





CONSTRUCTION LAW



THE EFFECT OF BANKRUPTCY ON MECHANIC'S LIEN RIGHTS IN VIRGINIA

Mechanic's liens are created by statute and are strictly construed by Virginia courts.¹ As such, courts often rule that liens are invalid because of technical deficiencies and inaccuracies in the lien form.² Lien claimants have a number of statutory deadlines and requirements that they must strictly meet to have an enforceable lien. For example, lien claimants must record their lien memorandum "not later than 90 days from the last day of the month in which they last perform labor or furnish materials, and in no event later than 90 days from the time such building, structure or railroad is completed, or the work thereon otherwise terminated."³

In addition, no lien memorandum can include amounts for labor or materials furnished more than 150 days before the last day on which the claimant last performed work or provided materials preceding the filing of such memorandum.⁴ After recording the lien, lien claimants must file suit to enforce the lien within "six months from the time when the memorandum of lien was recorded or after 60 days from the time the building, structure or railroad was completed or the work thereon otherwise terminated, whichever time shall last occur."⁵

The filing of bankruptcy by an owner, general contractor or subcontractor can have a material effect on some of these deadlines and on the rights, remedies and deadlines of potential mechanic's lien claimants. This article outlines the potential impact of a bankruptcy filing on different parties' mechanic's lien rights and remedies.

The Automatic Stay

When a bankruptcy petition is filed, the automatic stay under 11 U.S.C. § 362 (the "Automatic Stay") goes into effect and stays "any act to create, perfect or enforce any lien against property of the estate."⁶ Creditors who willfully violate the automatic stay can face stiff penalties, expensive fines and sanctions from the court. In Virginia, the recording of the mechanic's lien memorandum does not violate the automatic stay; however, the automatic stay precludes lien claimants from filing a suit to enforce a mechanic's lien.⁷ Importantly, 11 U.S.C. § 108(c) tolls the six-month statute of limitations on a suit to enforce a mechanic's lien until 30 days after the automatic stay is terminated.⁸

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Who Is Affected by the Bankruptcy?

The potential impact of the bankruptcy filing, and consequently the automatic stay, can differ depending on which party (owner, general contractor, subcontractor or lien claimant) is in bankruptcy. The courts can grant relief from the automatic stay, pursuant to 11 U.S.C. § 362, (1) for cause, including the lack of adequate protection of an interest in property of such party in interest; and (2) if the debtor does not have any equity in the property, and the property is not necessary to an effective reorganization.⁹

How the court will apply these factors depends on which party is the debtor. Typically, when the general contractor or subcontractor files for bankruptcy, the general contractor or subcontractor has no ownership interest in the real property, and therefore no equity in the real property, and the real property would not be necessary to an effective reorganization. Likewise, if the general contractor or subcontractor has no interest in the real property, it is less likely that the general contractor or subcontractor would be willing or able to provide adequate protection of the creditor's interest. As a result, the court is more likely to grant relief from the automatic stay.

However, if the property owner files for bankruptcy, the court will have to consider whether the owner has equity in the property, and whether the property is necessary to the bankruptcy. If there is equity or if the owner is willing to make adequate protection payments to protect the equity cushion, the court is more likely to deny relief from the automatic stay.

A mechanic's lien should not be affected by the lien claimant filing for bankruptcy. The automatic stay does not prohibit a lien claimant from continuing to prosecute the claim; however, any money obtained would become part of the bankruptcy estate.

What Should Lien Claimants Do When a Company Upstream Files Bankruptcy?

Although each situation is different, here are some general guidelines to best protect your clients' lien rights:

- 1) If you suspect that an owner, general contractor or subcontractor (i.e., someone upstream from your client) may file for bankruptcy protection, a mechanic's lien is your client's best, and possibly only, way of getting paid everything your client is owed.
- 2) Pay close attention to the 90-day and 150-day deadlines by which you must have filed your mechanic's lien. The automatic stay does not affect these deadlines. Advise your clients to develop a consistent system to flag and handle delinquent accounts before they reach these important deadlines.
- 3) If a contractor, subcontractor or owner on a project your client is working on filed for bankruptcy, determine your client's rights as quickly as possible. In addition to mechanic's lien rights, your client may have reclamation or other remedies that carry a very short deadline.
- 4) When recording a mechanic's lien, notice is very important and numerous different kinds of notices need to be given before, during and after a lien is recorded, depending on the type of project and where your client falls in the

chain of contract. On residential projects, for example, if a mechanic's lien agent is listed on the building permit, your client needs to give notice to that lien agent at the start of the project. You should ensure that your client has procedures in place to give proper notice to the required parties. 5) Keep in mind, however, that once the bankruptcy court enters an order granting relief from the automatic stay or once the bankruptcy case is dismissed or the stay otherwise terminated, a lien claimant's statute of limitations to file the suit recommences. The lien claimant will have the longer of (1) whatever time is left on the original six-month statute of limitation or (2) 30 days from the order granting relief from the stay.¹⁰

What Should Owners Do When a Company Downstream Files Bankruptcy?

- 1) Quickly determine the payment status and how many subcontractors and suppliers have not been paid. Owners need to determine who has mechanic's lien rights, claims directly against the owner, or other claims besides general unsecured claims. Owners should determine how to get any mechanic's liens or other payment issues resolved. The automatic stay and the bankruptcy filing in general will often alter the rights and remedies of owners, and owners want to make sure they don't end up paying twice.
- 2) Quickly get a handle on any open or unfinished projects with the bankrupt entity. Protect your client by taking steps to ensure that the project continues and that the work is protected.

- 3) Items two and three will help owners determine whether they have claims against the general contractor that can be offset.
- 4) Urge the general contractor, through contractual remedies or otherwise, to bond off or settle all liens, if possible.

Conclusion

Each case is unique and should be handled on a case-by-case basis. It is important to develop a case-specific strategy and ensure that you take the proper steps after a bankruptcy is filed to avoid violating the automatic stay or having to pay twice. ■

Endnotes

1. *Carolina Builders Corp. v. Cenit Equity Co.*, 257 Va. 405, 411, 512 S.E.2d 550, 552 (1999).
2. *Id.* ("[U]nless [a mechanic's lien] is perfected within the proper time and in the proper manner, as outlined by the statute, it is lost.")
3. Va. Code Ann. § 43-4.
4. *Id.*
5. Va. Code Ann. § 43-17.
6. 11 USC § 362(a)(4).
7. *In re Concrete Structures, Inc.*, 261 B.R. 627, 637 (E.D. Va. 2001); *In re Bain*, 64 B.R. 581, 583 (W.D. Va. 1986); *In re Richardson*, 123 B.R. 736, 738 (Bankr. W.D. Va. 1991).
8. *In re Concrete Structures, Inc.*, 261 B.R. at 642.
9. 11 U.S.C. § 362.
10. *In re Concrete Structures, Inc.*, 261 B.R. at 645-46.



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