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Bankruptcy Court Holds Mechanic's Liens Trump DIP Liens

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The bankruptcy court is frequently called upon to consider the priority between and among liens held by debtor-in-possession (DIP) lenders and pre-petition secured lenders and holders of other pre-petition perfected liens. In *Newhall Land and Farming v. American Heritage Landscape,* Adv. No. 09-51074 (KJC), decided August 30, the court faced just such a conflict. In the "particular circumstances" of that case, the bankruptcy court held in favor of the priority of pre-existing mechanic's liens over the lien of a DIP lender.

The debtors were engaged in the business of real estate development, which involved the land planning, entitlement, development, construction and remediation necessary to transform undeveloped land into ready-to-build home sites for home-building and commercial land for developers. One of the debtors, Newhall, a land management company, had entered into pre-petition contracts with AHL, a landscape contractor, for landscaping and irrigation work on property owned by Newhall, and with R&R, a general engineering contractor, to supply and install pipeline and related services and materials. Both companies recorded mechanic's liens against Newhall's property pre-petition.

The debtors filed a motion to approve DIP financing. The DIP financing was to consist of a senior revolving credit facility and a junior term loan. The revolving credit facility was to be secured by, among other things, priming loans on substantially all of the debtors' property. The Committee of Unsecured Creditors filed an objection to the proposed DIP financing, arguing that the DIP motion was unclear whether the lender was seeking to prime existing mechanic's liens and opposing the priming of mechanic's liens if that was intended. The objections to the DIP financing were resolved, and the DIP financing was approved.

The DIP credit agreement provided for permitted liens that would not be primed by the DIP financing. Specifically, the credit agreement defined permitted liens as any lien that would otherwise be a primed lien to the extent that the holder of the lien filed "an objection or other responsive pleading" to such lien being a primed lien at any time prior to the entry of the final order approving the DIP financing. In other words, lienholders could opt out of the priming of their liens by filing an objection with the bankruptcy court.

Neither AHL nor R&R filed an objection to the DIP motion. Newhall commenced an adversary action against them seeking a declaration that their liens were primed by the DIP liens. Newhall argued that because they had failed to file a formal objection to the DIP motion, they had tacitly consented to the priming of their mechanic's liens by the DIP liens. Because the debtors' obligations under the DIP loans exceeded the value of the collateral

securing the DIP liens, Newhall contended that, as a matter of law, AHL and R&R did not hold valid secured claims against the estate.

AHL and R&R argued that the notices of perfection they filed prior to the entry of the final DIP order were sufficient to deem their liens part of the permitted liens. They argued that the notices manifested their intentions to maintain the priority of their mechanic's liens and, although not an objection per se, were "other responsive pleadings" that were filed prior to the entry of the final DIP order.

The court identified competing policy considerations. On the one hand, DIP lenders expect to be able to rely on the efficacy of final financing orders, and given the nature of the debtors' business, it was important to identify valid, pre-existing liens that, if permitted liens, would be ahead of any DIP financing liens. Also, it is important that court-imposed objection deadlines in connection with financing requests be respected and there be consequences for the failure to meet such deadlines. On the other hand, the court was loathe to allow the cancellation of valid liens, falling within the safe harbor of Section 546(b), in light of the lienholders' undisputed efforts to assert their rights.

In the end, the court concluded that the Section 546(b) notices filed by AHL and R&R were sufficient to alert Newhall that they opposed the priming of their mechanic's liens by the DIP liens. The notices of perfection were filed before the entry of the final DIP order and supported a finding that AHL and R&R did not intend to waive their rights or tacitly consent to the priming of their liens.

The court's opinion does not explain why the mechanic's lienholders did not file a formal objection to the DIP motion. Surely they could have done so as easily as filing their notices of perfection. Nor does the opinion explain why the court was willing to ignore the mandate of the interim DIP order requiring a formal objection to the DIP loan, other than to state that it was loathe to invalidate otherwise valid liens. Perhaps the court did not want to wrestle with what was meant by "other responsive pleading." Moreover, the court's qualification in its opinion — "in the particular circumstances before me" — may have been an attempt to limit the precedential effect of the decision for the future. The better course for lienholders would be to pay heed to an order requiring the lodging of formal objections to DIP financing motions in order to preserve the priority of their liens and not hope that the court will be willing to excuse their failure to do so.

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