

## MECHANICS LIENS: A PRIMER FOR REAL ESTATE PROFESSIONALS

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Success or failure of a real estate project can depend on the absence of or the timely filing of a mechanics lien. This is equally true for the design of a small annex to multi-million regional commercial or industrial projects. A contractor may file a lien to collect large sums owed to it; but may also jeopardize its own right to payment and its right to continue to work if its subcontractors and suppliers file a lien claiming that the contractor failed to pay them. A developer who fails to keep the property free of liens may be in default to its construction lender, and a mechanics lien may interfere with the refinancing or sale of completed project. A title examiner firm can successfully contribute to the client's successful negotiations when the examiner can examine a lien filing, determine its validity, advise the client on whether it can or should be bonded off, and what it may represent with respect to other problems on the project.

A mechanics lien is a claim against a piece of property by someone who supplied work or products that were used to build, improve or repair the property and who expect payment for their contribution. In some respects mechanics liens operate similarly to mortgages. They are filed with the clerk of the county property registry; and if the debt is not satisfied, the lienor may foreclose, i.e., bring a suit to force the sale of the property to satisfy the debt. Like a mortgage, they "run with the property," so that if someone buys a property after the lien has been filed, the buyer's ownership to the property is subject to the pre-existing lien claim.

Mechanics liens exist because of the basic financial structure of the construction industry. In construction projects, most contractors are only paid on a monthly basis after doing work, and subcontractors are then paid by the general contractor thereafter. This creates obvious gaps during which payment is at risk. A real or feigned objection to the work, or financial problems, may result in non-payment. Therefore, lien rights may be a firm's best and sometimes only way of securing payment for the value they contribute to real estate. However, from the owner's point of view, its rights in the property are vulnerable to unilateral claims, sometimes by claimants with whom it had no direct dealings. State legislatures and courts, therefore, try to balance these two concerns through strict rules which seek to protect the owner in some instances and contractors/suppliers in others.

With this in mind, there are important differences between a mechanics lien and a mortgage. A mortgage is given in writing and signed by a property owner. The filing of a mortgage in no way indicates the owner has failed to pay its debts, and the mortgage holder does not have to provide special notice before filing the mortgage with the registrar of deeds. A mechanics lien, by definition, is an indication that there is a claim that money is owed, and the

lien is unilaterally filed by the claimant, with the property owner only receiving notice of the lien filing (usually by certified mail). The statutes sometimes require that a subcontractor, or a subcontractor's supplier and subcontractor give notice to the owner (and/or a general contractor) before filing a lien, even before a payment dispute has arisen. These notices advise the owner that it should take measures to ensure that all those who are contributing to the project receive the monies due to them. In states with such a notice requirement, failure to provide the notice will preclude the filing of a lien. A mechanics lien must be filed within a tight schedule, often within several months of the last work or material supplied to the job site. Then, unlike a mortgage lien, which remains effective until discharged, the lienor has a limited time to file a foreclosure suit once a mechanics lien is filed. If suit is not filed, the lien becomes "stale" and cannot be enforced. This rule protects the property owner from questionable liens, and also from having its title permanently clouded by a temporary dispute, simply because the parties forgot to file a formal discharge of a lien.

In addition, a mortgage can collateralize any form of debt to anyone. Although most mortgages exist to secure money lent for the purchase or refinancing of a piece of property, a mortgage lien can be created to secure any type of debt, such as divorce settlements, bond indemnity agreements, and loans to the owner of a small business. The owner's direct execution of the mortgage protects against wholly fraudulent claims.

A mechanics lien usually can only be filed where there is a written contract for the work being done. A mechanics lien can only be filed by the classes of claimants designated in that particular state's law, which typically include contractors, suppliers, construction equipment lessors (such as scaffolding companies), subcontractors and suppliers to the general contractors. In some states, architects and engineers may also be permitted to file mechanics liens. However, the extent to which lower tiers below those classes (subcontractors to a subcontractor, suppliers to a subcontractor) may file a lien will vary from state to state.

Development financing agreements, and commercial and industrial leases, generally require that the owner keep the property free of liens, and usually require the satisfaction or discharge of liens as part of supplying a "clean title." In addition, the existence of a lien may also be a symptom of a general construction dispute, such as one where payment was refused because of claims of defective or incomplete work. Therefore, where there are sizable mechanics liens on a property, a buyer or lender may wish to investigate the project's history before proceeding further.

Obviously, no one should buy or agree to lend money on property while unsatisfied current liens exist. This includes the conversion of a high interest construction loan to a lower interest permanent financing, since the pre-existing lien could have priority over the mortgage. Therefore, a construction firm which files a lien before such a transaction (or before a construction loan is replaced by a permanent financing) is in a strong position to realize payment without suit; either the lien will be directly satisfied by the owner, or it will be paid out of the closing funds.

Looked at from a developer's point of view, mechanics liens, particularly for large amounts, can doom a project. There are several steps a prudent owner will generally take to avoid the filing of liens. First, even in states where there is no notice requirement, owners should obtain a listing of all subcontractors and major suppliers on the project from the general contractor. Some state statutes permit owners to make this demand as a matter of law. As part of the normal monthly requisition process, an owner (usually through the architect) will demand "waivers of liens" to be provided for all subcontractors and suppliers, indicating that they have received all money previously owed them. An owner may demand the general contractor provide a payment bond before beginning work, which bonds against unpaid claims of workers and materialmen. If a lien is filed in the middle of construction, the owner should be entitled to withhold funds to satisfy liens filed by subcontractors and suppliers from the payments to a general contractor unless all liens are shown to have been satisfied, such as the owner obtaining releases discharging the liens. In the absence of a negotiated solution, owners should do this unless they are convinced that the lien claim is completely untenable.

Mechanics liens also hold dangers for construction firms. The improper filing of a lien, the filing of an "inflated" lien claim, or a wrongful refusal to discharge a lien, may subject the filer to attorneys' fees or other penalties either by statute or under a "slander of title" action. Therefore, a lien should not be filed without careful attention to the specific notice, written contract requirements and other provisions of a particular state law.

Where an owner (or a contractor whose subcontractor or supplier has filed a lien) objects to the lien claim, it may either file a suit to demand a discharge, or it may post a lien release bond to maintain the clear title on the property itself. This is separate from any performance or payment bond issued for the actual construction work. The lien bond is a promise by a surety (usually a commercial bonding company) that it will pay the lien if the owner does not. The bond is then filed with the county where it substitutes for the lien on the property itself. Usually, the surety requires the owner (or contractor) to indemnify it for any payments on the bond, and to provide a defense for any claims. In most cases, the surety will ask the owner or (contractor) to escrow sufficient funds for the payment. Therefore, obtaining a lien bond does not relieve the ultimate obligation to pay a proper claim, but it does allow the title to be cleared to allow a conveyance, refinancing, or payments of further requisitions while the underlying claim is disputed and adjusted.