The Impact of the Bankruptcy Code on the Claims of Contractors and Subcontractors in New Jersey

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New Jersey provides certain statutory protections including lien rights to contractors and subcontractors supplying goods and services to construction projects throughout the state. However, when the owner or the general contractor of a project seeks protection under the Bankruptcy Code, the rights of contractors to file and pursue the enforcement of liens are impacted.

The New Jersey Construction Lien Law provides that contractors who are unpaid for work and materials provided on a construction project may file a lien against the project owner for the unpaid amount. The effective date of the lien in NJ is the date of filing of the lien, rather than the date of performance of the work. Filing the lien as early as possible – upon signs of financial distress by either the owner or general contractor – is a good practice for subcontractors. However, once a bankruptcy is filed, the ability to either file or enforce the lien by commencing a lawsuit will be stayed by the Bankruptcy Code.

Upon the filing of a bankruptcy by a general contractor, the provisions of Code section 362 stay both the filing of a lien and collection efforts by the contractor of its pre-bankruptcy lien against the "debtor and the property of the debtor." "Property of the debtor" includes accounts receivable owed to the general contractor in the hands of the owner. Even when the owner is not the debtor, courts have held that the lien claimant cannot pursue the accounts receivable held by the owner, which belong to the debtor. Such would be a violation of section 362

Notwithstanding barring enforcement of liens against the owner when the general contractor is the debtor, subcontractors may have recourse against the owner under common law causes of action. The argument in favor is that (1) the statute states that remedies provided in the statute allowing the filing of liens are not exclusive remedies, and (2) whereas enforcing the lien against the account receivables is stayed, a common law cause of action for unjust enrichment by the subcontractor has no effect on property of the debtor's estate and may be permitted.

The Lien Law treats the rights of contractors providing goods and services to residential construction projects differently than the rights of contractors in industrial or commercial projects, as the path for residential project contractors to acquire a lien is more burdensome. When a lien is filed by a contractor working on a commercial or industrial project, the lien is effective as of the filing date; this is not the case when filing a lien against a residential project. NJ courts have determined that while protecting the rights of contractors is important, "the ability to sell and purchase residential housing is essential for the preservation and enhancement of the economy of the State of New Jersey."

The statutory scheme for residential projects includes single family homes as well as large residential developments, as determined in the Kara Homes bankruptcy case (2007) – this ruling was subsequently included in 2011 amendments to the Lien Law, clarifying that mixed-use projects including residential housing units are considered residential construction projects. In order to obtain a lien on a residential project, a subcontractor must first file a Notice of Unpaid Balance (NUB) and a demand for arbitration. The NUB filing is not the equivalent of filing a lien; it is the first step in the process to obtain the right to file the lien. Should the general contractor file for bankruptcy either before the NUB filing or after the NUB filing but before the arbitrator decides that the lien can be filed, the process will be stayed by the bankruptcy.

Despite the impact of the stay on the lien process, having a lien in place prior to bankruptcy by the general contractor has value. In a case presently pending in the U.S. Bankruptcy Court, subcontractors holding pre-petition liens against the debtor and the owner of a project were able to negotiate a better return than other project subcontractors in a court-approved settlement. Refusing to agree to the settlement without additional consideration in recognition of their alleged ability to continue litigation against the project owner provided the leverage to strike a better deal than the subcontractors without valid liens.

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