

New Jersey Law Journal

VOL. CXCI—NO.2 — INDEX 93

JANUARY 14, 2008

ESTABLISHED 1878

BANKRUPTCY LAW

Enforcing Liens on Real Estate Projects

Creditors must be diligent to protect their rights

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Real estate values have taken a precipitous drop the past several years; in some markets, falling between 40 percent and 60 percent. On top of that, lenders have taken multibillion-dollar write-downs on subprime mortgage bonds and collateralized obligations, and have tightened their credit standards. With home sales also slowing dramatically, homebuilders have been struggling to keep their operations going. Some have filed for bankruptcy. Others are negotiating with lenders, slashing prices, selling assets or all of the above.

While it is unknown whether the current downturn is a short- or long-term situation, history tells us a few things. First, housing starts over the past 30 years peaked from 2003-2006, with 2005 the highest and 2006 the fourth highest. The percentages of households owning a home and the rate of participation by investors also peaked during this period. 2005 was also the peak year of the subprime lending boom.

The subsequent crash has lasted for

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about two years. Historically, housing cycles have lasted four to eight years, and predictions are that this down cycle may not end until 2011. So, we will most likely have to deal with a distressed real estate environment for at least three more years. Creditors in the industry will be busy and need to be diligent to protect their rights.

Creating and enforcing liens is critical for a creditor to be paid on a real estate project, whether before or after a bankruptcy filing. Since the statutes and case law are somewhat complex, even a slight misunderstanding can turn what the creditor believes is a claim secured by the real estate into an unsecured claim.

The New Jersey Construction Lien Law (Lien Law) replaced the old Mechanic's Lien Law in 1994. Neither of these laws is applicable to public projects. The new Lien Law (N.J.S.A. 2A:44A-1 et seq.) eliminated the filing of a Mechanic's Notice of Intent. Instead, it is necessary to file certain information within 90 days following the date of the last work, services, materials or equipment provided with the clerk of the county in which the property is located.

A lien claim may only be filed if there is a written contract between the lien claimant and its customer (whether it be the owner, contractor or subcontractor). A lien claimant will lose any rights that it may have to enforce the lien, and the lien itself, if legal action is not instituted within one year of the date of the last work under the contract. The one-

year time period starts from the time of last work or services provided, not from the date of the filing of the lien.

If the project is commercial, as opposed to residential, a lien claimant is entitled to, but is not required to, file a "Notice of Unpaid Balance and Right to File Lien" (NUB). A NUB is also filed with the clerk of the county in which the property is located.

A lien claimant must take additional steps on a residential project. The Lien Law includes the following under the definition of residential: a one- or two-family dwelling; a condominium; a housing cooperative; and a townhouse development. However, the distinction between residential and commercial is not clear under the law.

If work is done under a residential construction contract, the lien claimant must do more to insure that the lien is properly filed and perfected. These steps include: filing a NUB, serving a Demand for Arbitration under the American Arbitration Association program created for residential construction lien claims, and then, if successful in the arbitration, filing the lien claim with the clerk in the county in which the property is located. All of these steps must be completed within 90 days from the date of the last work, services, material or equipment provided.

The Lien Law is deemed remedial in nature and has been construed by courts in New Jersey to implement this remedial purpose. New Jersey courts have

repeatedly stated that the Lien Law “must be read sensibly and consistent with the law’s overall intent to permit contractors to file liens and thus protect the value of the work they have provided.” See, e.g., *Thomas Group, Inc. v. Wharton Senior Citizen Housing, Inc.*, 163 N.J. 507, 517 (2000).

In *Thomas Group, Inc.*, a general contractor filed a lien claim against the property owner before all of the conditions of the construction contract had been satisfied. Those conditions required the general contractor to submit affidavits, certificates of insurance and other paperwork to the developer/builder before final payment would be turned over to the general contractor. The parties did not dispute that the general contractor had performed the majority of the work under the contract.

The trial court held that the general contractor’s lien had been filed prematurely because the contractor had not performed the work represented by the value of the lien “in accordance with the contract” as required by 2A:44A-3. The Appellate Division agreed that the general contractor’s claim was premature, but the Supreme Court reversed. The Supreme Court held that the contractor should not have to risk losing its statutory lien rights by waiting until all of the contractual preconditions to payment were satisfied before asserting its lien. To accommodate the interests of a property owner, the contractor’s right to enforce its lien could be stayed until the preconditions for payment have been met, and a reasonable schedule set for the contractor to complete those preconditions.

In a significant decision, a bankruptcy court in New Jersey recently ruled that lien claimants on what arguably was a commercial project had to follow the residential lien requirements, which included a NUB filing. It was also held that if the lien filing process was not completed before the bankruptcy petition was filed, the creditor did not have a valid lien.

In *In re Kara Homes, Inc.*, 374 B.R. 542 (Bankr. D.N.J. 2007), the court held that agreements with general contractors or developers in which contractors, sub-

contractors and suppliers agree to provide work, services, material or equipment to large-scale residential developments are residential construction contracts. This means that such contractors, subcontractors and suppliers must follow the more complex provisions applicable to residential construction contracts if they want to secure an unpaid balance with a construction lien.

Kara Homes and 56 of Kara’s affiliates filed voluntary petitions under Chapter 11. The affiliated debtors, with one exception, owned separate real estate development projects for the construction of single-family homes and condominiums. Prior to filing bankruptcy, Kara Homes entered into subcontractor agreements with various contractors who provided goods and/or services to construct improvements to the projects owned by each of the affiliated debtors. When the affiliated debtors failed to make payment for the goods and/or services, the contractors took steps to protect their rights under the Lien Law. In most cases, the debtors filed their respective bankruptcy petitions before the contractors could fully complete all of the requirements set forth under the Lien Law.

The contractors and subcontractors contended that contracts relating to construction of numerous homes within Kara’s developments were not residential construction contracts in that construction of homes for resale was commercial in nature, and that the scope of Kara’s developments exceeded the “one- or two-family dwelling” that was the target of the additional lien-filing requirements. Kara Homes and its affiliates argued that, because the developments were residential, their contractors and subcontractors needed to have strictly followed the provisions of N.J.S.A. 2A:44A-20 and 21 for a valid lien claim to have been filed and perfected.

After reviewing the few available unpublished New Jersey Superior Court cases considering the issue, the bankruptcy court stated “that the issue of whether a large construction project is

residential or commercial in nature is unsettled and the analysis arbitrary.” The court concluded that the literal language of the statute was not dispositive as to competing interpretations. In light of the legislative purpose articulated in N.J.S.A. 2A:44A-21, said the court, large residential projects must be included among residential construction contracts. The language of the lien law and the legislative findings, as written in the statute and taken as a whole, indicates that work done in a large-scale residential construction project pursuant to a residential construction contract is residential in nature. As such, the claimants are subject to the provisions set forth in N.J.S.A. 2A:44A-20 and 21. Accordingly, contractors, subcontractors and suppliers must observe the additional requirements applicable to residential construction contracts when working on large developments.

Essential to its decision was that the *Kara Homes* court viewed the process under the Lien Law as more than mere perfection of the lien, but going “to the heart or creation of the lien and/or interest. Until a determination on the validity and amount has been made in the Arbitration, a residential lien has not been created, since an arbitrator can deny the lien claim. Although post-petition perfection of a lien is permitted under the Bankruptcy Code, post-petition creation of a lien is not. Therefore, “unless a [claimant] has filed its NUB and obtained an arbitration award of a valid lien, a sufficient ‘interest in real property’ is not created.” Therefore, only those lien claimants with an Arbitration award prior to the filing date of a bankruptcy case will have a valid and enforceable prepetition lien. The rest will be unsecured creditors.

A real estate market that is characterized by declining values, slowing sales and a tightening of credit will impact virtually every aspect of a creditor’s pre-and post-bankruptcy filing relationship with its debtor. Understanding the law and remaining proactive will be the best way to maximize recovery of debt. ■