

## Bankruptcy Court Delivers Next Chapter In Developing Law Regarding Post-Petition Lien Perfection By Subcontractors

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In a prior alert ([Subcontractors and Suppliers Win Support for Lien Perfection During North Carolina Bankruptcies](#)) we told you about the order from the United States District Court for the Eastern District of North Carolina vacating the Bankruptcy Court's decisions in *In re Mammoth Grading, Inc.* and *In re Harrelson Utilities, Inc.* It hasn't taken long for the Bankruptcy Court to react to the District Court's order and give us the next chapter in this developing area of construction lien law and bankruptcy.

In the *Mammoth* and *Harrelson* cases, the Bankruptcy Court held that a subcontractor violates the automatic stay by serving, after the bankruptcy petition date, a notice of claim of lien on funds due to the debtor. Key to the court's analysis was whether the subcontractors had an "interest in property," the perfection of which could be effective against an entity that acquired rights in the property prior to the date of perfection. If so, serving of the notice of claim of lien on funds would fall under an exception to the automatic stay. The Bankruptcy Court concluded that subcontractors did not have an "interest" in the funds prior to the time they served a notice of claim of lien on funds. As a result, subcontractors without perfected liens as of the contractor's bankruptcy petition date were treated as general unsecured creditors with a much smaller chance of receiving payment on their claims.

The District Court took issue with the Bankruptcy Court's conclusion that a subcontractor's lien rights do not constitute an "interest in property," and indicated that perfection of such lien rights should be an exception to the automatic stay. However, for legal reasons, the District Court's comments on this issue were not binding legal precedent.

Shortly after the District Court's decision, the Bankruptcy Court for the Eastern District of North Carolina issued an opinion concluding that subcontractors can serve a notice of claim of lien upon funds post-petition without violating the automatic stay. ([In re Construction Supervision Services, Inc., Order dated March 14, 2012](#)) The Court ruled that statutory language explicitly provides that a lien on funds is granted upon the furnishing of materials, labor or equipment. Although the lien is not perfected at this time, the subcontractor still has the right to the benefit of the lien upon funds. To perfect the lien, the subcontractor must give notice, but the giving of notice is merely the last step in perfecting the interest in property. The right to payment is the "interest in property" upon which the lien claimants may rely. As such, the lien claimants were granted a lien on funds pre-petition, and could perfect the lien by serving the notice of claim post-petition without violating the automatic stay.

The Bankruptcy Court's decision is receiving mixed reaction in our jurisdiction. Subcontractors are eager to perfect their lien rights post-petition in hopes of increasing their odds of full payment. However, when numerous claims of liens on funds are asserted in a bankruptcy case, it can cripple the debtor's efforts to continue operations using incoming cash subject to the liens. If the debtor does not have access to sufficient cash to continue working on a particular construction project and defaults on the job, the resulting damages claim against the debtor can result in the subcontractor's liens being rendered worthless.

The assertion of subcontractors' liens post-petition also creates tension with the debtor's pre-petition secured lender who has a lien on the debtor's pre- and post-petition accounts receivable. The secured lender's desire to be paid from incoming cash conflicts with the subcontractors' competing claims, resulting in even greater pressure on the debtor's use of scarce cash.

The Bankruptcy Court's recent decision is being appealed, so interested parties should stay tuned for the next chapter to be written by the United States District Court in this saga.

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