MECHANIC'S LIENS
WHAT'S IN YOUR TOOL BOX?

THOMAS W. MYERS
Andrews Myers Coulter & Cohen, PC
3900 Essex Lane, Suite 800
Houston, Texas 77027
(713) 850-4216
tmyers@lawamc.com

State Bar of Texas
29TH ANNUAL ADVANCED
REAL ESTATE LAW COURSE
July 12-14, 2007
San Antonio

CHAPTER 45

THOMAS W. MYERS
Andrews Myers Coulter & Cohen, PC
3900 Essex Lane, Suite 800
Houston, Texas 77027

(713) 850-4216
tmyers@lawamc.com

Tom Myers is a shareholder of Andrews Myers Coulter & Cohen, P.C., Houston, Texas. Admitted to the Texas Bar in 1982, Mr. Myers' practice is focused on the construction industry. He represents Owners, Contractors, Trade Subcontractors and Manufacturers primarily in the commercial and industrial markets and has experience with a wide range of projects including power plants, industrial process plants, commercial office, multi-family, educational, retail, governmental and religious facilities. His practice includes drafting and negotiating contract documents, insurance coverage and claims for construction defects and losses, surety bond workouts, mechanic's lien and bond claims, prosecution and defense of complex construction claims, arbitration and mediation. Mr. Myers received his BBA and Juris Doctor from Texas Tech University. He is a Member of the Panel of Arbitrators, American Arbitration Association; State Bar of Texas Construction Law Section, Houston Chapter of the AGC; Houston Chapter of the ABC; Houston Bar Association Construction Law Section (Chair, 1999); Texas Bar Foundation; CFMA and the ABA Forum Committee on the Construction Industry.

TABLE OF CONTENTS

MECHANIC'S LIENS - WHAT'S IN YOUR TOOL BOX?

I. INTRODUCTION

Lenders, owners and contractors involved in the construction of commercial real estate share an interest in maintaining a lien free project during and upon the conclusion of construction. Mechanic’s liens impede construction financing, obtaining title insurance and the conveyance of real property. Liens may arise due to disputes between the owner and the original contractor or, more often, between the original contractor and its subcontractors and vendors. This paper will summarize the items found in the lawyer’s toolbox that are most frequently used to protect the property and the owner from such liens, identify traps for the unwary owner and highlight some issues that are often encountered when dealing with mechanic’s lien claims. The “Code” refers to Chapter 53 of the Texas Property Code.

II. WHAT’S IN THE TOOLBOX?

A. Statutory Payment Bond

1. §53.201, *et seq.* of the Code provides for the recordation of a "statutory" payment bond in the Real Property Records of the county in which all or part of the owner's property on which the construction or repair is being performed or is to be performed. The payment bond is to be endorsed with the written approval of the owner and filed with a copy of the construction contract or a memorandum of the construction contract. Although the cost of a statutory payment bond (normally coupled with a separate performance bond) typically adds about one or two percent to the overall cost of construction, the protections afforded an owner and original contactor by the use of such a bond are significant.
2. Who is protected?

   a. §53.204 states that a purchaser;
   b. lender;
   c. other person acquiring an interest in the owner's property; or
   d. insurer of title is entitled to rely on the record of the bond or contract.
   e. Although not specifically named in the statute, the original contractor benefits from the statutory payment bond (as opposed to a common law bond form such as the AIA A312) because the statutory payment bond requires claimants, particularly second tier claimants, to comply with the statutory notice provisions of the Code (§53.056) in order to perfect a claim against the bond.
3. Protection afforded:

   a. Per §53.204, the recordation of the bond and contract constitute payment of all claims and liens for labor, subcontracts, materials or specially fabricated materials incurred by the original contractor… as if each person furnishing labor or materials for the work performed under the original contract, other than the original contractor, filed a complete release and relinquishment of lien of record.
   b. The owner is relieved of its obligations to withhold "trapped" funds under §53.081 and the statutory ten percent retainage under §53.101.
   c. If the bond is recorded at the time a lien is filed, the claimant must sue on the bond within one year following perfection of his claim. If the bond is not recorded at the time a lien is filed, the claimant must sue on the bond within two years following perfection of his claims. If the bond has been recorded at the commencement of construction, this has the effect of shortening the normal statute of limitations period.
4. Is the owner really protected?

   a. The owner does receive real protection by being relieved of the fund withholding and statutory retainage requirements. This is especially significant when the original contract calls for the early release of retainage.
   b. When a properly drafted payment bond has been recorded, the claimant may not file suit against the owner or the owner's property (§53.201 (b)).
   c. Unfortunately, title companies do not usually rely on the protection afforded to them in § 53.204. Most title companies will not issue clear title policies in connection with the conveyance of the property or the refinancing of the property if a mechanic’s lien has been filed even if a statutory payment bond has been recorded because of the costs of defense associated with defending litigation to enforce the lien claim.
   d. Original contractors are therefore often required to “bond around” liens under §53.171 notwithstanding the fact that they have already provided and recorded a statutory payment bond. This often is a source of conflict as the original contractor is required to pay additional bond premium for the indemnity bond out of its own pocket and the owner achieves no greater protection.

e. One of the methods of perfecting a claim against a statutory payment bond is to send the notices required under the Code and to file a mechanic's lien affidavit (§53.206). Thus, even though the property is protected by the bond, claimants record lien affidavits resulting in problems with lenders and title companies.

B. Bond to indemnify against lien ("bonding around a lien")

1. §53.171 through §53.175 address bonds to indemnify against liens or, as it is commonly referred to, "bonding around" a mechanic's lien.
2. The bond is typically prepared by the owner's or contractor's attorney, signed, recorded and notice of the recorded bond is issued by the clerk and served on the claimant. The return of notice is also recorded. Most bonding agents and surety companies do not have a standard, preprinted form for this bond. The penal sum of the bond is established by a statutory formula (§53.172(3)). In most cases, it is in the original contractor's interest to have its attorney draft, record and serve the bond to ensure it is handled correctly. From start to finish the process normally takes anywhere from seven to fourteen days, usually dependent upon how quickly the clerk prepares and issues the notice and subject to any problems with service of notice on the claimant. Parties should allow adequate time for "bonding around" in the original contract provisions that address the original contactors indemnification obligations for mechanic's liens.
3. After filing the bond, issuance of notice and service of the notice and recordation of the notice, a purchaser, insurer of title or lender may rely on and is absolutely protected by the record of the bond and the notice to the same extent as if the lien claimant had filed a release of lien in the real property records (§53.174 (b)).

C. Filing the Deed of Trust prior to "commencement of construction"

1. Liens, encumbrances or mortgages on the land or improvements at the time of the inception of a mechanic's lien are not affected by the mechanic's lien (§53.123 (b)).
2. Well established case law and §53.124(a) of the Code provide that a mechanic's lien incepts upon the commencement of construction of improvements or delivery of materials to the land on which improvements are to be located and on which the materials are to be used. This is commonly referred to as the "relation back doctrine".
3. If construction commences before the Deed of Trust is recorded, the Deed of Trust securing the purchase of the property and the financing of construction is inferior and subordinate to the mechanic's lien rights of the original contractor and all subcontractors and suppliers of all tiers claiming through the original contractor.

D. Subordination agreements from prime contractors and subcontractors

1. As part of the "belt and suspenders" approach, owners and lenders frequently require written lien subordination agreements from the original contractor and its subcontractors. This agreement is usually prepared by the lender and often included in the original contractor's consent to the assignment of the construction contract as collateral security for the loan.
2. Subordination agreements should reference the pre-existing mortgage loan and any extensions, renewals, modifications and refinancing. The Deed of Trust should also specifically state that it is intended to act as security for advances made under the loan documents for construction.
3. For the owner's and lender's protection, the agreements should also include an express subordination of lien rights with respect to removables.
4. Owners should consider requiring their original contractor to include in all subcontracts a provision whereby the subcontractors expressly subordinate their lien rights to the Deed of Trust. Note that the prime contractor does not have the authority to subordinate the subcontractors' lien rights. That requires a separate writing executed by the subcontractors.
5. Owners may obtain blanket waivers of lien rights from contractors and subcontractors under Texas law. However, knowledgeable contractors and subcontractors will rarely sign blanket waivers.

E. Statutory Retainage

1. Subchapter E of the Code requires the owner to retain during the progress of the work and for 30 days after the work is completed ten percent of the contract price of the work to the owner or ten percent of the value of the work, measured by the proportion that the work done bears to the work to be done, using the contract price or, if there is no contract price, using the reasonable value of the completed work.
2. The owner's failure to hold back the statutory retainage may result in liability and lien exposure at least to the extent of the amount that should have been retained from the original contractor.
3. If the owner has not obtained a statutory payment bond, the owner can protect itself and its property

by withholding the statutory retainage and "trapped funds" under Subchapter D.

4. In order to obtain more beneficial pricing, owners often agree to the early release of retainage to certain trades and the original contractor. This poses no extra liability to the owner in the event a statutory payment bond was obtained and filed. In cases where there is no statutory payment bond in place, the owner that agrees to the early release of retainage opens itself to liability to first and second tier claimants for the amount that should have been withheld.

F. Withholding "trapped" funds

1. Subchapter D of the Code requires the owner to withhold from payments to the original contractor an amount necessary to pay the claims for which it receives notice. In Mechanic's Lien parlance, these are the second month and third month fund trapping notices that the lien claimants send out in order to perfect their lien claims and trap funds in the hands of the owner before payment is made to the original contractor.
2. Unless payment of the claim is made on demand, or the claim is otherwise settled, discharged, indemnified against under the bond to indemnify against lien provisions or the statutory bond provisions or determined to be invalid by a final judgment of the court, the owner must retain the funds until the time for filing the affidavit of mechanic's lien has passed or if a lien affidavit has been filed, the lien claim has been satisfied or released.
3. Section 53.083 allows the claimant to make written demand for payment to an owner authorized to withhold funds. A copy of the demand must be sent to the original contractor. Note that the original contractor has thirty days after the date it receives the copy of the demand to notify the owner, in writing, of its intent to dispute the claim. If the original contractor does not give the owner timely notice of dispute, it is considered to have assented to the demand and the owner "shall pay the claim". Accordingly, prime contractors should be careful to routinely send notice to the Owner disputing the lien claims. Conflicts and disputes arise when the claim is technically defective due to notice compliance issues, such as untimely notice, but the demand for payment has not been disputed by the original contractor within the thirty-day window.
4. Note that the time period for withholding "trapped funds" under § 53.082 may be, and often is, longer than the 30-day period for withholding statutory retainage under §53.101.

G. Summary lien removal procedure

1. In 1997, the Legislature added § 53.160-§53.162 to the Code. Those sections provide a procedure for filing summary motions to remove invalid or unenforceable liens. The motion must be part of a proceeding to foreclose a lien or to declare a claim or lien invalid or unenforceable.
2. The grounds for objecting to the validity or enforceability of the claim or lien are relatively limited and principally relate to defects in notices, deficiencies in the content of the lien affidavit or situations where the funds subject to the notice of a claim and the perfection of a claim against statutory retainage have been deposited in the registry of the court.
3. The procedure is something of a "last gasp" provision because owners and contractors usually deal with disputed lien claims by filing a bond to indemnify against lien. The procedure is helpful to contractors that are defending lawsuits against their indemnity bonds.
4. As a practical matter, by the time the suit to declare the claim invalid has been filed, served on the claimant, the motion filed and the hearing held, at least two or three months will have passed.
5. A major benefit of the provision is that once the motion has been filed, the burden of proof that the notice of claim and affidavit were furnished to the owner and original contractor as required by the Code shifts to the claimant.

H. Affidavits of commencement and completion

1. §53.124(c) allows the owner and contractor to file an affidavit of commencement (within thirty days after the date of actual commencement). The affidavit is prima facie evidence of the date of commencement of construction.
2. §53.106 allows the owner to file an affidavit of completion that is prima facie evidence of the date of completion for purposes of Subchapter E, which deals with statutory retainage and the thirty day time period to withhold that retainage. A problem can arise when the affidavit is filed more than 10 days after the actual date of completion. In that case, the date of completion for the purposes of Subchapter E is the date the affidavit is filed, not the date of completion stated in the affidavit. For some reason, Owners often ask the original contractor to execute the affidavit of completion. However, the Code only requires that the affidavit be executed by the owner.

I. Fraudulent lien statute: CPRC §12.002

1. Under Chapter 12 of the Texas Civil Practice and Remedies Code, an obligor, debtor or person who owns an interest in the real or personal property in

question may bring a cause of action for the filing of a "fraudulent lien". This statute, which was enacted primarily in response to the "Republic of Texas" group in west Texas, has been held to apply to garden variety mechanic's lien claims. See, e.g. *Taylor Elec. Services, Inc. v. Armstrong Elec. Supply Co. (Tex. App.-Ft. Worth,* 2005); *Centurion Planning Corp., Inc. v. Seabrook Venture II* (*Tex. App.-Houston [1 Dist.], 2004)*

2. A person who files a fraudulent lien is liable for the greater of $10,000 or the actual damages caused by the violation, court costs, reasonable attorney's fees and exemplary damages in an amount determined by the court. In the event the sale of property or refinancing is held up or cancelled, the actual damages could be significant.
3. In situations where the lien is clearly defective and unperfected, filing a lawsuit to declare the mechanic's lien invalid, promptly filing a summary motion to remove the mechanic's lien under §53.160 and asserting a cause of action for fraudulent lien filing under Chapter 12 of the Civil Practice and Remedies Code can be an effective tactic to persuade a mechanic's lien claimant to reconsider its refusal to release a recorded lien.

J. Right to demand release of lien upon payment

1. §53.152 of the Code states that when a debt for labor or materials is satisfied or paid by collected funds, the person who furnished the labor or materials shall, within ten days after receipt of a written request, furnish a release of the indebtedness in any lien claimed, to the extent of the indebtedness paid.
2. This provision can be helpful in the event a party desires to pay down an undisputed portion of a lien while at the same time seeking a release, at least to the extent of the payment, in order to minimize the penal sum of an indemnity bond and related bond premium.

K. Right to recover attorney's fees

1. In the event an owner or contractor initiates a proceeding (or counterclaim) to declare that a lien is unenforceable in whole or in part, §53.156 of the Code allows the court to award that party costs and reasonable attorney's fees as are equitable and just.
2. Any suit to declare a lien invalid, motion for summary removal of a lien or action asserting a fraudulent lien under Chapter 12 of Civil Practice and Remedies Code should include a request for attorney's fees and costs.

L. Proper drafting of construction contracts

1. Owner/contractor agreements should include:
   a. a provision subordinating the lien rights of the prime contractor, including the right to lien removables;
   b. a provision requiring the prime contractor to obtain lien subordinations from its subcontractors and vendors;
   c. exhibits showing the form of progress payment and final payment lien releases to be executed by the prime contractor and its subcontractors and state when those releases are to be provided (keeping in mind the Texas Prompt Pay statute, payments to subcontractors are due within seven days after receipt of payment by original contractor from owner);
   d. a provision addressing how much money an owner will be entitled to withhold from the prime contractor in the event of lien claims by subcontractors and vendors (usually 125% to 200% of the claim amount; note the formula in §53.172 regarding indemnity bonds);
   e. a provision adequately describing the requirement for bonding around mechanic's liens, including specific reference to § 53.171 of the Code.

III. TRAPS FOR THE UNWARY

A. Failing to withhold statutory retainage or trapped funds

1. The owner that fails to withhold retainage pursuant to §53.101 or trapped funds pursuant to §53.081 exposes itself and its property to the amount which should have withheld due to the fund trapping notice plus the amount which should have been withheld as statutory retainage.

   a. This can create significant problems for the original contractor if it has not provided a statutory payment bond and a "bad lien" notice far exceeding the amount of actual amount of indebtedness is sent to the owner. Even if the original contractor sends notice to the owner disputing the claim under §53.083(b), the owner is still obligated under §53.082 to withhold the amount of the claim from the original contractor.
   b. Unfortunately, if the claimant has only sent "notice" of the claim under §53.056 but not recorded a lien affidavit, the original contractor will not be able to "bond around" the claim under §53.171 as no lien affidavit has actually been recorded. In that circumstance, the owner and contractor must explore alternative means of protecting the owner, whether it be withholding a lesser amount of payment, a private, common law

bond to indemnify against the claim, or a specific indemnification agreement from the contractor (although one is probably already in the contract). However, none of these alternative methods of protection will relieve the owner from its statutory liability should the claim prove to be valid and subsequently perfected.

B. Owner may be liable even if no notices to original contractor

1. In a case handed down before the enactment of § 53.160 (summary motion to remove invalid or unenforceable lien), the Beaumont Court of Appeals held that an owner's property was subject to a lien notwithstanding the failure of the lien claimant to timely send periodic notices to the prime contractor, where the owner received timely notice. See *Don Hill Construction Company v. Dealers Electrical Supply Company, 790 S.W.2d 805 (Tex.App.-Beaumont 1990, no writ)* The validity of this opinion, even though it has not been expressly overruled, is doubtful given the legislature's enactment of §53.160 which provided for the summary removal of a lien due to the claimant's failure to send the statutorily required notices to the original contractor.

C. Statute of limitations

1. The Property Code contains several statutes of limitation periods.
2. §53.158(a) provides that except for claims arising from a residential construction project, suit must be brought to foreclose the mechanic's lien within two years after the last day a claimant may file the lien affidavit under § 53.052 or within one year after completion, termination or abandonment of the work under the original contract under which the lien is claimed, whichever is later. In most circumstances, the two-year period will be the latter period. Note, however, that despite § 53.052(b) requiring the filing of the lien affidavit by the 15th day of the fourth calendar month after the day on which the indebtedness accrues, § 53.103 may require an earlier filing date for affidavits regarding retainage.
3. Regarding a statutory bond to indemnify against lien, the party asserting the lien claim may not sue on the bond later than one year after the date on which the notice is served or after the date on which the underlying lien claim becomes unenforceable under §53.158.
4. Regarding a statutory payment bond, suit on the bond must be filed within one year following the perfection of the claim or, if the bond is not recorded at the time the lien is filed, the claimant must sue on the bond within two years following perfection of its claim. This can occasionally raise the issue of what constitutes "perfection" in the case of multiple notices and lien filings by one claimant. The safest position to take is that perfection took place on the date of the last filed mechanic's lien affidavit.

D. Failing to file the statutory payment bond, failing to obtain a payment bond in the amount of the original contract or failing to endorse the statutory payment bond and record a memorandum of contract with the bond

1. §53.211 is a powerful section that will reform the payment bond terms and read the provisions of Subchapter I into the bond. But, the bond has to be filed in order to achieve "attempted compliance" with the statute. Even an AIA A312 bond form that is endorsed by the owner and recorded of record along with a memorandum of the contract might be reformed by the court to incorporate the requirements of Subchapter I.
2. Payment bonds that do not appear to have been issued in attempted compliance with the statute (for example, a payment bond that expressly incorporates the provisions of the Government Code §2253) or that are issued with a penal sum in half the amount of the original contract will probably not be revised by the court to comply with Subchapter I.

E. Not including removables in lien subordination agreements

F. Late filing the Affidavit of Completion

Owners often inadvertently extend the date of completion for purposes of withholding statutory retainage. §53.106(d) states that if the affidavit of completion is filed more than 10 days after the actual date of completion, the date of completion for purposes of the Subchapter is the date the affidavit is filed.

G. Commencing construction before recording the Deed of Trust

H. Requiring the wrong payment bond form on M.U.D. work

1. Confusion often ensues on work for municipal utility districts, levy improvement districts, water control and improvement districts and similar public entities. Private developers typically own the land even though they may enter into a contract "for the benefit of" the public entity. Frequently, the engineers who prepare the contract documents will include a Government Code payment bond form rather than a statutory Property Code bond form and fail to record the

bond and the memorandum of the contract in the real property records. If the work is being performed on private property prior to the easements and the infrastructure being conveyed to the public entity, the owner should utilize a Property Code payment bond.

I. Guarantees and joint check agreements

1. Owners need to be wary of guaranteeing payments to subcontractors because they may inadvertently create a direct contractual arrangement between the subcontractor and the owner, thereby elevating the subcontractor to "original contractor" status and relieve the subcontractor from having to comply with the notice requirements of the Code.
2. Joint check agreements should be carefully scrutinized to avoid the creation of guarantees and waiver of the owner's contractual rights to withhold payments from the original contractor.

IV. OTHER FREQUENT ISSUES

A. Conditional vs. final lien releases

1. Contractors and subcontractors will often insist on providing conditional, rather than absolute, waivers of lien with progress payment applications and the final payment application. This is based on the fear that good funds will not be collected but the horse will have left the barn when the owner records the absolute waiver of liens.

B. Diverted materials: do they form the basis for a mechanic's lien?

1. Unlike public works projects, private work suppliers may assert a lien claim if the materials were delivered to the project, even though the materials were subsequently diverted to another project.

C. Time period to allow general contractors to remove mechanic's liens

1. When drafting construction contracts, bear in mind that the process of obtaining, filing, and serving an indemnity bond is a normally at least a one to two week endeavor.

D. What is not lienable?

1. Lost profits, loans and attorney's fees are not lienable.

E. Estate to which mechanic's lien attaches

1. Disputes often arise as to the extent of the estate to which the mechanic's lien will attach.
2. The general rule is that the lien will only attach to the extent of the interest in the property held by the party that enters into the original contract.
3. Original contracts with a lessee rarely create lien rights against the fee interest in the property. However, underlying lease agreements and work letters may indicate that the fee owner is exerting so much control over the process that its fee interest may be encumbered by a mechanic's lien from the lessee's contractor.
4. The number of lots to which a mechanic's lien will extend is a fact specific question. Consider entering into separate contracts for improvements to specific tracts of land in order to minimize the extent of property to which a mechanic's lien may attach.

F. Quantum Meruit/Substantial Performance

1. If the original contractor has not substantially performed the original contract, it is limited to recovery under quantum meruit, which is not an action in contract and, under Texas law, will generally not support a mechanic's lien. However, if the original contractor is prevented from achieving substantial performance by the actions of the owner, the owner may be estopped from asserting this defense.

G. Self Help

1. Self help (disconnecting and removing air conditioning units, stored materials, etc.) is prohibited and may be basis for a cause of action for trespass and conversion. Mechanic's liens can only be foreclosed by judicial action (but arbitrators can determine the validity of a lien claim).