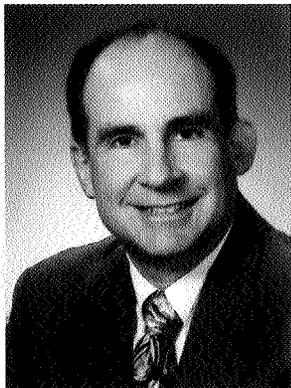


Lien Rights Provide Defense to Nasty Preference Claims

by Donald Gregory, Esq. and Larry McClatchey, Esq.



Donald Gregory, Esq.



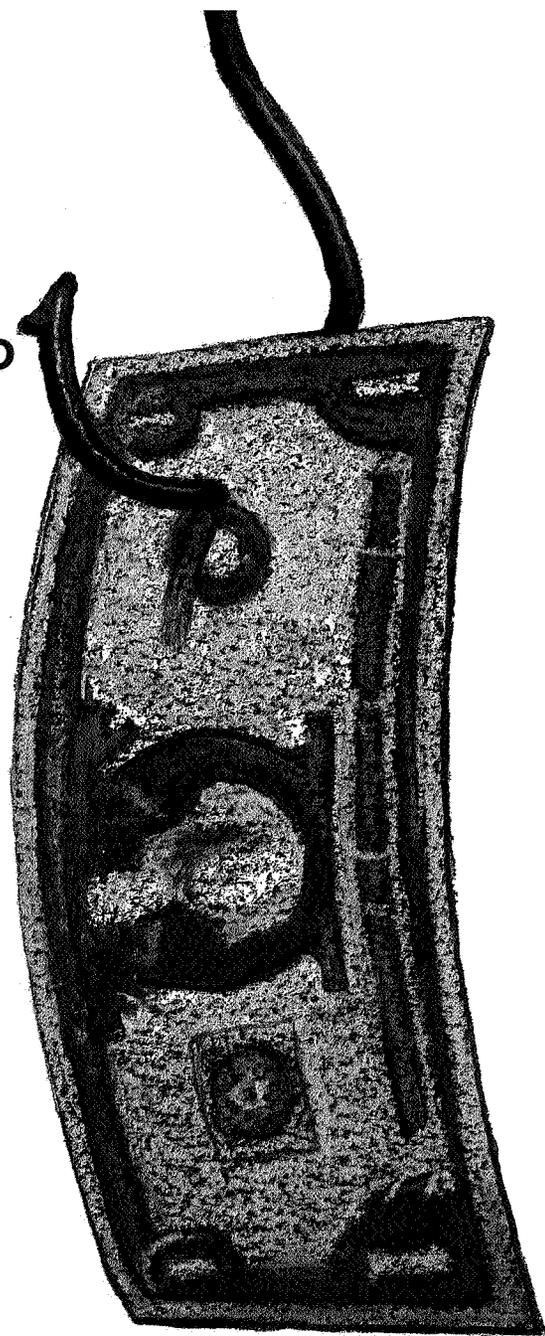
Larry McClatchey, Esq.

Savvy subcontractors and suppliers understand the importance of protecting their mechanic's lien rights. Two recently decided cases highlight the importance of just *having* rights to a lien at the time of payment, even if paperwork is not filed to perfect the lien. In the two cases, the very existence of lien rights helped suppliers keep their payments despite bankruptcy proceedings.

Sometimes when an owner or general contractor has financial problems, extraordinary collections efforts ensue that entangle payments to subcontractors/suppliers. If an owner or general contractor files a bankruptcy proceeding, subcontractors and suppliers may get a nasty surprise: a bankruptcy trustee demanding the return of payments received by the subcontractor or supplier within 90 days before the bankruptcy petition was filed. The trustee may take action to recover payments to a subcontractor or supplier on grounds that they were avoidable "preferential transfers" from the debtor.

A "preferential transfer" is a payment:

- Made to or for the benefit of the subcontractor or supplier, a creditor of the debtor, on account of work previously performed.
- Made when the debtor was insolvent.
- That cleared the account of the debtor within 90 days before the filing of the bankruptcy petition.
- That enabled the creditor to receive more than the creditor would have received through the bankruptcy distribution had the transfer not been made.



In two recent cases, suppliers of construction materials successfully defended themselves from bankruptcy trustees' actions to recover payments. The suppliers argued that at the time they received payments, they had the *right* to file a lien entitling them to their interest in the project but had not done so because they received the payments. Therefore, they argued, the payments were not "preferential transfers."

The first case arose in bankruptcy proceedings of 360 Networks (USA) Inc. in New York. A group of suppliers argued that they each had the right to file a lien against a construction project for materials at the time of payment from the debtor. Because of this lien right, the

payment did not "prefer" them over other unsecured creditors, they argued. The bankruptcy judge agreed that the existence of these "inchoate" lien rights enabled the suppliers to successfully defeat the preference claims of the bankruptcy trustee.

The bankruptcy case of Electron Corp. in Colorado had a similar result. The bankruptcy trustee sued to recover \$14,967 from JCOR Mechanical Inc. on grounds that JCOR had received avoidable preferences. The bankruptcy court originally rejected the argument of the supplier creditor that it would have filed a lien had it not been paid. This decision was reversed on appeal, and the supplier creditor won. The Bankruptcy Appellate Panel held that the

supplier had a good defense even if the lien was not actually filed.

Each of the suppliers in these cases still had to prove that their mechanic's lien rights were valid under state law at the time they received payment. In other words, to use this defense, a supplier or subcontractor has to show that it had satisfied all statutory pre-requisites to perfecting a lien prior to the time at which it received payment. The suppliers also had to show that the property had sufficient value to support the lien.

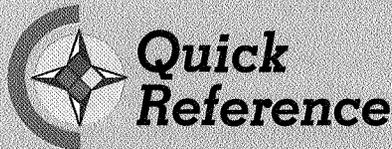
Therefore, subcontractors and suppliers must take care to preserve their rights by providing a preliminary notice in states that require it. A guide to what is necessary to preserve your lien rights in each state is available from the

Foundation of ASA on the CD-ROM, "Lien and Bond Claims in the 50 States." (Order online at www.contractorsknowledge.net/org.)

These cases highlight the importance of taking all the preliminary steps required under state law to perfect a subcontractor or supplier mechanic's lien. Even if the lien is not filed, the fact that the right to lien existed at the time of payment may prove useful in defeating a preference claim to avoid the transfer. If so, a subcontractor or supplier may retain its hard-won account receivable! ■

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