

Urban Land

Mechanic's Lien Conflicts

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Property owners can use certain rights and strategies to deal with the filing of a mechanic's lien.

Filing a mechanic's lien enables someone who claims to be owed money for labor performed or materials furnished to improve real property to secure the claim with a lien—even before the claim is determined to be valid. The contractor does not need to get a court order or to obtain the agreement of the property owner. Regardless of the merits of the contractor's claim, the lien is an encumbrance on the owner's property that must be dealt with on sale or financing and, for a construction loan, before the next advance of loan funds. If the contractor's claim is proven in court and is not paid, the lien may be foreclosed and the claim recovered upon judicial sale of the property; if the claim is denied in court, the lien is vacated. Although each state has its own version of a mechanic's lien statute, the New York statute is similar to many others.

A lien may be filed against the owner's property not only by the contractor with whom the owner dealt, but also by a subcontractor who has improved the property. The subcontractor may file regardless of how many tiers of subcontracts separate it from the prime contractor and even if the owner had no direct contractual relationship with the subcontractor and may not have

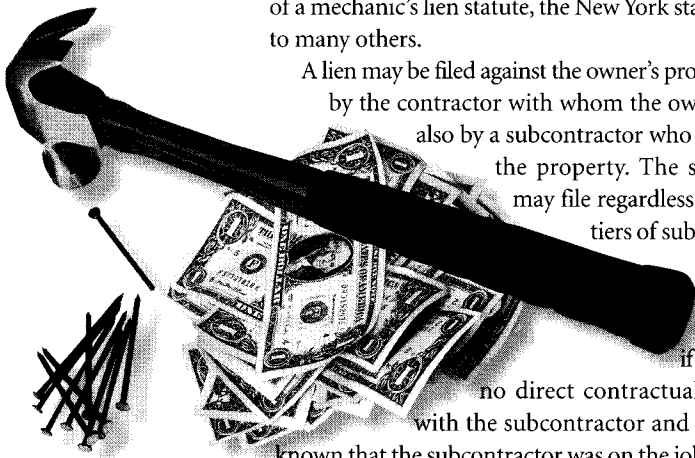
known that the subcontractor was on the job. Thus, a subcontractor of a subcontractor can file a lien against the owner (but a supplier of materials supplying to another such supplier cannot file). Such a subcontractor lien can arise when the prime contractor diverts money paid by the owner to another job and does not pay the subcontractors on the owner's job; when a dispute arises between the prime contractor and the subcontractor, causing the prime contractor to withhold payments; or when a subcontractor goes bankrupt. In situations like these, the owner may not be aware of the disputed claim, much less able to resolve it. However, under certain, but not all, circumstances, if an owner has fully performed its obligations to the prime contractor, the subcontractor's liens are invalid.

A lien may be filed only for an amount up to the amount

of the unpaid portion of the construction contract for the work actually performed (this is called the lien fund). This dollar limit applies at each level, so a subcontractor cannot file a lien for more than the amount owed to the prime contractor by the owner; in addition, a materials supplier cannot file a lien for more than the amount owed to the subcontractor with which the supplier dealt. These limits apply even if the lienor was owed more under its contract, or if it substantially performed its obligations but the prime contractor did not. For example, when the owner pays the prime contractor in full all sums payable under its contract, but the prime contractor did not pay its subcontractors, there is no lien fund. The unpaid subcontractor may not thereafter file, and if it does, the lien is invalid. Another way the lien fund may be reduced is by contractor default, creating an offset claim by the owner against its contractor. Thus, when the owner rightfully withholds payment or does not release retainage, there may be nothing owed to the contractor, and thus there is no lien fund. As the contractor cannot properly file a lien, thereafter neither may its subcontractors or materials suppliers.

However, liens of subcontractors may still be valid if they are filed prior to payment in full to the prime contractor or prior to the prime contractor's default. If the owner pays its prime contractor when it knows that subcontractors have filed liens, the payment is not a defense to these liens or to subsequent subcontractor's liens; the owner also will be at risk of having to make a double payment. If at the time a subcontractor files its lien there is a lien fund (sums actually earned and unpaid to the prime contractor), even though a subsequent default by the prime creates offset claims (which will reduce the lien fund), the later default will not invalidate the subcontractor's earlier valid, filed lien. In this case, the owner will risk having to pay subcontractors an amount that it does not owe based on its construction contract. These examples demonstrate the owner's risk if it fails to require its contractor to promptly discharge or bond off liens filed by subcontractors—or worse, if it continues to make payments to its contractor while such liens are outstanding.

What if the situation involves a default under the prime contract and the owner discharges the prime contractor and completes the work with another? The lien fund could



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be replenished if the owner completes the work “for the account of” the defaulting contractor at a cost less than the unpaid balance under the defaulted contract. That saving is then added to the lien fund and may be recovered or liened by the defaulting contractor and its subcontractors. To avoid this, the owner should make it clear that it is not completing the contract for the “account of” the contractor; the owner then can keep any savings.

Although a strategy to prevent mechanic’s lien filings would be to obtain a waiver of the right to file, it is against public policy—and thus void—to obtain a waiver prior to payment for work performed, although a waiver concurrent with or after payment is valid in regard to the payment made. While partial lien waivers

may thus merely amount to a receipt for payment, failure to provide a waiver is an early warning of financial trouble and may tell the owner whether funds are being diverted. The owner also can use dual/party checks to ensure that subcontractors receive their payments, but it should be clear that payment is on behalf of the contractor, so there is no implication that the owner is assuming the contractor’s obligations. There remains, of course, the practical problem of how far down the chain the owner can collect lien waivers or police payment to subcontractors.

A payment bond may be obtained from a surety company at the time of the contract, which secures the obligation of the prime contractor to pay its subcontractors. Although the cost of the bond premium adds to the cost of

the job, if the prime contractor fails to pay its subcontractors, the surety is liable to the owner and the unpaid subcontractors up to the amount of the bond.

An owner therefore has a number of strategies it can use before a mechanic’s lien is filed or to try to prevent its filing and various rights it can assert against its contractor and surety if a lien is filed. In addition, an owner can employ self-help, such as bonding off the lien with sums withheld from the construction contract. Of course, for the owner to determine the correct approach, it must be aware of the lien law of the state where the property is located, which will govern the rights and remedies of the owner and lienor. ■