontractor had worked or furnished materials. Section 44A-18 further states that a lien on funds created "under this section shall secure amounts earned by the lien claimant as a result of having furnished labor, common materials or rental equipment at the site of the improvement under the contract to improve real property…." As a result, the Subcontractors' lien rights arose upon the delivery of their goods and equipment to the construction project prior to the commencement of CSS' bankruptcy case.

The Fourth Circuit held that the Subcontractors' perfected "inchoate" lien rights were an "interest in property." There was no dispute that, before CSS' bankruptcy, the Subcontractors had delivered materials and equipment to CSS for its numerous construction projects. Under the North Carolina Lien Law, the Subcontractors' lien rights, therefore, arose pre-bankruptcy upon delivery of the materials and equipment for use on the Projects.

The Fourth Circuit also noted that according to Section 362(b)(3), the automatic stay does not apply to the post-petition perfection of lien rights as long as this constitutes an "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(b), in turn, subjects a bankruptcy trustee's rights and powers to 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…."

Applying both Sections 362(b)(3) and 546(b), the Fourth Circuit concluded that the Subcontractors' lien rights arose prior to CSS' bankruptcy filing when they had delivered goods for the Projects, and were, therefore, an interest in property of CSS. In addition, pursuant to the North Carolina Lien Law, once the Subcontractors had perfected their lien rights post-petition by providing the requisite notices, their lien rights related back to their pre-petition delivery of goods. As a result, the Subcontractors had satisfied Section 362(b)(3) and were

not barred by the automatic stay from noticing (*i.e.*, perfecting) their pre-petition inchoate lien rights (*i.e.*, their interest in property) post-petition.

The Fourth Circuit relied on the Seventh Circuit Court of Appeal's decision in *In re AR Accessories Group, Inc.* In that case, a government agency, invoking Wisconsin law, asserted a statutory wage lien on the property of an employer that

> The agency timely perfected its wage lien post-petition when it had filed a verified petition claiming the lien.

failed to pay its employees. The Seventh Circuit held the wage lien arose and was an interest in the employer's property prior to the employer's bankruptcy filing when the employees performed their last unpaid services. The agency timely perfected its wage lien post-petition when it had filed a verified petition claiming the lien. The court noted that the agency's post-petition perfection of its lien rights did not violate the stay because the lien arose pre-petition, and, under Wisconsin law, was granted superpriority rights over the rights of the employer's secured lender and other creditors.

The Fourth Circuit also rejected recent decisions by the United States Bankruptcy Court for the Eastern District of North Carolina that subcontractors' lien rights in project funds could not be perfected post-petition because their unperfected "inchoate" lien rights were not an "interest in property." The Fourth Circuit relied on a recent amendment to the North Carolina Lien Law (§44A-18) that entitled a subcontractor to a lien on project funds as soon as goods and services are delivered.[1]

Conclusion

The Fourth Circuit's decision is great news for creditors providing goods and/or services on construction projects in North Carolina and elsewhere. Once a subcontractor obtains a perfected lien in funds derived from a North Carolina construction project for which the subcontractor had provided goods and/or services, the subcontractor has a priority right to the project funds that is ahead of its customer's secured lender with a prior perfected security interest in the customer's accounts. Perfection and this priority occur notwithstanding the customer's bankruptcy filing and the resulting automatic stay. What a nice automatic stay exception to contend with!

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1. The court considered the amendment to the North Carolina Lien Law, even though the amendment became effective after the Subcontractors' claims arose, because the North Carolina legislature considered it a clarifying amendment.

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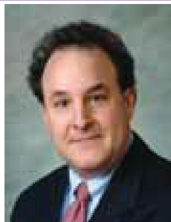

BRUCE NATHAN, ESQ.

Construction Trust Fund Payments as a Defense to Preference Claims: A Matter of Tracing

Suppliers of goods and services on construction projects may be the beneficiaries of construction trust fund rights. The trust, which can arise by contract, statute or common law, is imposed on sums payable by either the project owner or a general contractor for the benefit of their creditors that provide goods and/or services. The trust is designed to protect creditors providing goods and/or services on a construction project from the risk of nonpayment of their claims against a financially distressed general contractor or subcontractor. The trust frequently arises without the need for any notice and/or filing that would otherwise be required to create and/or perfect a mechanic's lien.

Trust fund status is also a defense to a preference claim. A trust beneficiary can argue that a debtor's trust payments are not property of the debtor and, therefore, do not satisfy one of the elements of a preference claim, the transfer of an interest of the debtor in property.

> A creditor asserting trust fund status as a defense to a preference claim must follow certain state law tracing rules to trace an alleged preference payment to the trust funds paid to the debtor on a specific construction project for which the creditor had supplied goods and/or services.

But what happens if the debtor commingles trust fund payments made for the benefit of their goods and labor suppliers with other funds not subject to trust fund protection? A creditor asserting trust fund status as a defense to a preference claim must follow certain state law tracing rules to trace an alleged preference payment to the trust funds paid to the debtor on a specific construction project for which the creditor had supplied goods and/or services. That is not necessarily so easy, and absent tracing the trust funds to an alleged preference payment, the supplier cannot assert trust beneficiary status as a defense to preference liability.

Tracing became an issue in *Lain v. Universal Drywall LLC (In re Erickson Retirement Communities, LLC),*

pending in the United States Bankruptcy Court for the Northern District of Texas. The liquidating trustee appointed under a confirmed Chapter 11 plan of liquidation had sought to recover a payment, made by a general contractor debtor to a subcontractor defendant, as an avoidable preference. The debtor was a general contractor on several construction projects and the debtor was required by its contract with one of the project owners to hold the owner's payments in trust for the benefit of the subcontractors that had provided goods and/or services on the project.

The wrinkle was that the debtor had commingled the owner's payments subject to the trust with non-trust payments from other projects and sources. Since the debtor had commingled trust and non-trust payments, the defendant had to employ state law tracing rules to trace the trust funds to the alleged preference payments in order to obtain the benefit of trust status to thereby avoid preference liability.

This article discusses the manner in which the parties employed state law tracing rules and the court's application of these rules that significantly reduced the subcontractor defendant's preference liability.

The Elements of a Preference Claim

Section 547 of the Bankruptcy Code governs preferences. A bankruptcy trustee can avoid and recover a preference by proving all of the following: (1) the debtor made a payment or other transfer of an interest of the debtor in property; (2) the payment or other transfer was to or for the benefit of a creditor; (3) the transfer was made on account of antecedent or existing indebtedness owing by the debtor to that creditor; (4) the

debtor was insolvent when the payment or other transfer was made, based on a balance sheet definition of insolvency (liabilities exceeded assets), which is presumed during the 90-day preference period; (5) the transfer was made within 90 days of the bankruptcy filing for non-insider trade creditors; and (6) the creditor obtained a greater recovery from the transfer than it would have received in a Chapter 7 liquidation of the debtor in the absence of the transfer.

A trustee must satisfy all of these requirements to prevail on a preference claim. The trustee's ability to satisfy Section 547(b)'s "payment from the debtor's property" requirement was at issue in *Erickson*. The *Erickson* court applied state law tracing rules to trace the trust funds to the alleged preference payment and significantly reduce (but not eliminate) the defendant subcontractor's preference liability.

The Facts of *Erickson*

The defendant, Universal Drywall LLC, a drywall construction company, was a subcontractor on a construction project, the Linden Ponds project, on which the debtor, Erickson Construction LLC (the debtor) was a general contractor. The project was owned by Hingham Campus LLC. The debtor and project owner had entered into a Prime Contract that governed their relationship. Under the Prime Contract, "payments received by the Contractor [the debtor] for Work properly performed by Subcontractors [such as the defendant] and suppliers shall be held by the Contractor for those Subcontractors or suppliers, who performed work, or furnished materials, or both, under contract with the Contractor for which payment was made by the Owner".[1] Bottom line, the project owner had paid funds to the debtor for work performed by the debtor's subcontractors (like the defendant) and other suppliers on the Linden Ponds project which the debtor had agreed to hold in trust for their benefit.

The debtor maintained an operating account and a corresponding investment sweep account as its only bank accounts. The debtor's operating account included funds received from different landowners, including the project owner, on various construction projects, other debtors and affiliates, and sometimes other sources, all of which were commingled in the debtor's operating account. The operating account was swept into the investment sweep account on a regular basis and was usually left with a zero balance.

The defendant performed work on the Linden Ponds project. The debtor had paid defendant sums totaling $2,348,134 prior to the preference period. On February 16, 2009, the defendant submitted a final requisition for payment of $215,312 to the debtor.

From January through September 2009, the project owner had paid sums totaling $2,058,660.03 to the debtor for the debtor's work on the Linden Ponds project. The debtor deposited these sums in its operating account. On March 20, 2009, the project owner made its largest payment, of $1,022,503.15 to the debtor. Almost six months later, the debtor paid the sum of $215,312 (the alleged preference) to the defendant by check dated September 23, 2009 that cleared on September 28, 2009.

Shortly thereafter, on October 19, 2009, the debtor filed its Chapter 11 petition. The debtor obtained court approval of a liquidating plan under which a creditor trust was created and the liquidating trustee was appointed. On October 14, 2011, the liquidating trustee commenced a lawsuit against the defendant seeking recovery of the alleged preference.

> The trustee's ability to satisfy Section 547(b)'s "payment from the debtor's property" requirement was at issue in *Erickson*.

The defendant moved for summary judgment to dismiss the lawsuit because, in pertinent part, the trustee could not satisfy his burden of proof that the alleged preference was paid from an interest of the debtor in property. The defendant argued that the debtor had no legal or equitable interest in the funds used to pay the alleged preference because they were impressed with trust fund status. As such, the trustee had the burden of proving that the funds used to pay the alleged preference were from non-trust fund sources.

The bankruptcy court denied summary judgment on whether the debtor had used trust funds to fund the alleged preference. The court agreed with the defendant that the prime contract had created a trust in funds the project owner had paid to the debtor for the defendant's work as a subcontractor on the Linden Ponds project. The court also agreed with the defendant that the commingling of the funds the debtor had received from the project owner with other non-trust funds did not defeat the trust.

However, all this did not negate the need to trace the trust funds to the alleged preference. While the trustee had the burden of proving, through normal state law tracing rules, that no trust funds were used to pay the alleged preference, the trustee was able to raise a question of fact as to whether trust funds were dissipated prior to the debtor's payment of the alleged preference.

The *Erickson* Court's Tracing Analysis

The *Erickson* court held a trial on December 18, 2012 over whether the alleged preference was paid from property of the debtor. That required considering whether the alleged preference was paid from funds that were held in trust for the benefit of the defendant. Since the debtor had commingled the project owner's payments subject to trust fund status with non-trust property, the parties had to trace the commingled funds to determine whether any trust funds were included as part of the alleged preference.

The court relied on state law tracing rules and, in particular, a rule known as the "lowest intermediate balance" test. Accord-

ing to the lowest intermediate balance test, if the amount of trust and non-trust commingled funds had at all times equaled or exceeded the amount of the trust claim, the trust beneficiary would be entitled to payment of the full amount of its trust claim from the commingled funds. This test creates a legal fiction that a debtor is deemed to first use non-trust funds when payment is made from a commingled account containing trust and non-trust funds. If the balance of the cash in the account on any given day, after withdrawal of non-trust funds, is less than the amount of the trust claim, the trust claim is limited to that "lowest intermediate balance."

In *Erickson*, the court conducted a tracing analysis by applying the lowest intermediate balance analysis to the debtor's operating account and investment sweep account on a combined basis. At the trial, the trustee's expert testified that on August 26, 2009, just prior to the payment of the alleged preference, the lowest intermediate balance in both accounts, combined, was $191,631.13. The expert then noted that another subcontractor on the Linden Ponds project, asserting the same trust fund rights regarding the project owner's payments to the debtor on the Linden Ponds project, had received payment from the debtor on the same day as the defendant received the alleged preference. The debtor's payment to the other subcontractor was by check that cleared first on September 25, 2009, three days before clearance of the alleged preference on September 28, 2009.

> The defendant argued that the debtor had no legal or equitable interest in the funds used to pay the alleged preference because they were impressed with trust fund status.

The expert concluded that the debtor's earlier payment of trust funds to the other subcontractor had reduced the amount of trust funds available to pay the defendant on a dollar for dollar basis. The expert treated the other subcontractor as a beneficiary of the same "lowest intermediate balance" of trust funds, totaling $191,631.13, that was available to the defendant. The expert argued that the other subcontractor's earlier receipt of payment reduced the trust fund portion of the alleged preference to only $19,812.18 ($191,631.13 minus the $171,818.95 payment to the other subcontractor). The remainder of the alleged preference, $195,499.82, was property of the debtor and recapturable as a preference.

The court rejected the liquidating trustee's novel application of the tracing rules as an inappropriate hybrid of the lowest intermediate balance rule and literal tracing. The court held that every subcontractor asserting trust status is entitled to do its own "lowest intermediate balance" test separate and apart from other trust fund claimants. That requires: (1) identifying whether there was a trust fund (here, the sum of $2,058,660.03) that the project owner had paid to the debtor from January through September, 2009 for work done on the Linden Ponds project prior to payment of the alleged preference; (2) identifying the lowest intermediate balance in the debtor's accounts prior to the payment of the alleged preference (here $191,631.13); and (3) treating the lowest intermediate balance as the remaining trust funds that belonged to the defendant.

Applying the lowest intermediate balance test in this manner, the court held that $191,631.13 of the alleged preference of $215,312 was paid from trust funds and not subject to preference liability. The defendant was liable for only $23,680.87 of non-trust funds that were considered "an interest of the debtor in property."

> The court rejected the liquidating trustee's novel application of the tracing rules as an inappropriate hybrid of the lowest intermediate balance rule and literal tracing.

Conclusion

Erickson made clear that where commingled funds are involved, a construction supplier's trust fund status is a defense to preference liability only where the supplier can trace the trust funds to the alleged preference payment. However, proving the existence of a trust is one thing; tracing the trust funds to an alleged preference payment to rebut preference liability is quite another.

The defendant in *Erickson* successfully applied the tracing rules, and in particular, the "lowest intermediate balance rule," to deflect a significant portion of its preference exposure. It just took a little "tracing" to accomplish that.

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1. The trust fund in *Erickson* arose by contract. More than a dozen states also have builders' or construction trust fund statutes that impose a trust on the sums payable to suppliers of material and labor on a construction project.

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NATIONAL ASSOCIATION OF CREDIT MANAGEMENT
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MAY 2012
THE PUBLICATION FOR CREDIT & FINANCE PROFESSIONALS $7.00

SELECTED TOPIC

Bruce Nathan, Esq.

Preference Relief for Real Estate Material and Service Providers

Providers of goods and services for the improvement of real property enjoy mechanic's or materialmen's lien rights under state law to secure payment of their claims. Their lien rights provide a defense to preference liability in addition to the typical preference defenses of subsequent new value, ordinary course of business and contemporaneous exchange for new value (COD).

That is precisely what happened in *In re Johnson Memorial Hospital, Inc.,* a Chapter 11 case pending in the United States Bankruptcy Court for the District of Connecticut. In the *JMH* case, a creditor was not subject to risk of preference liability based on its receipt of payment from a hospital debtor within 90 days of the debtor's bankruptcy filing for the creditor's repair and installation of the debtor's emergency generator radiator. The *JMH* court relied on the fact that the creditor could have obtained a perfected fully secured mechanic's lien on the debtor's real property when the creditor had received the alleged preference payment. As a result, the creditor rebutted one of the elements of the preference claim: the creditor's receipt of a greater recovery from the alleged preference payment than the creditor would have otherwise received in the debtor's Chapter 7 liquidation case. This is quite a nifty way for sellers of goods and services that improve real property to limit or eliminate their preference liability.

> The *JMH* court relied on the fact that the creditor could have obtained a perfected fully secured mechanic's lien on the debtor's real property when the creditor had received the alleged preference payment.

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The Elements of a Preference Claim

According to Bankruptcy Code Section 547(b), a trustee can avoid and recover a payment or other transfer of property as a preference if the trustee satisfies all of the following requirements: (a) the payment or other transfer was from the debtor's property; (b) the payment or other transfer was to or for the benefit of a creditor; (c) the payment or other transfer was in payment of an antecedent or existing debt that the debtor owed the creditor; (d) the payment or other transfer was made within 90 days of the debtor's bankruptcy filing for transfers to non-insider trade creditors; (e) the payment or other transfer was made while the debtor was insolvent (the debtor's liabilities exceed its assets), which is easy to prove because insolvency is presumed during the 90-day non-insider preference period; and (f) the payment or other transfer enabled the creditor to receive more than it would have recovered in a Chapter

7 liquidation. It is this final element of a preference claim, known as the "greater than liquidation recovery" requirement, contained in Section 547(b)(5), that was at issue in the JMH case.

Preference recovery is denied if the trustee cannot satisfy all of these requirements. In *JMH,* the court ruled that Section 547(b)(5)'s "greater than liquidation recovery" requirement for a preference claim could not be satisfied where the creditor had received payment and held off obtaining a perfected fully secured mechanic's lien on the debtor's real property.

The Johnson Memorial Hospital Case

On November 4, 2008, Johnson Memorial Hospital, Inc. and other affiliated entities (collectively the "debtors") filed voluntary Chapter 11 petitions with the United States Bankruptcy Court for the District of Connecticut. On August 11, 2010, the Connecticut Bankruptcy Court confirmed the debtors' joint Chapter 11 plan under which a plan custodian was appointed to pursue avoidance actions, including preference claims, on the debtors' behalf. The plan custodian, on JMH's behalf, commenced a lawsuit against New England Radiator Works (NER) for recovery of the sum of $7,262 that JMH had paid to NER on September 17, 2008 for NER's repair and installation of JMH's emergency generator radiator. NER filed an answer to the plan custodian's complaint in which NER had alleged a full defense to the preference claim, based in part on the custodian's failure to prove Section 547(b)(5)'s "greater than liquidation recovery" requirement.

NER had begun working on the radiator on or about August 6, 2008. Payment was due when NER had completed work on the radiator on August 18, 2008. NER sent JMH an invoice for this work showing the sum of $7,262 was due and payable by JMH to NER. Between August 19, 2008 and September 17, 2008, NER's representatives made 14 telephone calls to JMH seeking payment of the invoice. JMH tendered payment of $7,262 to NER in full payment of the invoice on September 17, 2008, just 48 days before JMH's filing of its Chapter 11 petition.

NER's Defense to the Preference Claim

NER argued that it had a fully secured mechanic's lien on JMH's real property arising from NER's repair and installation of the emergency generator radiator at the hospital.[1] Conn. Gen. Stat. §§ 49-33 and 49-34 govern NER's mechanic's lien rights under Connecticut law.

Conn. Gen. Stat. § 49-33 states in pertinent part as follows:

> (a) If any person has a claim for more than ten dollars for materials furnished or services rendered in the construction, raising, removal or repairs of any building or any of its appurtenances…the building, with the land on which it stands…is subject to payment of the claim.
> (b) The claim is a lien on the land, building and appurtenances…and the claim takes precedence over any other encumbrance originating after commencement of the services, or the furnishing of such materials.…
> (d) . . . If any instrument constituting a valid encumbrance upon such land other than a mechanic's lien is filed for record while the building is being constructed, raised, removed or repaired, …all such mechanic's liens originating prior to the filing of that instrument for record take precedence over that encumbrance.

> **The plan custodian, on JMH's behalf, commenced a lawsuit against New England Radiator Works (NER) for recovery of the sum of $7,262 that JMH had paid to NER on September 17, 2008.**

Conn. Gen. Stat. § 49-34 further states in pertinent part:

> A mechanic's lien is not valid unless the person performing the services or furnishing the materials (1) within 90 days after he has ceased to do so, lodges with the town clerk of the town in which the building, lot or plot of land, is situated a certificate in writing, which shall be recorded by the town clerk with deeds of land…

In *JMH,* NER's mechanic's lien arose when NER had commenced work on JMH's generator on August 6, 2008. NER then had until November 16, 2008, 90 days after it had completed its work (on August 15, 2008), to record its lien in the land records in order to obtain a perfected fully secured mechanic's lien on JMH's real property. However, any need on NER's part to file its mechanic's lien was mooted by JMH's full payment of NER's claim on September 17, 2008, prior to the end of the 90-day deadline for NER to record its lien.

NER argued that JMH's payment of $7,262 to NER, within 48 days of JMH's bankruptcy filing, was not avoidable as a preference because JMH's plan custodian could not satisfy Bankruptcy Code Section 547(b)(5)'s, "greater than liquidity recovery" requirement for a valid preference claim. The plan custodian had to prove that NER had recovered more from JMH's payment than NER would have recovered in a hypothetical Chapter 7 liquidation had the payment not been made. NER relied on the fully secured mechanic's lien that it could have perfected in the absence of JMH's payment and that would have entitled NER to full payment of its claim in any hypothetical Chapter 7 liquidation.

JMH's plan custodian disagreed, arguing that NER's claim was unsecured because its mechanic's lien was not recorded when it had received the payment from JMH. As a result, the custodian argued that it had satisfied Section 547(b)(5) because NER's receipt of full payment of its claim, as a result of the alleged preference payment, exceeded the *pro rata* distribution that NER would have otherwise received as an unsecured creditor.

The *JMH* Court Decision

The *JMH* court ruled in favor of NER that JMH's payment to NER was *not* an avoidable preference. The court agreed that NER would have obtained a fully secured perfected mechanic's lien by recording its lien in the land records if the alleged preference payment had not been made.

The *JMH* court relied on a ruling of the United States Court of Appeals for the Second Circuit, in *Ricotta v. Burns Coal and Bldg. Supply Co.,* prior to the adoption of the Bankruptcy Code. The Second Circuit held that a creditor was not subject to preference liability when, at the time of the payment, the creditor had the right, under state law, to record a fully secured mechanic's lien in the debtor's real property. After its receipt of the payment, the creditor should not be penalized for failing to record the lien.

As the *JMH* court's decision makes clear, suppliers of material and labor for the improvement of real property have an additional way to avoid preference liability based on the mechanic's lien protections arising under state law.

The *JMH* court also relied on the 2005 decision of the United States Bankruptcy Court for the Southern District of New York in *In re 360Networks (USA) Inc.* In *360Networks*, the bankruptcy court had similarly held that a payment, to a creditor was not avoidable as a preference where the creditor held an "inchoate" mechanic's lien in the debtor's real property. The creditor could have timely perfected its "inchoate" lien at the time of payment in which event the creditor would have a fully secured mechanic's lien claim. The *360Networks* court held that the Second Circuit's decision in *Ricotta v. Burns Coal and Bldg. Supply Co.* remained good law and is binding on all courts in the Circuit, including the *JMH* court. The *360Networks* court further noted that a creditor cannot perfect an inchoate mechanic's lien after it receives full payment of its claim. If the creditor faced preference exposure due to the inability to perfect its mechanic's lien, the creditor would face an unacceptable Hobson's choice between accepting payment of its claim or taking the commercially unreasonable step of declining payment of its claim in order to perfect its mechanic's lien.

Conclusion

As the *JMH* court's decision makes clear, suppliers of material and labor for the improvement of real property have an additional way to avoid preference liability based on the mechanic's lien protections arising under state law. This additional protection from preference risk supplements the new value, ordinary course, contemporaneous (COD) exchange and other section 547(c) preference defenses. They all do come in handy on a "rainy preference day." ●

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1. According to JMH's schedules filed in its bankruptcy case, JMH had over $400,000 of equity in its real property to fully secure NER's mechanic's lien claim in the amount of $7,262 against JMH.

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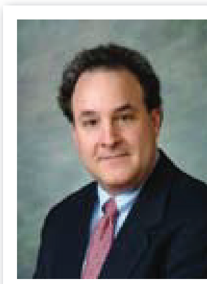
credit column

Bruce Nathan, Esq.



Release of State Law Lien Rights As a Defense to Preference Claims? Yes and No!

Introduction

Suppliers of goods and services on construction projects enjoy the enhanced prospects for payment of their claims afforded by most states' mechanic's and other lien laws. While that is all well and good, can suppliers that have waived or released their state law lien rights, in exchange for an alleged preferential payment, assert a full defense to the preference claim? Two recent bankruptcy court decisions have reached differing holdings on whether a creditor's waiver or release of its state law lien rights is a preference defense.

In *In re Charwill Construction, Inc.*, the New Hampshire Bankruptcy Court ruled that a general contractor's payments to a subcontractor within 90 days of the general contractor's bankruptcy filing, in exchange for the subcontractor's release of its lien rights under New Hampshire law, are protected by the Section 547(c)(1) contemporaneous exchange for new value defense, thereby freeing the subcontractor from preference exposure. The court reasoned that the subcontractor's release of its lien rights conferred new value upon the debtor, general contractor, that justified the applicability of the contemporaneous exchange for new value preference defense.

Two recent bankruptcy court decisions have reached differing holdings on whether a creditor's waiver or release of its state law lien rights is a preference defense.

However, in *In re Cape Haze Windward Partners, Inc.*, the United States Bankruptcy Court for the Middle District of Florida held that a debtor's payment to a cabinet installer within the 90-day preference period, in exchange for the installer's release of its mechanic's lien that was previously filed against the debtor's real property, was a preference and not subject to the Section 547(c)(1) contemporaneous exchange for new value defense. The court concluded that the installer's mechanic's lien rights were valueless and their release did not provide any new value to the debtor that would have otherwise justified invocation of this preference defense.

So what's the story here? Onward, reader!

The Elements of a Preference Claim and the Contemporaneous Exchange for New Value Defense

Section 547 of the Bankruptcy Code governs preferences. A bankruptcy trustee can avoid and recover a preference by proving that (1) the debtor had made a payment or other transfer of an interest of the debtor in property (Section 547(b)); (2) the payment or other transfer was to or for the benefit of a creditor (Section 547(b)(1)); (3) the debtor made the payment or other transfer on account of existing indebtedness owing by the debtor to that creditor (Section 547(b)(2)); (4) the debtor was insolvent when it made the payment or other transfer (i.e., the debtor's liabilities exceeded its assets, which is presumed during the 90-day preference period) (Section 547(b)(3) and (f)); (5) the payment or other transfer was made within 90 days of the bankruptcy filing for non-insider trade creditors, and within one year of the filing for payments to insider creditors, such as a debtor's officers, directors, controlling persons and certain affiliated companies (Section 547(b)(4)); and (6) the creditor recovered more from the transfer than the creditor would have received in a Chapter 7 liquidation in the absence of the payment or other transfer (Section 547(b)(5)). Section 547(b)(5)'s "greater than Chapter 7 liquidation recovery requirement" is always satisfied unless the debtor's unsecured creditors receive full payment of their claims; the recipient of the payment or other relief is fully secured by the debtor's assets; or the payment or other transfer was from the proceeds of the creditor's collateral.

A preference defendant can reduce its exposure by invoking any one or more of the preference defenses

contained in Section 547(c). The Section 547(c)(1) contemporaneous exchange for new value defense excuses any payment or other transfer that the debtor and creditor had intended as a contemporaneous exchange for new value and was, in fact, a substantially contemporaneous exchange. The contemporaneous exchange for new value defense, consistent with the other Section 547(c) preference defenses, is designed to encourage creditors to continue doing business with, and extending credit to, financially troubled companies. A creditor that provides new goods and/or services substantially contemporaneously with the alleged preferential transfer, such as a cash on delivery ("COD") payment, replenishes the debtor and should not be forced to return the COD payment or other transfer. In the absence of the contemporaneous exchange for new value and other preference defenses, creditors would not have any incentive to continue providing goods and/or services to troubled companies, and, thereby, precipitate such troubled companies' descent into bankruptcy.

The Charwill Construction Case

The debtor, Charwill Construction, Inc. ("Charwill") was a general contractor on a construction project to build a wastewater treatment facility for the town of Durham, New Hampshire (the "Town"). The creditor and preference defendant, Seacoast Redimix Concrete, LLC ("Seacoast"), was a subcontractor that supplied concrete to Charwill for the project. The Town owned the project. In accordance with New Hampshire's lien law, N.H. R.S.A. Section 447:16, the project was bonded to insure payment to all laborers and suppliers. Under N.H. R. S.A. Section 447:15, Seacoast was also the beneficiary of statutory lien rights that "attach to any money due or to become due from the state or from any political subdivision thereof by virtue of any contract for any public work or construction, alteration or repair, in the performance of which contract the lienor participated by performing labor or furnishing materials or supplies," (N.H. R.S.A. Section 447:15). Seacoast was not required to provide notice of its lien rights; they arose automatically upon Seacoast's full performance of its obligation to supply concrete under its subcontract with Charwill.

> Seacoast proved that the Town had a fully secured indemnification claim against Charwill.

Seacoast fully performed under its subcontract with Charwill and requested payment from, and provided lien waivers to, Charwill. Seacoast's lien waivers released "any and all lien or right of lien on …[the project] …under the Law, in relation to Mechanic's Lien Law, on account of labor and materials, or both, furnished by [Seacoast] to or on the account of the said contract for the said project." That meant Seacoast had waived its lien rights against the Town. Charwill then forwarded Seacoast's lien waivers to the Town; the Town, in turn, paid Charwill; and Charwill then used those funds to pay Seacoast the sum of $6,652.00 on August 28, 2003 and the sum of $10,026.00 on October 22, 2003 (collectively, the "Payments"). On October 24, 2003, Charwill filed a Chapter 7 bankruptcy petition.

The Chapter 7 trustee for Charwill's bankruptcy estate commenced a lawsuit against Seacoast to recover the Payments as a preference. Seacoast moved for summary judgment to dismiss the Trustee's preference complaint. Seacoast invoked the Section 547(c)(1) contemporaneous exchange for new value defense, asserting that its release of statutory lien rights in exchange for the Payments was a full defense to the preference claim. However, Seacoast's statutory lien rights, that were waived in exchange for the payments, were against the Town, having attached to monies held by the Town that would otherwise be payable to Charwill. So what new value did Seacoast provide to Charwill that justified the applicabil-

ity of the Section 547(c)(1) contemporaneous exchange for new value defense?

The Bankruptcy Court granted Seacoast's motion for summary judgment and dismissed the preference complaint against Seacoast, ruling that Seacoast had a full contemporaneous exchange for new value defense to the Trustee's preference claim. The court noted that in the event Charwill failed to pay the sum of $16,678 (the alleged preference payments) to Seacoast, Seacoast could have asserted its lien rights against the Town. The Town, in turn, would have been forced to pay the sum of $16,678 to Seacoast; then seek indemnification from Charwill, as general contractor on the project, and obtain payment of the Town's indemnification claim by setting off the Town's payments totaling $16,678 to Seacoast from the Town's indebtedness to Charwill. So long as the Town's indemnification claim against Charwill was fully secured, (i.e., the Town owed Charwill more than the Town's exposure to Seacoast by virtue of Seacoast's lien rights), Seacoast's waiver of lien rights in exchange for the Payments was new value that benefited Charwill, and would be a full defense to the Trustee's preference claim.

By making the Payment to Reliable, the Debtor ended up preferring Reliable to the detriment of other creditors. That meant preference exposure for Reliable!

Seacoast proved that the Town had a fully secured indemnification claim against Charwill. The over $200,000 balance that the Town owed to Charwill substantially exceeded the Town's fully secured indemnification claim against Charwill. Seacoast's release of its statutory lien rights against the Town provided new value that benefited Charwill because of the coincident release of the Town's fully secured indemnification claim against Charwill, which, in turn, made it unnecessary for the Town to exercise any setoff rights with respect to the sums owing to Charwill. Charwill's bankruptcy estate was, therefore, left with an additional $16,678 for the benefit of its unsecured creditors. Bottom line, Seacoast had no preference exposure!

The Cape Haze Windward Partners Case

In 2005, the preference defendant, Reliable Home Services, Inc. ("Reliable"), provided labor and materials for cabinets supplied to the debtor, Cape Haze Windward Partners, Inc. (the "Debtor") and installed in a condominium project that the Debtor had owned and developed. After the Debtor had failed to pay for the cabinets, Reliable filed a mechanic's lien against the Debtor's real property on or about August 24, 2005. Prior to Reliable's recording its mechanic's lien, at least three mortgages were filed against the property. On or about September 1, 2005, the Debtor paid the sum of $16,687.07 (the "Payment") to Reliable. In exchange, Reliable released its mechanic's lien against the property. On October 15, 2005, the Debtor filed Chapter 11 and a Chapter 11 Trustee was subsequently appointed.

The Trustee commenced a lawsuit against Reliable for the recovery of the Payment as a preference. Reliable relied on the Section 547(c)(1) contemporaneous exchange for new value defense as a full defense to preference exposure. Reliable argued that the release of its mechanic's lien against the Debtor's real property was new value that was tendered in exchange for the Payment. The Trustee rejected the applicability of the contemporaneous exchange for new value defense because the property was fully encumbered by the three prior recorded mortgages and Reliable's released mechanic's lien, therefore, had no value.

The court sided with the Trustee and ruled that Reliable was subject to preference exposure because Reliable could not satisfy the Section 547(c)(1) contemporaneous exchange for new value defense to the Trustee's preference claim. The Court found that Reliable's mechanic's lien, released in exchange for the Payment, was valueless, and, therefore, Reliable did not provide any new value to the Debtor. There were at least three mortgages filed against the Debtor's real property that were all in default prior to Reliable's recording of its mechanic's lien against the property. The mortgages remained outstanding when the Debtor had filed Chapter 11 and the Debtor's bankruptcy estate lacked sufficient funds to fully pay the mortgages. In the absence of the Payment to Reliable, the Debtor would have had $16,687.07 available for distribution to all of the Debtor's creditors. By making the Payment to Reliable, the Debtor ended up preferring Reliable to the detriment of other creditors. That meant preference exposure for Reliable!

Conclusion

Suppliers of labor and materials on construction projects may have additional protection from both nonpayment of their claims and preference risk based on their state law mechanic's and other lien rights. However, as the courts have made clear in *Charwill Construction* and *Cape Haze Windward Partners*, a creditor's waiver or release of lien rights, in exchange of payment during the 90-day preference period prior to a debtor's bankruptcy filing, does not automatically satisfy the Section 547(c)(1) contemporaneous exchange for new value defense to preference exposure. A lienholder's ability to satisfy this preference defense depends on the value the debtor realizes from the lien rights that are being waived or released in exchange for the alleged preferential transfer. A creditor's waiver or release of lien rights that have value to the Debtor may defeat preference exposure; a creditor's waiver or release of lien rights that have no value to the Debtor fare less well! ●

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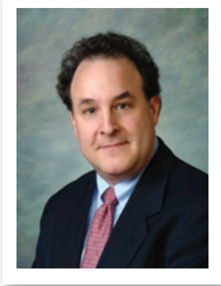

Mechanic's Liens and the Bankruptcy Code

Meandering Through the Minefields of the Recent Cook Case

A mechanic's or materialman's lien is a state law lien granted to secure payment of the claims of creditors that supply goods and/or labor for the improvement of real property. While all states have mechanic's lien laws, they differ in the manner in which a creditor creates, perfects and/or enforces the lien.

For example, in some states, a mechanic's lien arises when the creditor first provides material and/or labor or when the contract for the goods and/or services is first executed. In other states, the lien arises when the creditor files or serves notice of the lien as required by state law. And in yet other states, the lien arises when the creditor records the lien in the real property records of the county or other locality where the improved property is located.

The states' mechanic's lien laws also vary in the manner in which a creditor perfects a mechanic's lien. In most states, a creditor perfects a mechanic's lien by recording the lien in the real property records of the county or other locality where the improved property is located. However, a few states, like Alabama whose mechanic's lien law is the subject of the case discussed in this article, also require a creditor to commence, and obtain a judgment in, a lien enforcement proceeding as an additional prerequisite for perfecting the lien.

The states' mechanic's lien laws also differ in determining the priority of a validly created and perfected mechanic's lien. Many states provide that if a creditor perfects its lien within a specified time period, priority of the lien will relate back to an earlier date, and will have priority over all interests arising in the real property from such earlier date to perfection. This retroactive pre-perfection priority of mechanic's lien rights amounts to a secret lien.

Finally, most states require that, following the creation and perfection of a mechanic's lien, the creditor must enforce the lien in the manner, and within the time frame, prescribed by state law. A creditor that fails to timely enforce its mechanic's lien forfeits its lien rights.

Well, since "Meandering The Minefields of 'Hidden' Liens" at the recent Credit Congress in Louisville, Kentucky (yes folks, that was a session at Credit Congress), the United States Bankruptcy Court for the Northern District of Alabama, in *In re Cook*, recently addressed

what happens when a general contractor provides materials and/or labor to improve real property owned by a debtor that has filed bankruptcy. How is a creditor's ability to perfect, enforce and otherwise preserve its unperfected or inchoate mechanic's lien rights impacted by a real property owner's or lessee's bankruptcy filing?

The Impact of the Owner's/Lessee's Bankruptcy Filing on Real Property Subject to a Mechanic's Lien

A debtor's bankruptcy filing triggers the automatic stay by virtue of Bankruptcy Code Section 362(a). The stay bars a wide variety of creditor actions against the debtor and/or the debtor's property, unless the bankruptcy court grants relief from the stay. For instance, pursuant to Bankruptcy Code Sections 362(a)(4) and (a)(5), the stay bars a creditor's creation, perfection, or enforcement of a lien against property of the debtor and/or property of the debtor's estate.

However, Bankruptcy Code Section 362(b) prescribes certain exceptions to the automatic stay. For example, Section 362(b)(3) permits a creditor "... 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 Section 546(b) [of the Bankruptcy Code] ..." This exception to the bankruptcy stay applies to mechanic's lien creditors that can satisfy Bankruptcy Code Section 546(b).

Section 546(b)(1) states that a bankruptcy trustee's rights:

> "... 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 such 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."

Section 546(b)(1) permits the post-petition perfection, and/or maintenance or continuation of perfection, of a property interest, such as a mechanic's lien, that arose prior to a debtor's bankruptcy filing, to be effective against any third party that acquired rights in the property prior to the date of perfection, and/or the date of any act to continue or maintain perfection of the lien. The stay does not prevent a mechanic's lien creditor, whose lien arose prior to bankruptcy, from perfecting or maintaining its lien post-petition if, under state law and in the absence of bankruptcy, the creditor could have perfected or maintained its mechanic's lien and had its perfected lien rights relate back and have priority over any other entity acquiring rights in the property prior to perfection or maintenance of perfection.

However, Section 546(b)(1) does not deal with a creditor's post-petition enforcement of its mechanic's lien rights. That means the bankruptcy stay applies to a creditor's post-petition action to enforce its lien rights, and the creditor cannot take any post-petition action to enforce its lien unless it obtains a Bankruptcy Court order granting relief from the stay.

So how does all of this apply to the *Cook* case? Read on and you will see.

The Facts of the *Cook* Case

On April 29, 2005, Dianna Phillis Cook ("Debtor") and Bobby Dale Welch Construction Company L.L.C. ("Welch") entered into a Contractor Agreement. Under the agreement, Welch agreed to construct a home on the Debtor's real property located in Etowah County, Alabama (the "Real Property").

Welch claimed that the Debtor had failed to pay the sums due for materials that Welch had supplied to the Debtor under the agreement. On December 12, 2005, Welch filed a Verified Statement of Lien with the Office of the Judge of Probate of Etowah County, Alabama. The Verified Statement of Lien stated that Welch had a mechanic's lien in the Real Property to secure Welch's claim in the amount of $73,275.41 plus interest from April 29, 2005.

The agreement contained an arbitration provision for the resolution of disputes. On June 14, 2006, Welch served a Demand for Arbitration on the Debtor, as respondent, in which Welch sought recovery of the sum of $98,112.76, plus interest, attorneys' fees and costs. Welch did not make any reference to its mechanic's lien in the arbitration demand.

An arbitration proceeding was conducted on May 2, 2007. On May 11, 2007, the arbitrator handed down an award that directed the Debtor to pay Welch the sum of $98,112.76, plus interest at 12% from July 1, 2007 for sums due under their agreement. The arbitrator's award did not mention Welch's mechanic's lien in the Real Property as security for payment of the award. On May 22, 2007, Welch filed an application to confirm the arbitration award with the Circuit Court of Etowah County Alabama. However, Welch did not seek to enforce the mechanic's lien, or otherwise mention the mechanic's lien as security for the arbitration award. The Alabama Circuit Court entered an order confirming the arbitration award as a judgment without mentioning Welch's mechanic's lien.

On May 31, 2007, the Debtor filed her Chapter 7 petition with the United States Bankruptcy Court for the Northern District of Alabama. On September 24, 2007 Welch filed an application with the Alabama Circuit Court to amend that court's May 22, 2007 order to reduce to judgment Welch's mechanic's lien against the Real Property. The Alabama Circuit Court did not act on Welch's motion, presumably concluding that the automatic stay barred Welch's attempt to enforce its lien.

Thereafter, Welch moved in the Bankruptcy Court for relief from the automatic stay to allow Welch to perfect, maintain and enforce its mechanic's lien against the Real Property under Alabama's mechanic's lien law.

Alabama's Mechanic's Lien Law

The Bankruptcy Court noted that under Alabama's mechanic's lien law, a general contractor's mechanic's lien for goods and/or services provided for the improvement of Alabama real property arises when the contractor performs the work on and/or delivers the materials used to improve the real property. A general contractor, such as Welch, must take two steps to perfect and maintain its mechanic's lien for the unpaid balances due on a construction project involving Alabama real property. First, the general contractor must timely file a Verified Statement of Lien that is in the proper form and contains the statutorily required information (ALA. CODE § 35-11-213 (1975)). The general contractor must file the Statement of Verified Lien with the office of the judge of probate of the county in which the real property is located within six months after the contractor performed the last work or provided the last item of materials under the contract (ALA. CODE § 35-11-215 (1975)). Second, the contactor must commence an action to enforce its lien in the Alabama Circuit Court within six months after maturity of its claim secured by the lien and obtain judgment on the lien (ALA. CODE §§ 35-11-220, 221, 222, 224(1975)).

Any third party acquiring rights in Alabama real property after the creation, and prior to timely perfection, of a mechanic's lien would be subject to the lien. Therefore, Alabama's mechanic's lien law is "generally applicable law" that falls within the scope of Bankruptcy Code Section 546(b)(1) because under Alabama's mechanic's lien law, any third party that acquires rights in real property after creation of the lien (when work is performed or materials are delivered), and prior to timely perfection of the lien, is subject to the lien. The lien law allows a general contractor, such as Welch, to acquire a secret lien in Alabama real property prior to perfection of the lien. And,

subject to the contractor's timely perfection and enforcement of its lien rights, the lien would relate back to the date of its creation. As a result, the contractor's mechanic's lien would have priority over any intervening interest in the real property, including a Chapter 7 trustee who acquires rights in the real property between attachment and perfection of the lien.

Welch's Post-Petition Enforcement of Its Mechanic's Lien Violated the Automatic Stay and Was Void

Welch's problem in the *Cook* case was seeking to enforce its mechanic's lien rights following the Debtor's bankruptcy filing, without either first obtaining relief from the automatic stay, or preferably utilizing Bankruptcy Code Section 546(b)(2) that provides a far simpler and less expensive alternative to preserve Welch's lien rights. The Bankruptcy Court noted that while Section 362(b)(3) excepts the post-petition perfection of a mechanic's lien from the automatic stay, the stay still applies to, and bars, a creditor's post-petition enforcement of its lien, even if necessary to perfect the lien as required under Alabama law. Therefore, Welch had to first obtain the Bankruptcy Court's approval of relief from the automatic stay prior to seeking to enforce and obtain judgment on its lien rights. Since Welch had failed to obtain relief from the stay, Welch's post-petition filing of a motion with the Alabama Circuit Court to enforce its mechanic's lien against the Real Property violated the automatic stay and was ruled void.

Section 546(b)(2) Notice Preserves Mechanic's Lien Rights

The *Cook* court also ruled that Bankruptcy Code Section 546(b)(2) made it unnecessary for Welch to seek relief from the automatic stay to enforce Welch's mechanic's lien rights against the Real Property as a prerequisite for perfecting or maintaining Welch's lien. Welch could preserve its lien rights by satisfying the notice requirements prescribed by Section 546(b)(2) as follows:

> "If – (A) a law … requires … commencement of an action to accomplish such perfection, or maintenance or continuation of perfection of an interest in property; and (B) … such an action has not been commenced before the date of the filing of the petition; such interest in such property shall be perfected, or perfection of such interest shall be maintained or continued, by giving notice within the time fixed by such law for … such commencement."

A Section 546(b)(2) lien preservation notice states that a mechanic's lienholder, such as Welch, intends to perfect or maintain and enforce its mechanic's lien against the real property subject to the lien. The lien creditor must file the lien preservation notice with the Bankruptcy Court and serve the notice on the debtor's bankruptcy trustee, in a Chapter 7 case, or on the debtor in possession, in a Chapter 11 case, prior to expiration of the state law deadline for commencing an action to enforce lien rights.

In *Cook*, the court concluded that Welch should have provided the Section 546(b) lien preservation notice if Welch needed to commence a lien enforcement action to both perfect and enforce its mechanic's lien in the Real Property as Alabama law requires. Welch's request for stay relief to go back to state court was unnecessary!

Conclusion

While Bankruptcy Code Section 362(b)(3) allows a creditor to perfect its mechanic's lien following a debtor's bankruptcy filing, without the necessity for first obtaining relief from the automatic stay, there is no comparable exception to the applicability of the automatic stay that allows a creditor to enforce its lien post-petition without first obtaining relief from the bankruptcy stay. However, when a creditor must enforce its mechanic's lien following a debtor's bankruptcy filing, as a condition for perfecting or preserving its mechanic's lien rights, and state law allows the lien to relate back pre-petition, the creditor could timely file a Section 546(b) lien preservation notice with the Bankruptcy Court and serve it on a Chapter 11 debtor or bankruptcy trustee in lieu of obtaining relief from the stay to enforce its lien rights. That would have done the job for Welch! ●

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Among his various legal recognitions, Bruce received the Top Hat Award in 2011, a prestigious annual award honoring extraordinary executives and professionals in the credit industry. He was co-chair of the Avoiding Powers Committee that worked with the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 and also participated in ABI's Great Debates at their 2010 Annual Spring Meeting, arguing against repeal of the special BAPCPA protections for goods providers and commercial lessors, and was a panelist for a session sponsored by the American Bankruptcy Institute. He is a frequent presenter at industry conferences throughout the country for the National Association of Credit Management (NACM) and its affiliates and affiliated credit groups, as well as a prolific author regarding bankruptcy and creditors' rights topics in various legal and trade publications, including NACM's Business Credit Magazine. He received a J.D. from the University of Pennsylvania Law School; an M.B.A. from Wharton School of Finance and Business; and a B.A., *Phi Beta Kappa*, from the University of Rochester.

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