

Mechanics' Lien Prevention in North Carolina

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As any practitioner who closed loans in the 1990's knows, the past decade was one of the most prosperous periods in the history of real estate sales. Despite the health of the real estate economy, Investors Title continued to incur mechanics' lien claims at a surprisingly high level. In fact, over the past three years, mechanics' lien claims ranked as either the first or second largest loss category in this state. Unfortunately, it appears that even the most ebullient demand for new homes is no match for poor business management.

The last episode of severe mechanics' lien claims occurred at the beginning of the 1990's. The significant slowdown in home sales at that time contributed to a level of mechanics' liens that helped drive the state-wide level of claims as a percent of premiums written to an all-time high.

With the recent attempts by the Federal Reserve to brake the economy, the interest rate scenario has again changed to become less friendly for homebuilders. With history as a guide, now is a good time to review the nature of mechanics' liens and how real estate attorneys and title companies can protect their clients and insureds.

The Statute

Under Chapter 44A, persons who provide material and labor for the construction or improvement of a structure on real property are entitled to a lien against such property if they are not paid. The supplier or laborer must file the notice and claim of lien within 120 days from the date they last furnished labor or materials. Further, they must perfect the lien by filing a complaint within 180 days from the date of last furnishing. The key provision is that the lien priority "relates back" to the date on which the laborer or supplier first supplied labor or materials to the project, not the date of public notice.

Unfortunately, once a mechanic's lien has been filed, the damage is typically difficult to repair. The optimal way to minimize risk for insured borrowers and lenders is to focus on prevention. Prevention in this context means screening construction related closings for the existence of outstanding but unrecorded mechanics' liens.

Screening for unrecorded liens obviously cannot be foolproof. However, armed with an understanding of the evidence that suggests a particular builder or transaction may be a higher risk, practitioners can be alert for such signs and the associated need for greater care.

Spec Homes

The most risky closing for hidden mechanics' liens is the sale of a "spec" home. Specifically, this is where the builder owns the lot and is now selling the house to a homebuyer. Pursuant to the statute, any unpaid supplier or laborer who contracts directly with the owner of the property will have a lien on the property superior to the new lender's deed of trust and the buyer's interest, even if the lien has not been filed.

Practitioners should be on the lookout for signs indicating that, despite having signed a lien affidavit, the builder has not or will not be able to completely pay for construction expenses incurred. Clues to look for include:

- When searching the subject lot, are liens discovered on other lots the builder may own?
- Does the builder appear to be in an unusual hurry to close suggesting a desperate need for cash?
- What is the size of the builder? Historically, by volume of mechanics' liens claims filed, the majority have been caused by smaller, thinly capitalized builders unable to withstand a slowdown in sales.
- Has the builder, his staff or one of his subcontractors said something to warrant an additional inquiry?
- What is the reputation of the builder? Is the builder known for always being behind on his financial obligations or slow to pay?
- What is the character of the individual? This factor, historically used by lenders as the best overall indicator of creditworthiness, may be the best tool for determining the riskiest general contractors.

If an attorney becomes aware of facts suggesting a possibility of hidden mechanics' liens, then further investigation is warranted and advisable from an ethical perspective. To effectively find problems, practitioners can target the largest potential lien claimants. These typically include the primary building supply company and the electrical and plumbing subcontractors. Inquiry to these parties would most likely uncover any problem.

If inquiry uncovers delinquent accounts, then the long form version of the Affidavit Regarding Liens should be utilized to ensure that proper payment occurs at closing.

Construction Loans by Building Supply Companies

A unique situation exists where certain supply companies will provide construction loans to general contractors building spec homes.

Investors Title was recently involved in a lawsuit involving a mechanic's lien filed by a supply company under this fact scenario. Investors argued that by not informing the closing attorney of the amount of the delinquent supply line of credit when the attorney called for the construction loan pay off, the supply company was in violation of the unfair and deceptive business practice statutes. The supply company's position was that a department separate from the lending division handled the financing of building materials, and the two departments operated independently.

Ultimately, the court of appeals confirmed the lower court's ruling in the supply company's favor. The court concluded that the closing attorney should have known to ask

about the supply line of credit balance thus essentially implying that it is the closing attorney's duty to inquire.

As a result of the decision, a number of practitioners have begun utilizing a form to obtain the outstanding balance on any open building materials account when obtaining pay off information.

Custom Homes

This situation is defined as when an owner of the lot or land contracted with a general contractor to provide construction services to improve the owner's property. Construction financing is in the name of the owner and is later converted to permanent financing. Under Chapter 44A, the rights of subs and suppliers to recover from the owner are limited to undisbursed construction loan funds. If the general has been paid in full, subcontractors and suppliers cannot effectively lien the owner's property.

Construction Loan Closings

To preserve the construction loan's priority, the closing attorney will need to obtain an Affidavit Regarding Liens from the general contractor to verify that no work has commenced or supplies delivered prior to the deed of trust being filed of record.

If work has commenced on a custom home, the general contractor should subordinate its lien rights to the lender. For spec homes, subcontractors would be the appropriate party to subordinate lien rights. In this situation, practitioners should call the title company for the best manner to proceed given the specific facts.

If a lien is filed during construction or a shortage of funds occurs, the title company should be notified immediately.

Affidavit Regarding Liens

The instrument title companies utilize to protect insureds against mechanics' liens is the Affidavit Regarding Liens. The industry originally often required a long form version of this document, which required signatures from all subcontractors and suppliers. As a service to attorneys and lenders and to expedite closings, the industry began accepting a short form version that only requires signatures from the general contractor. By doing so the industry accepted a significantly higher level of risk. The willingness of the title industry to accept this document in order to provide affirmative mechanic's lien coverage should not be taken lightly. All due care should be exercised to ensure that it is respected by the building community and correctly executed.

The lien affidavit must always be signed by the owners in a custom scenario and the seller/builder when the home is a "spec" home. Where property is jointly owned, the spouse must always sign this document.

Even more significant is obtaining the proper signature of the builder. If the builder is a corporation or LLC, the proper officer must sign the lien affidavit. In the case of a corporation, that person is the president or a vice-president, whose signature the corporate secretary must attest to. For an LLC or a partnership, the manager or managing partner should sign. Practitioners should also carefully review the execution of lien affidavits prepared and provided by third parties.

Failure to submit an adequate lien affidavit may result in the inability to obtain affirmative coverage.

Remedies After the Fact

NC General Statute 44A-24 makes it a crime to issue a false affidavit of payment of subcontractors. Offenses are punishable as a Class I misdemeanor.

In addition, title underwriters may pursue a civil action against the general contractor. Many contractors will file bankruptcy to attempt to avoid their financial obligations. Under federal bankruptcy law, a debt arising out of fraud, including a false affidavit regarding liens, is non-dischargeable.

Additionally, the execution of a fraudulent lien affidavit by individuals, even if acting as an officer of a corporation, subjects them to personal liability for their misrepresentation.

In other words, builders should not sign lien affidavits and expect to be protected by the bankruptcy courts. Mechanics' lien claims are too significant for title underwriters not to hold contractors accountable for their affirmative representations.

Ethical Considerations

Generally, an attorney may represent all parties to a real estate transaction if there is no conflict between the parties. See RPC 210. However, this Opinion and the Rules are clear that if a conflict arises, the attorney must withdraw. See RPC 210 Rule 5.1(a). Thus, if an attorney becomes aware that a builder or developer is not financially secure and may cause a mechanic's lien to be filed on a property, under RPC 210 and 97 Formal Ethics Opinion 8, the attorney should step back from his representation of one of the clients. If that occurs, the attorney should advise the client that they should seek the advice of separate counsel. See CPR 100. In that way, the buyer can have counsel working to protect his (and the lender's) interest. The failure of the attorney to "step back" could result in a violation of the ethical rules.

Title insurance underwriters and their approved attorneys can work together to help minimize the effects of these hidden liens upon their clients. If new home sales slow as a result of rising interest rates, marginal builders faced with cash flow shortages will be tempted to falsify lien affidavits. Risk prevention is best achieved by screening closings for risky contractors that may be in financial trouble.