Bankruptcy and Mechanics Liens in Illinois

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BANKRUPTCY AND MECHANICS LIENS

The United States Bankruptcy Code includes a comprehensive scheme for the orderly administration and liquidation of insolvent businesses. The bankruptcy code also provides a format for the reorganization of businesses which face acute financial difficulties, but which still may be viable enterprises. In addition, the bankruptcy code contains the rules of how creditors will be paid, although state law may determine the rights of creditors and the validity of individual claims.

Only federal bankruptcy courts administer and hear bankruptcy cases. The bankruptcy courts handle cases involving individuals, partnerships, limited liability companies and corporations. Since most businesses operate either as corporations or limited liability companies, this chapter will be limited to the discussion of the bankruptcy code as it applies to those entities.

There are two major types of bankruptcies. They are commonly referred to as Chapter 7 and Chapter 11 bankruptcies. In a Chapter 7 or "straight" bankruptcy, the business is insolvent and the owners have concluded that the business cannot be saved and should be liquidated. In a Chapter 11 proceeding, the owners and creditors think that the business may be saved, but in order to continue the business should be reorganized.

In a Chapter 7 bankruptcy, the court appoints a trustee. The job of the trustee is to marshal the assets of the business and evaluate the debts of the business. The trustee petitions the court to sell assets of the business and to pay claims of creditors pursuant to the priorities established in the bankruptcy code so that the business may be liquidated.

In a Chapter 11 proceeding, the debtor remains in possession of the business and continues to operate the business, although the debtor in possession owes certain fiduciary duties to the creditors of the business. A Chapter 11 provides protection for the business from its creditors, while management prepares a plan of reorganization.

In both Chapter 7 and Chapter 11 bankruptcies, there are two major classes of creditors--secured and unsecured. Secured creditors are those firms or persons who have secured claims against specific assets of the corporation, such as a mortgagee which has leant money to the corporation in exchange for a mortgage on certain real estate owned by the corporation. Banks often have security interest in certain assets of a corporation, such as its accounts receivable, to finance working capital for the corporation. In addition, the holder of a perfected mechanics lien is a secured creditor with an interest in the real estate against which the mechanics lien has been filed. Unsecured creditors have no lien or claim against specific assets of the business. They are typically trade creditors of business who have sold goods or furnished services to the business on open account.

The debtor in possession in a Chapter 11 bankruptcy proceeding presents a plan of reorganization to the bankruptcy court. In the plan, the debtor in possession recommends the method for determining the manner in which claims should be paid. The plan of reorganization must make provision of payment of secured and unsecured creditors. Creditors may object to the plan of reorganization.

In the typical plan of reorganization, the security interest of the secured creditors continues after completion of the reorganization. However, certain classes of secured creditors may have to give up some of their position in the reorganization in order to have an effective plan. For example, a class of bond holders may exchange bonds with high interest rates for bonds with lower interest rates or the collateral protecting the bonds may be reduced or otherwise modified. After payment of administrative fees, any cash remaining is paid to the unsecured creditors. Thus, in many Chapter 11 reorganizations, the unsecured creditors end up with a relatively small percentage of the amount each is owed. After the plan of reorganization is paid, the debts incurred prior to the filing of the petition for bankruptcy are discharged and the Debtor is permitted to continue its business.

While the business is in bankruptcy under Chapter 11, debts incurred by the business after the filing of a petition of the business are paid in the ordinary course of business. After the plan of reorganization is confirmed, all pre-petitioned debts are paid in accordance with the plan and any balance owing is discharged.

In a Chapter 7 proceeding, the trustee marshals the assets of the business. Secured creditors are paid first from the proceeds of the collateral securing each of their debts. Thus, if a bank has a mortgage on a piece of real estate for less than the real estate is sold, the bank is paid in the entirety and the balance becomes cash available in the bankrupt estate available to pay unsecured creditors. If the sale of the real estate does not generate enough cash to pay the bank in the entirety, then the bank becomes an unsecured creditor for the balance.

After the secured creditors are paid, then the unsecured creditors who have priority under the bankruptcy code are paid next. The unsecured creditors with priority are typically the Internal Revenue Service, which is owed money for income tax and withholding, and the state tax authorities, who are also owed taxes. Additionally, wages, salaries, commissions, vacations, severance and sick leave pay earned within 90 days before the date of filing of the petition or date of cessation of business, whichever is first, is a priority to the extent of $10,000 per individual. When the unsecured creditors with priority are paid, then the balance is available to pay the unsecured creditors on a pro rata basis.

Whenever a Chapter 7 or Chapter 11 petition is filed, there is an automatic stay of all litigation involving the business. Pending lawsuits are stayed. No pending lawsuit can be revived or no new lawsuit can be filed against the business without leave of the bankruptcy court. Also, no other steps may be taken by a creditor to collect the sums owed it.

The automatic stay does not apply to the four month period for perfecting a mechanics lien. Accordingly, the claimant who may have mechanics lien rights should perfect its mechanics lien as it would otherwise. Further, once the mechanics lien is perfected, the lien holder becomes a secured creditor against the property subject to the lien.

The automatic stay also tolls the limitation period for filing a foreclosure action. If the lien holder wants to proceed with the foreclosure action during the bankruptcy, then the lien holder must seek leave of the bankruptcy court to do so. The bankruptcy court then must decide whether the lien holder should proceed with the foreclosure action in the state court or in the bankruptcy court.

Under the bankruptcy code, the trustee in a Chapter 7 proceeding and the debtor in possession in a Chapter 11 proceeding may avoid unperfected liens to the extent a purchaser could avoid the lien on the date the bankruptcy petition is filed. If the lien claimant perfected its mechanics lien before the petition for bankruptcy was filed, the lien holder has a secured claim against the real estate equal to the value of the lien and an unsecured claim for any deficiency. The trustee or the debtor in possession cannot avoid the lien.

If the petition for bankruptcy is filed within four months after substantial completion of the work by the lien claimant, the lien claimant may record the lien after the bankruptcy filing, the lien relates back to the date of the general contract giving the lien holder a pre-petition secured claim and the trustee may not avoid the lien. If the lien holder fails to perfect the mechanics lien, then the trustee may avoid the lien, leaving the lien holder only with an unsecured claim.

Accordingly, the bankruptcy code affords a mechanics lien claimant with a perfected lien a position of a secured creditor in the bankruptcy estate. This is an important benefit to lien claimants.

During a bankruptcy proceeding, the court will place a deadline for filing proofs of claim. Proofs of claim filed after the deadline date may not be allowed. If the schedules filed by the debtor in the bankruptcy proceeding accurately reflect the sum owed a creditor and the status of the creditor as either a secured or unsecured claimant, the creditor need not file a proof of claim. However, if the debt is not accurately listed on the schedules filed by the debtor, or not listed, then the creditor must file a proof of claim with the bankruptcy court in order to preserve its rights. The better practice is to always file a proof of claim.

Occasionally, creditors may be sued by the trustee or debtor in possession because they have received payments from the debtor in the 90-day preference period. Any payments made by the debtor on an antecedent obligation in the 90 days prior to the filing of the bankruptcy petition are presumed to be preferences and may be set aside by the bankruptcy court with the result that the creditor who had received the money during the 90 day period may have to return it to the bankrupt estate. However, if payments are made in the ordinary course of business, new value is given for the debt, or there is a contemporaneous exchange there is no preference.