

CONSTRUCTION SUBCONTRACTING

A Comprehensive Practical and Legal Guide

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CHAPTER 5

Mechanic's Liens and Other Remedies

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I. Introduction

Mechanic's liens and other remedies available to subcontractors and suppliers provide powerful tools to secure payment for work and services performed and materials provided to construction projects. This chapter covers mechanic's liens, liens on construction fund/stop notices, and trust-fund statutes. This is not a 50-state survey of lien laws or other remedies. Rather, the chapter discusses these remedies in general terms, with some specific examples of how different jurisdictions approach the most important issues raised by each of these remedies. As these remedies are creatures of state statutes, and vary widely by jurisdiction, it is incumbent upon counsel to become familiar with the requirements of their local state statutes.

II. Mechanic's Liens

Mechanic's liens are intended to protect the rights of subcontractors and suppliers who improve the property of others, providing a mechanism for contractors and suppliers to obtain a lien for unpaid balances against the owner of a construction project and the property on which it sits. A mechanic's lien provides a security interest in real property for subcontractors and suppliers in connection with payments due and unpaid for labor, materials, services, and equipment provided on a construction project.¹ Lien laws are a

1. *Rudisell v. Fifth Third Bank*, 622 F.2d 243, 248 (6th Cir. 1980) (a mechanic's lien is a security interest in property).

unique vehicle affording a direct right of action against an owner's property, absent contractual privity.²

All 50 states have mechanic's lien statutes, and the specific lien laws vary from state to state.³ This chapter is intended to give a general overview of issues and considerations that arise in the context of mechanic's liens.

A. Overview

Mechanic's liens are very effective tools for subcontractors to obtain payment on a project. Typically, mechanic's liens can be filed both by the party who has a contract with the owner, like a general contractor, and by those parties who are not in direct privity with the owner, including subcontractors and suppliers.⁴ The lien remains on the owner's property until it is discharged, stricken, or extinguished. An owner may not generally sell, transfer, or refinance the encumbered property without first satisfying the lien.⁵ As such, mechanic's liens preserve a subcontractor's right to payment, even in instances where the prime contractor is no longer in business.

Unfortunately, the important rights granted under mechanic's lien laws can easily be lost or waived. Mechanic's liens are creatures of statute, and courts strictly construe and enforce the requirements of the statutes.⁶ Thus, courts routinely strike liens filed by claimants who have failed to notify the correct parties or to strictly comply with the time frames set forth in the statutes.

2. See *Hartford Accident & Indem. Co. v. N.O. Nelson Mfg. Co.*, 291 U.S. 352, 358 (1934) ("Materialmen and laborers may be secured by mechanics' liens upon land improved or affected by their material or labor, and this without reference to technical and ancient concepts of privity of contract. . . . The fundamental liberties protected by the Fourteenth Amendment do not include immunity from restraints so deeply rooted in policy and justice.").

3. There are a number of 50-state compendiums of lien laws available that provide a useful starting point for understanding an applicable state's lien law. See, e.g., ROBERT F. CUSHMAN & STEPHEN D. BUTLER, *FIFTY STATE CONSTRUCTION LIEN AND BOND LAW* (Aspen Publishers, 2d ed. 2000); FULLERTON & KNOWLES, *CONSTRUCTION LAW SURVIVAL MANUAL: MECHANIC'S LIENS, PAYMENT BONDS, CONTRACTS, CLAIMS AND BANKRUPTCY* (Supp. 2013), <http://www.fullertonlaw.com/construction-law-survival-manual.html>.

4. *Rure Assocs., Inc. v. Dinardi Constr. Corp.*, 917 F.2d 1332, 1335–36 (2d Cir. 1990) (no privity required between owner and subcontractor in order for subcontractor to lien owner's property).

5. *Barker's, Inc. v. B.D.J. Dev. Co.*, 308 N.W.2d 78, 81 (Iowa 1981) (noting that in order to refinance a construction loan on a liened project, the owner would be required to obtain subordination agreements from the lien claimants).

6. *Niewind v. Carlson*, 628 N.W.2d 649, 652 (Minn. Ct. App. 2001) (strict construction of lien statute resulted in the court invalidating lien for failure to put pre-lien notice in bold typeface).

B. Right to a Lien

A right to a mechanic's lien arises when a contractor or supplier has billed for work performed or materials supplied on a construction project, and has not been paid. Not all unpaid claimants, however, have the right to file a lien. In order to be a proper claimant, the claimant and the project must fit within the parameters defined by statute. Once the determination has been made that a lien is appropriate, the claimant must strictly follow the statutory process and timelines for providing written notice to the owner and others, recording or filing the lien, and, ultimately, enforcing or foreclosing on the lien.

1. Proper Claimant

Generally, to be entitled to mechanic's lien rights, the lien claimant must have performed labor and/or supplied materials that were incorporated, used, or consumed in a construction project. In most states, lien rights are afforded to the prime contractor, all subcontractors, and suppliers on a private project.⁷ Typically, suppliers of rental equipment are not proper lien claimants, unless the state statute expressly provides for liens for the supply of rental equipment.⁸

There are some states that provide a more expansive list of claimants entitled to liens, including first-, second-, and third-tier subcontractors and suppliers.⁹ In addition, some states provide that individual laborers or trustees on behalf of such laborers, like union benefit funds, have lien rights.¹⁰ Other states permit design professionals to file mechanic's liens.¹¹

2. Construction Project Subject to Liens

A claimant must determine if the construction project is subject to a lien under the statute. Typically, mechanic's liens may be filed only against private construction projects. Most states do not permit mechanic's liens to be filed on public construction projects, as a matter of public policy.

7. See, e.g., GA. CODE ANN. § 44-14-316.

8. See *Bush Constr. Mach. v. Kan. City Factory Outlets*, 81 S.W.3d 121, 123–25 (Mo. Ct. App. 2002) (holding that rental equipment suppliers were not proper claimants and compiling cases from other jurisdictions addressing the issue).

9. See, e.g., N.C. GEN. STAT. § 44A-23 (providing that a first-, second-, or third-tier subcontractor that has furnished labor or equipment may enforce a lien); TEX. CONST. art. XVI, § 37 (“covering mechanics, artisans and materialmen, of every class”).

10. Lien statutes that provide that individual laborers may file a lien include Hawaii, HAW. REV. STAT. § 507-42; Connecticut, CONN. GEN. STAT. § 49-33; and Texas, TEX. CONST. art. XVI, § 37. Lien statutes that expressly provide union benefit funds have standing as lien claimants include those of Oregon, OR. REV. STAT. § 87.010(4) (“Trustees of an employee benefit plan shall have a lien upon the improvement....”). See also *Bricklayers of W. Pa. Combined Funds, Inc. v. Scott’s Dev. Co.*, 41 A.3d 16 (Pa. Super. 2012) (interpreting “sub-contractor” for purposes of lien rights to include union benefit funds).

11. MD. CODE ANN., REAL PROP. § 9-102(a).

a. Private Construction Projects

Typically, private commercial, industrial, oil, and gas development and multi-family residential properties are subject to liens. However, not all private construction projects are subject to a mechanic's lien. For example, some renovation and repair work and newly built, single-family homes under a certain dollar value are exempt from a lien in Maryland.¹²

b. Public Construction Projects

Public construction includes federal, state, and local projects. State lien laws do not apply to federal projects. The sole payment protection on federal projects is the Miller Act payment bond claim.¹³ Most state and local governments generally require prime contractors to supply payment bonds on public construction projects, which serve as additional security for the payment of subcontractors and suppliers.¹⁴ Payment bonds help ensure that subcontractors and suppliers will be paid in the event of a prime contractor's default, bankruptcy, or failure to pay its subcontractors and suppliers.¹⁵

c. Hybrid Construction Projects

Some projects do not easily fit into a strict category of public or private projects—for instance, those projects that are jointly funded by taxpayer funds and private funds. For example, public-private partnerships, known as “P3s,” are an emerging type of construction project, in which the public authority generally owns the real estate, and the prime contractor, privately held entity, or consortium of privately held entities generally provides the financing for the construction of the project.¹⁶ In those instances, it is important to ascertain whether there is a payment bond or any other security posted for the benefit of subcontractors and suppliers and to determine the claimant's right to lien the interest in the project owned by the private entity.¹⁷

12. *Ridge Heating, Air Conditioning & Plumbing, Inc. v. Brennen*, 762 A.2d 161, 168 (Md. Ct. Spec. App. 2000) (residential exception in state's mechanic's lien statute applies to repairs or improvements to homes).

13. *United States ex rel. Consol. Elec. Distrib., Inc. v. J.D. Grainger Co.*, 945 F.2d 259, 263 (9th Cir. 1991) (“The purpose of the Miller Act is to provide a remedy for subcontractors on federal projects where ordinary mechanic's liens on federal property are banned, and to effectuate the Congressional intent to protect those whose labor and materials go into public projects.”). Surety bonds are discussed in chapter 14, and public projects are discussed in chapter 17.

14. *Gen. Ins. Co. v. Lamar Corp.*, 482 F.2d 856, 860 (6th Cir. 1973) (“Mechanics' or materialman's liens ordinarily do not apply to public projects”).

15. Payment bonds are discussed in chapter 14.

16. Alternative project-delivery methods, including P3s, are discussed in chapter 18.

17. *S. Bay Expressway, LP v. Otay River Constructors (In re S. Bay Expressway, LP)*, 434 B.R. 589 (Bankr. S.D. Cal. 2010) (held that mechanic's liens involving the SR 125 tollway, a public-private partnership, were valid against debtor's franchise rights and leasehold interest in a public project).

C. Property Interest Subject to a Lien

A lien is generally filed against (and limited to) the property interest the owner of the project holds in the subject real estate. For example, when the project owner is also the fee owner of the real property, the lien is against the fee owner's equity in the property. When the project is developed by a lessee or tenant, the lien attaches only to the lessee's leasehold interest in the property.¹⁸

On complex projects, difficulties can arise in determining both the owner of the construction project and the owner's interest in the property.¹⁹ For example, on commercial and industrial projects, the owner may hire a developer, who in turn enters into contracts with contractors and suppliers. In that instance, the developer does not hold any traditional real estate interest in the property. Additionally, the true owner of the real estate may not be disclosed, or may hold only a leasehold interest. Therefore, in order to determine the proper owner, the claimant must conduct a complete title search, review the public records (which may not show all leases and other transactions regarding the real estate), and obtain as much information as possible from the project team about the developer and owner.

D. Filing and Enforcing a Lien

Once a claimant determines there exists a right to file a lien, the claimant must strictly follow the procedures outlined in the statute.

1. Preliminary Notices

Some states require that subcontractors serve a notice prior to starting their work, often called a notice of furnishing.²⁰ Generally, service is required to be made on the owner and prime contractor.

Statutes also require that a subcontractor claimant give an owner a preliminary notice of its intent to file a lien prior to filing its lien claim. Typically, the notice of intent must be sent one to two months prior to filing the lien. The notice may be required to be sent to both the owner and the construction lender.²¹ For projects with multiple owners, such as condominiums, a notice must be sent to each individual owner.

18. *Diversified Mortg. v. Blaylock*, 576 S.W.2d 794, 805 (Tex. 1978) ("If a lessee contracts for construction, the mechanic's lien only attaches to the leasehold interest, not the fee interest of the lessor."); MD. CODE ANN., REAL PROP. § 9-101(f).

19. *Venture v. Sicoli & Massaro, Inc.*, 77 N.Y.2d 175, 182 (1990) (liens were valid when they were filed against developer's property prior to undisclosed sale-leaseback transaction with ultimate owner).

20. See, e.g., OHIO REV. CODE ANN. § 1311.05(A); MICH. COMP. LAWS ANN. § 570.1; LA. REV. STAT. ANN. § 9:4801, *et seq.*

21. *Kodiak Indus. v. Ellis*, 185 Cal. App. 3d 75, 85–88 (1986) (discussing requirement under California lien law to provide preliminary notice to construction lender); *Pac. Cont'l Bank v. Soundview 90, LLC*, 273 P.3d 1009, 1012–14 (Wash. Ct. App. 2012) (discussing lien

2. *Contents of the Notice and Lien Claim*

Mechanic's lien laws typically outline in detail what must be included in the notice(s) and lien and, at a minimum, require the claimant to identify and describe

- the owner and property location;
- the project;
- the contract under which work was performed, and the parties to that contract;
- the work performed or materials furnished by the claimant;
- the unpaid amount due and basis for calculation; and
- the last date work was performed or materials were furnished to the project.

Common pitfalls include identifying the wrong owner or failing to adequately identify the property subject to lien. If a claimant names the wrong owner, the lien may be stricken by the court. However, some courts permit amendments to the lien claim, particularly in instances where it is difficult to ascertain the correct owner of the property interest at issue.²² For instance, in some states, leases and subleases are not always recorded in the public records, and the leasehold interest may be the only lienable interest. Counsel should review the applicable statute not only for types of amendments allowed but also for the timing within which amendments can be made.²³

A mechanic's lien claim is typically limited to an amount reflecting the remaining subcontract value of the work actually performed. A lien may be asserted for only liquidated amounts—that is, an amount that can be ascertained or determined by reference to the subcontract and invoices, and not for extra-contractual or delay damages. The amount of the lien may include interest and costs as set forth in the statute. In some states, in the event that a lien claimant is determined to have overstated or inflated the value of the lien, the entire lien may be forfeited.²⁴

3. *Filing the Lien*

Liens are filed either in the land records of the county in which the property is located or in the appropriate county court in which the property is located.²⁵

claimant's obligation to provide a stop notice to the construction lender under Washington lien law).

22. See, e.g., *Moss & Blakely Plumbing, Inc. v. Schauer*, 150 Pa. Super. 318, 322 (1942).

23. See, e.g., NEB. REV. STAT. § 52-148 (allowing only certain amendments after the original filing time has passed); MD. CODE ANN., REAL PROP. § 9-112 (same).

24. *Carolina Builders Corp. v. Cenit Equity Co.*, 512 S.E.2d 550, 552–53 (Va. 1999) (lien that included work performed outside the 150-day look-back period was invalid in its entirety).

25. See, e.g., *Burkhard Hotel Partners v. A. Giacalone Constr. Corp.*, 15 MASS. L. RPTR. 634, *6 (2003) (lien must be filed and enforced in county where the real property is located); Maryland Rule 12-302(a).

Most states require that lien claims be filed or recorded within a specified time, usually somewhere in the range of three to six months of a claimant's last work on a project.²⁶

Once the lien claim has been filed, written notice of its filing lien must be timely served on the owner. A claimant typically has six months to two years to commence a civil action on its claim, often described as enforcing or foreclosing on a lien.²⁷ If a claimant fails to enforce or foreclose on the lien in the time provided by the statute, the lien is extinguished by operation of law.²⁸

E. Lien Waivers

If a claimant has validly waived its right to a lien for the sum at issue, the claimant may not file a lien against the owner or the project. There are two main inquiries here: the validity and the scope of the lien waiver. Most states have determined that not all lien waivers are enforceable.²⁹ It is important to assess the enforceability and the scope of the lien waiver and the current state of the law in order to determine if waivers signed prior to and during the course of the project are enforceable.

There are two primary types of lien waivers. The first is a prospective lien waiver, in which a subcontractor unconditionally waives all future lien rights prior to the performance of any work on a project. The second type is a waiver signed by the subcontractor in connection with the receipt of payment for work. Note that lien waivers may be included in the subcontract and may also be contained in other project documents such as in change orders. Depending on applicable state law, lien waivers may be enforceable, partially enforceable, or not enforceable at all.

1. Prospective Lien Waivers

Prospective lien waivers are signed prior to the performance of any work on the project and waive a party's right to file a lien. Prospective lien waivers may be contained in the contract documents that are signed at the outset of a project. A prospective lien waiver that is signed by a prime contractor may be incorporated by reference or through flow-down provisions into subcontracts.

26. See, e.g., VA. CODE ANN. § 43-4 (90 days); N.H. REV. STAT. ANN. § 447:9 (120 days); 49 PA. STAT. ANN. § 1502(a)(1) (30 days prior to six-month deadline for filing lien).

27. See, e.g., MD. CODE ANN., REAL PROP. § 9-105 (180 days); 770 ILL. COMP. STAT. 60/28 (two years).

28. See, e.g., *Oxford Paint & Hardware, Inc. v. Baxter*, No. VV91-03-68-768, 1992 Conn. Super. LEXIS 2914 (Oct. 7, 1992) (plaintiff's failure to foreclose on lien within the statutory time frame results in lien being extinguished); *United Pac. Ins. Co. v. Cottonwood Props.*, 156 Ariz. 149 (Ct. App. 1987) (same).

29. Prospective lien waivers prohibited: California, CAL. CIV. CODE § 8124; Michigan, MICH. COMP. LAWS § 570.1115; Missouri, MO. REV. STAT. § 429.005; Pennsylvania, 49 PA. STAT. ANN. § 1401; Delaware, DEL. CODE ANN. tit. 25, § 2706(b).

Fortunately for subcontractors, many states' statutes prohibit prospective lien waivers as contrary to public policy.³⁰

2. *Lien Waivers Provided in Connection with Payment*

As a condition of payment, a subcontractor may be required to submit a payment application and a lien waiver for the payment amount.³¹ A subcontractor who enters into a lien waiver in exchange for payment may not thereafter file a lien for that amount.

It is important to review the lien waivers closely. For example, a lien waiver form signed after the receipt of a progress payment may provide that all liens, including liens for retainage, are waived "through the date hereof," despite the fact that the payment was only for work performed 30 days prior to the progress payment. It is important to be wary of any document that mentions waiving lien (or claim) rights.

F. Special Considerations

1. *Defense of Payment*

An owner may be able to assert payment as a defense to a lien by a subcontractor or supplier if the owner has paid the general contractor for the work that is the subject of the lien prior to receiving the subcontractor or supplier's notice of the lien.³² The defense of payment is lost, however, if the owner has been supplied notice of the lien by the subcontractor and continued to make payments to the general contractor.

In some jurisdictions, an owner does not have a payment defense, and, therefore, if the general contractor absconds with payment or goes out of business, the owner will be required to pay for the same work twice.³³

2. *Discharge Bonds*

An owner or a contractor may obtain a discharge bond to remove a lien from the property. Discharge bonds may be obtained from insurance brokers and

30. Prospective lien waivers prohibited: California, CAL. CIV. CODE § 8124; Michigan, MICH. COMP. LAWS § 570.1115; Missouri, MO. REV. STAT. § 429.005; Pennsylvania, 49 PA. STAT. ANN. § 1401; Delaware, DEL. CODE ANN. tit. 25, § 2706(b).

31. *L&L Builders Co. v. Mayer Associated Servs.*, 46 F. Supp. 2d 875, 891 (N.D. Iowa 1999) (discussing execution of mechanic's lien waiver in connection with payment).

32. States providing for defense of payment: Massachusetts, MASS. GEN. LAWS ch. 254, § 4; Virginia, VA. CODE ANN. § 43-11.

33. *See, e.g., Overberg Decorating Ctr., Inc. v. Selbah Props.*, 741 S.W.2d 879, 881 (Mo. Ct. App. 1987) (purpose behind § 429.012 of the lien law is to warn inexperienced property owners of the danger that lurks in the mechanic's lien statute that they might be forced to pay a second time to the unpaid lien claimants); *cf. Lee Deering Elec. Co. v. Pernikoff Constr. Co.*, 247 S.W.3d 577 (Mo. Ct. App. 2008) (payment to the prime contractor is an affirmative defense, even though as a result "the subcontractor may remain unpaid and thus suffer detriment, equity will not require the owner to pay twice").

surety companies in the same manner as a performance or payment bond. The effect of a discharge bond is that the lien is no longer attached to the real property but, rather, is attached to the bond. The lien, in conjunction with the discharge bond, provides security for the payment claim.

An owner may obtain a discharge bond in instances where it disputes the mechanic's lien claim but does not wish to have a lien attached to the real property at issue. For instance, an owner may want to transfer or sell the property before the lien claim is resolved. A general contractor may be required, by contract with the owner, to discharge any liens filed by their subcontractors against the property. A discharge bond is a means for the contractor to satisfy its obligations to the owner.

A discharge bond discharges only the claim against the real property. It does not discharge the lien, which is transferred from the real property to the bond. The lien claimant must, however, continue to follow all statutory processes for foreclosing upon the lien. If a claimant fails to do so, the lien will be extinguished by operation of law.

3. Bankruptcy

A bankruptcy may impact whether the subcontractor can pursue its right to payment on a claim outside of the bankruptcy court because of the automatic stay of 11 U.S.C. § 352. However, it will probably not prohibit a claimant from filing a mechanic's lien in accordance with state law, as it is merely a perfection of a preexisting lien right and as such is permitted under 11 U.S.C. § 546, similar to the filing of a UCC-1 within the prescribed time period.³⁴ This is true even if the debtor is the project owner and the lien is against its interest in the real property improved.

4. Mechanic's Lien Priority

There are three types of statutory schemes relating to the priority of mechanic's liens. A majority of jurisdictions follow the model that priority is established by the date on which materials or labor is first provided (or the commencement date) (inchoate), so long as the lien is filed or recorded.³⁵ There are a few states where priority is established by the date of filing a notice of commencement or the lien itself.³⁶ Finally, only two states, Maryland and New Hampshire, require judicial action to establish a lien. Notably, some states in

34. *Pioneer Constr., Inc. v. Global Inv. Corp.*, 202 Cal. App. 4th 161, 167–69 (2011) (automatic stay does not bar filing of a mechanic's lien; however, the time for foreclosing on the lien is tolled during the pendency of the bankruptcy).

35. Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Montana, Nevada, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, and Wisconsin.

36. Florida, Kentucky, Louisiana, Maine, Massachusetts, Mississippi, Nebraska, New Jersey, Pennsylvania, Rhode Island, and South Carolina.

all categories give priority over previously existing mortgages, construction loans, or other recorded encumbrances.³⁷

III. Liens on Funds/Stop Notices

In addition to the right to a mechanic's lien against real property codified in every state, some states have also enacted legislation permitting subcontractors and suppliers to place a lien upon any amounts held on construction projects by public owners, private owners, lenders, or a combination thereof. Currently, at least 20 states have enacted legislation permitting a claimant to assert such a remedy.³⁸ This remedy is commonly referred to as a "lien on funds" or "stop notice" (or, in California, a "stop payment notice").³⁹ Unlike mechanic's liens, which provide subcontractors and suppliers with an interest in real property, these claims are a security interest in construction funds.⁴⁰

As a creature of statute, in order to establish a valid lien, a claimant typically must strictly follow any and all procedural requirements, which vary substantially from state to state. Once a lien on the funds is perfected, an owner—or in some states, a lender—that distributes any liened funds becomes personally liable for the lien amount. The lien may also continue to attach to the funds after they leave the hands of the owner (or other holder of funds), potentially making additional parties personally liable to the claimant for the wrongly disbursed funds.

37. New York, Illinois, Maine, and New Hampshire; see *Stewart Title Guar. Co. v. Linowes & Blocher*, No. 93-1950, 1994 WL 689122 (4th Cir. Dec. 12, 1994) (under VA. CODE ANN. § 43-21, "mechanic's liens have priority over the security interests of banks and other secured lenders even when the mechanic's liens are established subsequent to the recording of the lender's security interests").

38. The following jurisdictions permit a claimant to lien either a public or private owner or lender: Alabama, ALA. CODE § 35-11-218; Alaska, ALASKA STAT. § 34.35.062; Arizona, ARIZ. REV. STAT. ANN. § 33-1051, *et seq.*; California, CAL. CIV. CODE § 9350, *et seq.*; Illinois, 770 ILL. COMP. STAT. 60/23; Indiana, IND. CODE § 32-28-3-9; Kentucky, KY. REV. STAT. § 376.210; Louisiana, LA. REV. STAT. ANN. § 38:2242; Mississippi, MISS. CODE ANN. § 85-7-181; New Hampshire, N.H. REV. STAT. ANN. § 447:15; New Jersey, N.J. STAT. ANN. § 2A:44-125, *et seq.*; New York, N.Y. LIEN LAW § 5; North Carolina, N.C. GEN. STAT. § 44A-19; Ohio, OHIO REV. CODE ANN. § 1311.26; Rhode Island, R.I. GEN. LAWS § 34-27.1-1; Texas, TEX. PROP. CODE ANN. § 53.101, *et seq.*; South Dakota, S.D. CODIFIED LAWS § 5-22-1; Washington, WASH. REV. CODE § 60.28.011; and Wisconsin, WIS. STAT. §§ 779.036, 779.15.

39. See *A.J. Setting Co. v. Trs. of Cal. State Univ. & Coll.*, 119 Cal. App. 3d 374, 381 (1981) ("The stop notice code sections recognize the public interest mandate that public property remain unencumbered by mechanics' liens by only permitting a lien upon funds the public entity is otherwise obligated to pay to the prime contractor."); *In re Yobe Elec., Inc.*, 30 B.R. 114, 118 (Bankr. W.D. Pa. 1983) ("[T]he proper filing of a stop-notice has the effect of perfecting a lien against funds in the hands of the owner.").

40. See, e.g., *A-1 Door & Materials Co. v. Fresno Guar. Sav. & Loan Ass'n*, 61 Cal. 2d 728, 732 (1964); *Cal Sierra Constr., Inc. v. Comerica Bank*, 206 Cal. App. 4th 841 (2012).

While a mechanic's lien or payment bond may suffice to protect a claimant on some projects, the liens on funds/stop notices can add additional security and leverage for claimants in states with this remedy. For instance, on both public and private projects, the claimant circumvents typical privity requirements for contract lawsuits and asserts a direct right of action against an owner or lender that disburses funds after the claimant perfects the lien against the funds. In addition, on private projects, a mechanic's lien may be insufficient security against an owner if the property lacks sufficient equity to satisfy the claimant's lien. Furthermore, on public projects, the lien on funds may provide the only true source of recovery when the public body fails to require a payment bond from the general contractor. Note, however, that owners and lenders are required to hold only funds that are currently in their possession. Consequently, a subcontractor or supplier must ensure that it strictly and timely complies with its jurisdiction's procedural requirements before all project funds are disbursed.

A. Private Projects

In addition to being able to file a mechanic's lien on a private project, some states permit a subcontractor or supplier to file a lien against funds held by a private owner.⁴¹ In general, the claimant must mirror statutory prerequisites necessary to establish a mechanic's lien. For example, North Carolina grants a lien upon funds to any subcontractor or supplier at the time of first furnishing labor, materials, or rental equipment at the project site.⁴² The lien is then perfected upon the claimant's provision of notice of the lien to the owner.⁴³ The notice of lien must contain the same information necessary to establish a mechanic's lien, including (1) the identity of the claimant, (2) a general description of the property, (3) the identity of the party with whom the claimant contracted, (4) the identity of any higher-tier contractors, (5) a general description of the contract work, and (6) the amount of the lien upon funds claimed.⁴⁴ Once the owner receives the statutory notice, the owner must retain enough funds to satisfy any notice of liens received.⁴⁵ If the owner pays the liened funds to the contractor after receipt of notice of the lien, the owner becomes personally liable for the amount stated in the notice.⁴⁶ As with a mechanic's

41. See, e.g., N.C. GEN. STAT. § 44A-18; IND. CODE ANN. § 32-28-3-9; S.D. CODIFIED LAWS § 5-22-1; ARIZ. REV. STAT. § 33-1053; CAL. CIV. CODE § 8508; *McGraw v. Bd. of Supervisors*, 125 Miss. 420 (1921); N.M. STAT. ANN. § 48-2A-2 (allowing stop notices only on residential construction projects of no more than four dwelling units).

42. See N.C. GEN. STAT. § 44A-18.

43. See *id.* § 44A-18(f).

44. See *id.* § 44A-19.

45. See *id.* § 44A-20(a).

46. See *id.* § 44A-20(b).

lien, a lien upon funds may be discharged by depositing a bond, and the same bond may be used to release a concurrent mechanic's lien.⁴⁷

B. Public Projects

Several jurisdictions permit a subcontractor or supplier to lien funds held by public owners under contracts for public improvements.⁴⁸ For example, under the New York lien law, a subcontractor can assert lien rights against funds held by state or local contracting authorities.⁴⁹ The claimant must file a notice of lien within 30 days of the project's completion with the head of the department or bureau having charge of the construction and the comptroller of the state or other person having responsibility for disbursement of funds.⁵⁰ A copy must be served upon the general contractor or any other higher-tier subcontractor.⁵¹ The lien is generally valid for one year, in which time the claimant may petition to enforce the lien.⁵²

While New York permits broad rights to a claimant to lien any funds held by any public body at the time that notice is received, other jurisdictions limit liens on funds for public projects. For instance, public-fund liens do not apply to federal government owners.⁵³ In New Jersey, a claimant can lien funds held by local public bodies but not funds held by the state or state departments or authorities.⁵⁴ In Washington, the claimant is limited to asserting a lien on the retainage withheld by the public owner, not to exceed five percent of the contract price.⁵⁵ In general, the requirements to lien public funds differ substantially from jurisdiction to jurisdiction, and typically differ from the requirements for perfecting a lien on a private project.

C. Rights Against Lenders

In addition to permitting liens against private entities, certain jurisdictions permit the claimant to lien funds held by the lender prior to disbursement.⁵⁶ In general, the statutory requirements for asserting a lien claim against the

47. *See id.* § 44A-20(f).

48. *See, e.g.,* N.Y. LIEN LAW § 5; 770 ILL. COMP. STAT. 60/23; WASH. REV. CODE ANN. § 60.28.011 (West); CAL. CIV. CODE § 9356.

49. *See* N.Y. LIEN LAW § 5.

50. *See id.* § 12.

51. *See id.* § 11-c.

52. *See id.* § 18, § 60.

53. *See* Madison Restoration Corp. v. Smithsonian Inst., 985 F. Supp. 434 (S.D.N.Y. 1997).

54. *See* N.J. STAT. ANN. § 2A:44-125, *et seq.*

55. *See* WASH. REV. CODE § 60.28.011.

56. *See, e.g.,* ALASKA STAT. § 34.35.062; WASH. REV. CODE § 60.04.221; WIS. STAT. § 779.036(3).

lender mirror the requirements for asserting a lien against a private owner.⁵⁷ However, claimants in certain jurisdictions must take additional steps to assert and perfect a lien upon the funds in the hands of the lender due to the potential harm that can result to the owner or general contractor from an improperly issued stop-payment notice. In California, for example, the claimant must include, along with the standard stop-payment notice, a bond in the amount of 125 percent of the claim amount.⁵⁸ In the event that the lender, owner, or general contractor obtains a judicial determination in its favor, the claimant must reimburse the successful party its costs or damages suffered by reason of the wrongful stop notice.⁵⁹ These costs can include the harmed party's attorneys' fees incurred in defending the claim.⁶⁰

D. Priority in Bankruptcy

In bankruptcy proceedings, lien on funds claimants generally receive quite favorable treatment.⁶¹ The lien remains attached to the funds in the event of bankruptcy, elevating the claimant from an unsecured creditor to a secured creditor.⁶² Likewise, the claimant's perfection of the lien against the funds after the commencement of bankruptcy proceedings generally does not constitute a violation of the automatic stay.⁶³

E. Constitutionality of Stop Notices

In *Connolly Development, Inc. v. Superior Court of Merced City*, the California Supreme Court long ago held that the state's stop-notice statute is constitutional.⁶⁴ There, the court found that the procedures available to a property owner to obtain interim relief from unjustified claims before the claimant files suit on a stop notice comport with constitutional due process requirements because they provide sufficient safeguards against such claims delaying or otherwise interfering with a construction project until the dispute can be resolved:

57. See, e.g., WIS. STAT. § 779.036(3).

58. See CAL. CIV. CODE § 8532.

59. See *id.*

60. See *Flintkote Co. v. Presley of N. Cal.*, 154 Cal. App. 3d 458 (1984).

61. See, e.g., *In re Constr. Supervision Servs., Inc.*, No. 12-569-8-RDD, 2012 WL 892217 (Bankr. E.D.N.C. Mar. 14, 2012) ("No longer will North Carolina subcontractors be deprived of their statutorily created and granted lien on funds.").

62. *Id.*; *In re Davicter Enter., Inc.*, 248 B.R. 794 (Bankr. S.D. Ill. 2000).

63. *In re Prizant & Co.*, 257 F. Supp. 145 (Bankr. N.D. Ill. 1965).

64. *Connolly Dev., Inc. v. Super. Ct. of Merced City*, 17 Cal. 3d 803 (1976).

[T]he recordation of a mechanics' lien, or filing of a stop notice, inflicts upon the owner only a minimal deprivation of property; that the laborer and materialman have an interest in the specific property subject to the lien since their work and materials have enhanced the value of that property; and that state policy strongly supports the preservation of laws which give the laborer and materialman security for their claims. . . . [T]he safeguards provided by California law to protect property owners against unjustified liens are sufficient to comply with due process requirements.⁶⁵

Much more recently, however, the Fifth Circuit Court of Appeals reached the opposite conclusion with regard to Mississippi's stop-notice statute. In *Noatex Corp. v. King Construction of Houston, LLC*,⁶⁶ the Fifth Circuit affirmed the district court's finding that Mississippi's statute is unconstitutional in that it deprives the general contractor of a significant property interest (its right to payment from the owner and its right to be free from any interference with that right to payment) without due process. The court noted that a stop-notice claim deprives the general contractor of payment "for an indefinite period of time and could prevent a contractor from paying its ordinary business obligations." It also noted the statute's lack of procedural safeguards, in that it provides for no pre-deprivation notice or hearing, does not require posting of a bond, does not limit the remedy to exigent circumstances, and does not require any attestation of the facts or legal entitlement to the funds subject to the stop notice. The court found that the post-deprivation protection the statute does provide—judicial review and potential imposition of a civil penalty for filings submitted "falsely and knowingly"—is insufficient to overcome the deficient pre-deprivation protection.

It remains to be seen whether state courts in Mississippi will follow *Noatex* or how, if at all, the Mississippi legislature will respond to that decision. As it stands, subcontractors and suppliers in that state may have no stop-notice remedies available to them. Possible legislative responses being considered include a revised stop-notice law with due process protections added.

It also remains to be seen whether challenges will be brought regarding the constitutionality of other states' stop-notice statutes, many of which lack the pre-deprivation protections the court found due process required in *Noatex*.

65. *Id.* at 827–28; see also *Cal. Sierra Constr., Inc. v. Comerica Bank*, 206 Cal. App. 4th 841 (2012).

66. 732 F.3d 479 (5th Cir. 2013).

IV. Construction Trust Fund Statutes

Numerous states have enacted trust fund laws to protect subcontractors and suppliers from nonpayment.⁶⁷ Trust fund statutes vary among the states, much like lien laws do, but core concepts are standard. Some states have a trust fund statute,⁶⁸ some states offer other partial protection to subcontractors and suppliers,⁶⁹ and about half of them have no trust fund protection at all.⁷⁰

As a general proposition, at its most basic, the typical trust fund law provides that the payments that a general contractor receives from an owner are trust funds, and the general contractor holds such funds in trust for payment to its subcontractors and suppliers. The general contractor is the “trustee,” and the subcontractors and suppliers are “trust fund beneficiaries.” As a trustee, the general contractor is under a fiduciary duty to use the funds to pay the trust fund beneficiaries—the subcontractors and suppliers. These funds, however, can be withheld if there is a bona fide dispute between the parties. In some states, corporate officers and managing agents that knowingly use trust funds for purposes other than paying subcontractors and suppliers can be held personally liable for breach of trust and for violation of the statute.⁷¹ Many trust fund statutes also impose criminal liability if trust funds are misapplied.⁷²

The trust fund statute protects subcontractors both by creating a vesting mechanism for when the owner’s obligations terminate and by creating a separate identity for trust funds. Trust funds are not the general contractor’s property until all the subcontractors and suppliers have been paid. After such payment, any remaining funds vest in the general contractor. Because trust funds are not the general contractor’s property until they vest, trust funds are not subject to attack by the general contractor’s creditors. Thus, when a contractor declares bankruptcy, any payments due to the contractor that represent trust funds do not become the property of the bankruptcy estate.⁷³

67. See FOSTER & KNOWLES, CONSTRUCTION CONTRACTS AND CONSTRUCTION TRUST FUND STATUTES: A FIFTY STATE SURVEY, <http://www.fullertonlaw.com/appendices/construction-contracts-and-construction-trust-fund-statutes-fifty-state-survey.html>. Fifteen states have trust fund statutes.

68. See, e.g., DEL. CODE tit. 6, § 3502; 770 ILL. COMP. STAT. 60/21.02.

69. See, e.g., N.H. REV. STAT. ANN. § 447:15 (2003); FLA. STAT. §§ 713.32, 713.345.

70. See FOSTER & KNOWLES, *supra* note 67.

71. See, e.g., *Ippolito v. TJC Dev., LLC*, 83 A.D.3d 57, 70–71 (N.Y. App. Div. 2011) (“[W]e conclude that the plaintiffs, as a general matter, have standing to assert a Lien Law article 3-A claim against the defendants. Contrary to the Supreme Court’s determination, their claim is prima facie viable.”); MD. CODE ANN., REAL PROP. § 9-202 (imposing personal liability on officers who use trust funds for other purposes than payment of subcontractors).

72. See, e.g., TEX. PROP. CODE ANN. § 162; WIS. STAT. §§ 779.02(5), 779.16 (2003); MICH. COMP. LAWS ANN. § 570.151, *et seq.*; OKLA. STAT. tit. 42, §§ 152, 153.

73. See, e.g., *Universal Bonding Ins. Co. v. Gittens & Sprinkle Enters., Inc.*, 960 F.2d 366 (3d Cir. 1992); *Huizinga v. United States*, 68 F.3d 129 (6th Cir. 1995); *In re Marrs-Winn Co.*, 103 F.3d 584 (7th Cir. 1996).

This means trust funds are not shared among the contractor's general unsecured creditors; rather, they are shared only among the unpaid subcontractors and suppliers. As such, trust funds have a separate identity so that they are typically allocated among the subcontractors and suppliers.⁷⁴

A. New York's Trust Fund Statute as Model

New York has a broad and developed trust fund statute. New York's statute provides: "The assets of the trust of which a contractor is trustee are the funds received by him . . . under the contract for the improvement of real property, or home improvement or the public improvement."⁷⁵ "The trust assets of which a contractor . . . is trustee shall be held and applied for the . . . payment of claims of subcontractors."⁷⁶

The statute identifies when trust funds vest in the trustee:

The trust of which a contractor . . . is trustee shall continue with respect to every asset of the trust until every trust claim . . . has been paid Upon termination of the trust by payment or discharge of all the trust claims, . . . any remaining assets shall vest in the . . . contractor.⁷⁷

As noted by one court:

[T]he contractor-trustee holds the trust assets in a fiduciary capacity akin to that of the trustee of an express trust . . . and thus, "[the contractor] does not have a sufficient beneficial interest in the moneys, due or to become due from the owner under the contract, to give him a property right in them, except insofar as there is a balance remaining after all subcontractors and other statutory beneficiaries have been paid."⁷⁸

The New York trust fund law extends to lower-tier subcontractors to protect sub-subcontractors without limitation on tier.⁷⁹ This means a subcontractor becomes a trustee of trust funds if a sub-subcontractor is hired.

74. Cf. *McDonald v. Little Limestone, Inc. (In re Powers Lake Constr. Co.)*, 482 B.R. 803 (Bankr. E.D. Wis. 2012) (material supplier loses right to trust funds in preference action because the debtor commingled trust funds with other funds prior to filing for bankruptcy, requiring the supplier to trace the funds).

75. N.Y. LIEN LAW § 70(6).

76. *Id.* § 71(2)(a).

77. *Id.* § 70(3).

78. *Cannon Corp. v. City of N.Y.*, 89 N.Y.2d 147, 157–58 (1996); see also *Aspro Mech. Contr., Inc. v. Fleet Bank, NA*, 1 N.Y.3d 324, 328 (2004) ("The trust concept was . . . intended to require that [the trustee] act . . . as fiduciary manager.").

79. N.Y. LIEN LAW § 71.

Whoever expends labor or material to improve real property or under a public improvement is a trust fund beneficiary, no matter how low of a tier the person stands in the chain.

The trustee is required to keep books and records of the trust assets, having the burden to show that the funds were properly applied.⁸⁰ The failure to keep these records “shall be presumptive evidence that the trustee has applied or consented to the application of trust funds . . . for purposes other than a purpose of the trust.”⁸¹ In sum, such failure supports an action for breach of the trust, which has significant consequences.

The statute describes diversion of trust funds and a breach of the trust:

Any transaction by which any trust asset is paid, transferred or applied for any purpose other than a purpose of the trust . . . before payment or discharge of all trust claims with respect to the trust, is a diversion of trust assets . . . , and if the diversion occurs by the voluntary act of the trustee or by his consent such act or consent is a breach of trust.⁸²

Corporate officers are personally liable for the diversion of trust funds based on the principle that such diversion constitutes conversion of the property, even if done while acting for the corporation.⁸³ Diversion of trust funds is grounds for awarding punitive damages.⁸⁴

Breach of the trust under the New York statute is also a criminal offense, as the trustee can be found guilty of larceny.⁸⁵ For example, in *People v. Miller*,⁸⁶ a general contractor was convicted of “scheme to defraud [and] grand larceny” after failing to pay 15 different subcontractors that had provided materials, equipment, or services on a project and failing to keep records as mandated by the statute. The appellate court rejected the general contractor’s defense that “he believed that these subcontractors would be paid once he received

80. *Id.* § 75(2).

81. *Id.* § 75(4).

82. *Id.* § 72(1).

83. *Id.* § 79-a. See *Ippolito v. TJC Dev., LLC*, 83 A.D.3d 57, 70–71 (N.Y. App. 2011) (“[W]e conclude that the plaintiffs, as a general matter, have standing to assert a Lien Law article 3-A claim against the defendants. Contrary to the Supreme Court’s determination, their claim is prima facie viable.”). See, e.g., MD. CODE ANN. REAL PROP. § 9-202 (imposing personal liability on officers who use trust funds for purposes other than payment of subcontractors); OKLA. STAT. tit. 42, §§ 152, 153 (same).

84. *Pinnacle Env'tl. Sys. v. R.W. Granger & Sons*, 245 A.D.2d 773 (N.Y. App. Div. 1997) (“[U]nauthorized disbursement of trust assets, without satisfying the claims of contractors or subcontractors, constitutes larceny punishable under the Penal Law (see, Lien Law § 79-a) and ‘thus, would clearly satisfy the high threshold of moral culpability necessary to support a punitive damages award.’”).

85. N.Y. LIEN LAW § 79-a(1).

86. 23 A.D.3d 699 (N.Y. App. Div. 2005).

compensation on other, unrelated projects."⁸⁷ Notably, some states without such statutes make it a crime for a general contractor to receive funds and fail to pay its subcontractors and suppliers.⁸⁸

B. Types of Projects Subject to Trust Fund Protection

Subcontractors and suppliers should be aware of their local protections. Not all projects are subject to the trust fund statute's protections. For example, Arizona provides protection on owner-occupied residential property.⁸⁹ Colorado's trust fund statute applies to both private and public projects.⁹⁰ Delaware and Oklahoma provide trust fund protection only on private projects.⁹¹

C. Trust Fund Statutes and Bankruptcy

Trust fund statutes provide significant protection to subcontractors when a contractor declares bankruptcy, because the funds are not property of the bankruptcy estate. Thus, the contractor's accounts receivable from a particular project belong exclusively to the subcontractors and suppliers for that project and may not be distributed to other creditors.⁹² This is a powerful protection, as generally the main assets of an insolvent general contractor are its accounts receivables with the project owners. Unpaid subcontractors and suppliers, therefore, have, in effect, priority to certain receivables over other creditors.

Trust fund debts owed by individual corporate officers may not be dischargeable in bankruptcy, meaning such claims will survive the bankruptcy proceeding.⁹³ This is because a breach of one's fiduciary duties under the trust fund statute falls under the Bankruptcy Code's exception to a discharge for "defalcation while acting in a fiduciary capacity."⁹⁴ Recent case law has required that the debtor "know" of his fiduciary duty under the trust fund statute in order for the exception to apply.⁹⁵ To ensure that the general contractor

87. *Id.* at 700–01. The court also rejected the contractor's defense that his actions were mere breaches of contract.

88. ARK. CODE ANN. § 18-44-132; FLA. STAT. § 713.345; GA. CODE ANN. § 16-8-15.

89. ARIZ. REV. STAT. § 33-1005; *see also* N.J. STAT. ANN. § 2A:29A, *et seq.* (applies to residential dwelling projects).

90. COLO. REV. STAT. § 38-22-127; *see also* WIS. STAT. §§ 779.02(5), 779.16 (2003).

91. OKLA. STAT. tit. 42, §§ 152, 153; DEL. CODE ANN. tit. 6 § 3501 *et seq.*

92. 11 U.S.C. § 541(a), (d); *Buchwald v. Di Lido Beach Resort, Ltd. (In re McCann, Inc.)*, 318 B.R. 276, 282–83 (Bankr. S.D.N.Y. 2004).

93. *See Woodworking Enters., Inc. v. Baird*, 114 B.R. 198 (9th Cir. 1990).

94. 11 U.S.C. § 523(a)(4).

95. *Bullock v. BankChampaign, NA*, 133 S. Ct. 1754, 1755 ("We here consider the scope of the term 'defalcation.' We hold that it includes a culpable state of mind . . . as one involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior.").

has knowledge of his fiduciary duties, one bankruptcy judge advised, “the court has no doubt that Plaintiff may now be telling its customers about their obligations under the Lien Law [trust fund statute] in a concerted attempt to help establish actual knowledge.”⁹⁶

V. Conclusion

Mechanic’s liens, liens against funds/stop notices, and trust fund statutes are effective collection tools for subcontractors and suppliers. The best way for claimants to recover payment is to preserve their rights to use these remedies. Once nonpayment becomes an issue, it is important to act in a timely manner and to comply strictly with the statutory requirements.

⁹⁶. *White’s Lumber, Inc. v. Spies (In re Spies)*, Case No. 09-30283-mcr, chapter 7, Adv. Proc. No. 09-50121-5-mcr (Bankr. N.D.N.Y. July 29, 2011).

