

Liens in North Carolina– Change in the Air?

By Douglas P. Jeremiah, P.E., Esq.

Several recent court cases could have a significant effect on mechanic's liens in North Carolina. The opinions rendered in these cases have helped accelerate an effort by the North Carolina Bar Association Construction Law Section to pursue passage of substantial revisions to the mechanic's lien statute in the 2011-2012 session of the General Assembly. This article will summarize the recent cases impacting lien law and the statutory revision efforts.

I will briefly summarize the different types of mechanic's liens. For a more extensive analysis of the current lien statute, please refer to my article in the Winter 2007 issue of *The Professional Engineer*.

In North Carolina, there are different lien rights and procedures depending upon whom the claimant contracts with. Where the claimant has a contract directly with the owner of the improved real property ("contractor"), the claimant has the right to assert a claim of lien on real property. Where the claimant contracts with someone other than the owner ("subcontractor"), the claimant has the right to assert a lien on funds, and may also have the right to assert a subrogated claim of lien on real property. If an engineer contracted directly with the owner, the engineer would be deemed a "contractor" for purposes of the lien statute. If an engineer contracted with an architect, who in turn contracted with the owner, the engineer would be deemed a "subcontractor."

The North Carolina General Statutes establish five requirements that must be met before a contractor may enforce a claim of lien on real property: (1) the claimant must perform or furnish labor or professional design or surveying services or furnish materials or rental equipment; (2) the claimant must do so pursuant to a contract, express or implied; (3) the contract must be with the owner of the real property; (4) the contract must be for the improvement of the real property; and (5) the claimant must comply with the procedural requirements of Part 1 of Article 2 of Chapter 44A of the North Carolina General Statutes.

A lien must be "perfected" and enforced by the engineer. In order to perfect the lien, a Claim of Lien on Real Property must be filed with the Clerk of the Superior Court in the county where the real property is located. The lien must be perfected by filing within 120 days of the last day the engineer provided professional engineering services. The Claim of Lien on Real Property is enforced by filing a lawsuit. The lawsuit must be commenced within 180 days of the last day the engineer provided professional engineering services. The priority of the lien relates back to the date of first furnishing of services by the engineer. The lawsuit includes a claim for money owed. The lien is only a means to secure payment of the court judgment that is found to be owed under the

contract to improve real property. The judgment is secured through the court-ordered sale of the real property.

If the engineer is a subcontractor (i.e. has contracted with the architect), the engineer may file a subrogated Claim of Lien on Real Property against the owner by standing in the architect's shoes to enforce the architect's lien rights on the real property. However, in order to do this, the engineer must also serve a Notice of Claim of Lien Upon Funds.

A lien on funds is a lien on the project funds that the owner owes to the contractor. A subcontractor/claimant's establishment of a lien on the funds serves as notification to those above it in the contract chain that money has not been properly paid downstream. The claimant may be able to prevent the party above it in the contract chain from getting paid until the claimant's lien claim has been satisfied. If the contractor has been paid in full before the subcontractor's lien on funds is served, this lien on funds will be ineffective because no funds are owed by the owner to the contractor upon which the lien may attach.

To assert a lien on funds, the subcontractor serves a Notice of Claim of Lien Upon Funds to the party who is holding the project funds owed to the person who in turn owes the subcontractor. For instance, in the example cited earlier, the engineer would serve the Notice of Claim of Lien Upon Funds on the owner who holds project funds owed to the architect who then owes the engineer. The engineer would also serve the Notice of Claim of Lien Upon Funds on the architect.

If the owner receives the Notice of Claim of Lien Upon Funds and owes project funds to the architect who owes the engineer, the owner must retain funds up to the amount stated in the Notice and cannot pay those funds until the claim is satisfied or discharged. If the owner owes more money than the amount being claimed in the Notice, the owner is only required to hold the amount that has been claimed, and the owner is free to pay the balance otherwise due and owing.

It had long been understood by construction law practitioners that a lien on funds could be asserted after a debtor filed its petition for bankruptcy. Once the petition for bankruptcy is filed, an automatic stay is granted by the bankruptcy court that prohibits creditors from claiming debts against the debtor that were not claimed prior to the automatic stay, subject to certain exceptions. Prior to the recent bankruptcy cases, the understanding was that the lien on funds was an inchoate right, existing at the time funds were owed to the lien claimant and perfected by the serving of the Notice of Claim of Lien Upon Funds. An exception exists to the automatic stay which allows perfection of an existing right to a lien; however, the automatic stay prevents a creditor from asserting new lien rights.

The first series of recent cases affecting lien rights are out of the U.S. Bankruptcy Court for the Eastern District of North Carolina. These cases are known as *Shearin*, *Harrelson*, and *Mammoth*. In *Shearin*, the court found that the Notice of Claim of Lien

Upon Funds does not merely perfect a lien on funds but actually creates the lien on funds. Thus, the exception to the automatic stay does not apply and no right to a lien on funds exists unless the Notice of Claim of Lien Upon Funds is served prior to the automatic stay.

The *Mammoth* and *Harrelson* cases involved subcontractors who served Notices of Claim of Lien Upon Funds and filed subrogated Claims of Lien on Real Property on the debtor post-petition. The cases followed the holding in *Shearin* in regard to the lien on funds being invalid. In addition, because the perfection of the subrogated claim of lien on real property is derivative of the lien on funds being served (created), these cases held that subrogated claims of lien on real property were not perfected by the subcontractors prior to the bankruptcy filings. The court in *Mammoth/Harrelson* noted that a direct claim of lien on real property is perfected by its filing, and relates back to and is created on the date of first furnishing by the lien claimant. Thus, it appears that a direct claim of real property can be filed post-petition and qualify under the exemption to the automatic stay.

A recent non-bankruptcy case also has the potential to disrupt lien law in North Carolina. When determining priority of a lien against other liens or a deed of trust, relation back of the claim of lien on real property to the date of first furnishing of labor is of great importance. Contractors and subcontractors are routinely required to execute interim partial waivers of lien rights that are conditional upon receipt of the interim payment. Construction law practitioners have understood the interim partial lien waiver as modifying the amount of funds subject to lien going forward, and not the priority date of the relation back.

In the *Wachovia v. Superior Construction* case in the North Carolina Business Court, the judge found that the contractor's execution of an interim partial lien waiver not only relinquished the contractor's lien rights in the amount of the progress payment, but also changed the priority date from relation back to the date of first furnishing to the date of the interim partial lien waiver. While interim partial lien waivers routinely relinquish lien rights for work performed up to the date of the lien waiver, it was always understood that subsequent claims of lien on real property could relate back to the priority date of the contractor's first furnishing. The decision in *Wachovia*, if upheld on appeal, could have a significant effect on the priority of lien claimants, especially against deeds of trust.

Due in part to these recent court decisions affecting lien law and a general desire to clarify certain portions of the existing mechanic's lien law, the North Carolina Bar Association Construction Law Section has formed the Lien and Bond Law Revision Committee ("Committee"). The Committee has been tasked, among other things, with identifying changes that should be made to the lien law, meeting and obtaining input from stakeholders, and drafting proposed statutory revisions. The goal of the Committee is to get a bill passed in the General Assembly during the 2011-12 session. The Committee's proposed bill has gone through several iterations over the past few months. The different iterations of the bill have been shared with construction industry stakeholders and then revised after receiving feedback. As of March 2011, the

Committee has identified bill sponsors in the General Assembly and the bill is currently in the drafting process, but has not yet received a bill number. I will address some of the provisions in the bill that could have a significant effect on liens for engineers. I will also summarize the provisions of the bill addressing the aforementioned court decisions.

As mentioned earlier, the priority of claims of lien on real property relate back to the date of first furnishing of labor or materials. Since engineers routinely perform their work before contractors do, engineers' liens can have a higher priority than liens of contractors and construction lenders' deeds of trust. Title insurers do not like relation back because a property can become encumbered by a claim of lien on real property after the property has changed hands, leaving the title insurer potentially responsible for discharging the lien. Relation back can lead to what are referred to as "hidden liens." A hidden lien can occur when an engineer asserts a claim of lien on real property after the property has been sold, such as an owner-builder selling a residential property. In this example, the lien is hidden to the title insurer. Another type of hidden lien is possible when a second-tier subcontractor, unknown to the owner or contractor, asserts a claim of lien on real property. In this example, in addition to the lien being potentially hidden from a title insurer, the lien is hidden from the owner and contractor. One of the Committee's top priorities was getting rid of relation back to the date of first furnishing, and as a result, hidden liens.

Hidden liens would be eliminated by requiring a document referred to as a "Notice of Commencement" to be filed by the owner at the Clerk of Court's office prior to the commencement of construction. The Notice of Commencement would also be required to be posted next to the project's permit, if a permit is required. The Notice of Commencement would identify the project owner, landowner, contractor, a brief description of the improvement, and a description of the real property where the improvement is located. There is a provision that would allow contractors to file the Notice of Commencement if the owner refused to do so.

After the filing of the Notice of Commencement, any subcontractors who wished to preserve their claim of lien on real property rights would be required to file and serve a document called a "Notice to Owner" within 30 days of the subcontractor's date of first furnishing. The Notice to Owner would include most of the information contained in the Notice of Commencement, along with identification of the subcontractor to all contracting parties upstream and the nature of the work to be performed under the subcontract. Under the current law, the owner can be surprised by a lien of a subcontractor the owner had no idea was involved in the project. The contractor and subcontractor would still be required to file a Claim of Lien on Real Property in order to assert their lien rights. The Notice of Commencement would replace relation back to the date of first furnishing by making the date of filing of the Notice of Commencement the priority date for all lien claimants under that Notice of Commencement asserting a lien after the date of filing, equalizing the priority amongst these claimants.

There could be more than one Notice of Commencement on a project, depending on how many parties contracted directly with the owner. In the event that multiple

Notices of Commencement exist, lien priority would be determined by the respective date of filing of the Notice of Commencement the lien was asserted under. It is important to remember that under the lien law, if an engineer contracts directly with the owner, the engineer is considered to be a “contractor.” In this case, the engineer could ensure that a Notice of Commencement was filed in order to preserve the best possible lien priority date. Since engineers often work prior to the start of construction, the engineer’s Notice of Commencement could provide a higher lien priority over the general contractor’s Notice of Commencement. The engineer would not be required to post the Notice of Commencement at the project site unless the engineer’s work required a permit. Lien claimants would also be allowed to file a Claim of Lien on Real Property before a Notice of Commencement was filed, but the lien would relate back to the date of the lien filing and not the date of first furnishing, as is the case under current law. If the engineer ensured that a Notice of Commencement was filed concurrent with the date of first furnishing, then the engineer should be able to enjoy a lien priority similar to what is provided under the current lien law.

If the proposed bill makes it into law, engineers will need to view liens a bit differently than under the current statute. Under the current law, the engineer does not need to take any action to enforce his/her claim of lien on real property prior to the filing of the lien. If the engineer wants to maintain a lien priority similar to that provided under the existing lien law, the engineer will now need to make sure the project owner files a Notice of Commencement at the beginning of the project. If the project owner does not file the Notice of Commencement after requested by the engineer, the engineer will need to file it. This has the potential to create an awkward situation between the engineer and the owner. What happens if the owner wants the project kept out of the public record but the engineer wants to preserve the best possible lien priority date? In that event, the engineer may be left with a business decision.

The proposed bill reverses the effect of the *Wachovia* decision by stating specifically that lien waivers do not modify the priority date of the lien. The bankruptcy court decisions in *Shearin*, *Harrelson*, and *Mammoth* are addressed as well. The Committee decided to decouple the lien on funds from the subrogated claim of lien on real property. Therefore, the right to a subrogated lien on real property would be created by the filing of the Notice of Commencement and not the lien on funds. A provision has also been added that states the right to a lien on funds is effective when the work is commenced and not when the Notice of Lien Upon Funds is served. Otherwise, the lien on funds framework would essentially remain the same as provided under the current law.

It is important to realize that the proposed bill could be modified before being passed into law, or not even pass at all. If you would like to share any ideas or concerns that you may have about these proposed changes or other aspects of the lien law that you would like changed, please contact PENC’s CEO, Betsy Bailey, as she will be lobbying on behalf of PENC with regard to any proposed statutory revisions to the lien law.

Bio

Mr. Jeremiah practices construction law in the Raleigh office of Conner Gwyn Schenck PLLC, a construction law firm with offices in Raleigh and Greensboro. Mr. Jeremiah received his B.S. in Civil Engineering from Virginia Polytechnic Institute & State University. He received his J.D. from the University of North Carolina at Chapel Hill. Prior to law school, Mr. Jeremiah worked as a project development engineer with NCDOT in Raleigh. If you have a question or issue for a future column, please email Mr. Jeremiah at djeremiah@cgspllc.com.