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## THE NEXT LEVEL FINANCE

### Protecting Against Mechanic's Lien Filings and Foreclosures

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In today's struggling construction industry, the number of lawsuits filed by contractors and suppliers that seek to foreclose a mechanic's lien has increased significantly due to nonpayment for materials or services rendered at a construction project. There are multiple reasons for this recent trend, however one of the most common causes is when an owner or developer fully pays the general contractor the funds due to subcontractors and suppliers that worked on the project, but the general contractor unlawfully uses those monies to pay off debts unrelated to the project. As a result, owners may be forced to pay off the liens or risk losing the property in a foreclosure lawsuit, even though the owner may already have paid for the services or materials that are the subject of the lawsuit.

Generally these situations are the result of inattentive or lax owners who fail to utilize some simple preventive measures that ensure monies paid to the general contractor are used to pay all subcontractors and suppliers involved in the project.

#### Mechanic's Lien Protection

Mechanic's lien laws in California were established to guarantee a professional's, contractor's or supplier's security interest in real property to secure payment for materials or services rendered at a construction project. This security interest is in the form of a lien that is recorded against the property by the unpaid contractor or supplier prior to filing a lawsuit to compel payment. If the lien is recorded and the contractor/supplier is still not paid, the contractor/supplier must timely file a lawsuit to foreclose on its lien and force the sale of the property.

Assuming there is equity in the property, an owner will have a strong motivation to pay off the lien promptly to avoid foreclosure or a cloud on title. Indeed, a mechanic's lien that clouds title may prevent a sale or refinancing of the property, prevent construction lenders from further disbursing funds to the owner or may even cause a construction lender to deem the owner in default under a deed of trust on the property.

The harsh reality of today's economy is that many general contractors owe a lot of money to many creditors, including

contractors and suppliers who worked for the general contractor on unrelated projects. While an unsuspecting owner may trust that money disbursed to the general contractor will be used to satisfy legitimate charges by subcontractors and suppliers on his project, the potential for abuse is substantial and requires closer attention to the actions of the general contractors.

#### Precautions Are Preferred Remedy

If a general contractor misuses project funds, an owner can most certainly file a lawsuit against that general contractor to recover the funds. However, if the general contractor is insolvent, as is more common in today's economy, the owner has little after-the-fact recourse. California law has no sympathy for owners who fail to take precautionary measures to ensure that all contractors and suppliers are paid. Indeed, an owner could have easily prevented this situation by taking some simple steps, rather than having to pay twice for the same materials and services.

Here are some helpful ways owners can safeguard against mechanic's liens:

Require the general contractor to:

- Obtain a payment and performance bond;
- Indemnify and defend the owner against any claims arising from the wrongful acts of the general contractor or its agents, including the general contractor's failure to pay its subcontractors and suppliers;
- Correctly identify the owner in a conspicuous place on any construction subcontract and/or purchase order. This will ensure that the owner receives requisite notices from contractors and suppliers that enable the owner to keep track of potential lien claimants.

Other strategies an owner could employ include:

- Closely monitoring and keeping a record of any "20-day Preliminary Notices" received from contractors and suppliers of their intention to record a mechanic's lien in the event they are not paid for materials or services rendered. This will allow the owner to keep track of everyone who needs to be paid.
- Avoiding large advances to the general contractor if possible. Instead, pay the general contractor monthly "progress payments" and upon receipt of executed lien releases that are

signed by each contractor and supplier who worked on the project. In fact, an owner may want to insist on the use of joint checks for payment to contractors and their suppliers.

■ Once the project is completed or ceases, the owner can immediately record a notice of completion or notice of cessation against the property. This will reduce the time period for lien claimants to record mechanic's liens against the property.

For example, a mechanic's lien claimant usually has 90 days from the date of the project's completion to record a mechanic's lien. However, if an owner records a notice of completion or notice of cessation, the 90-day period to record mechanic's liens is reduced to a 60-day period for original contractors, and to a 30-day period for subcontractors/suppliers, to record a mechanic's lien.

■ If a contractor and/or supplier records a mechanic's lien against the property, owners may withhold further payment from the general contractor of the amount of money for which the mechanic's lien was recorded.

■ After the project is completed, the owner may want to retain a certain percentage of the contract price for a specified period to ensure that no mechanic's liens will be recorded and to ensure all lien releases have been executed. However, when holding retention funds, owners should be careful to comply with late payment statutes. Otherwise, they could be liable for statutory penalties and fees.

■ If the owner's tenant is requesting and contracting for tenant improvements to the property, the owner should timely post and record a notice of nonresponsibility.

The instability of the real estate market has put added pressure on owner/developers to be proactive in protecting their interests in projects from unscrupulous general contractors and/or avoiding unpleasant surprises in the form of mechanic's liens and lawsuits. 🏠

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