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Lien Times

A growing number of title clouds from unpaid contract work is causing major headaches for lawyers

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Minneapolis construction law litigators Matthew Collins (left) and Gary Eidson have noticed a boom in litigation involving mechanic's liens. "It's stretching the law into corners we don't usually visit," says Eidson. (Photo: Bill Klotz)

There's more talk about the side effects of the real estate crash than there are nails on sale at hardware stores. The ensuing litigation is hammering the courts as well.

As the market has fallen, inevitably the number of liens filed has risen, and that has meant that the number of cases adjudicating the rights of property owners, lien claimants and builders has increased. Litigation over liens, infrequent during prosperity, is "stretching the law into corners we don't usually visit," said Minneapolis attorney Gary Eidson.

It appears that the legal aftermath of the construction crash has wound its way through the trial courts and is now at the appellate level, said attorney David J. Meyers of St. Cloud.

In recent months, Minnesota has seen a number of significant appellate decisions on liens and pre-lien notices, which are tightening up construction practices and setting traps for unsuspecting clients.

Attending to the details of a picky law like the mechanic's lien statute, let alone litigating it, goes against the grain of many builders.

"The construction industry is based on relationships. Filing a lien can destroy the relationships," Minneapolis attorney Matthew Collins said. So sometimes deals are made on a handshake, but then turn sour. The mechanic's lien statute is very specific and no equitable arguments will work against the strict requirements of the statute, he said.

That's a problem for clients because many times the lawyer doesn't get the case until after the lien is filed, either by the client or a lien service.

"Clients have to have some understanding of the requirements of the law," Fridley attorney Anne T. Behrendt said. She noted that the courts frequently state that the lien law is to be liberally construed in favor of claimants, but don't always rule that way.

"The tie is not always going to the claimants," Behrendt said.

Who's on first

Much of the litigation has come about because as the money dried up, people standing in line to get paid began to quarrel about who was on first.

A short summary of the situation: The real estate deal tanks, leaving the lender in the lurch. The general contractor is out of business or judgment proof. The property can't be refinanced because the loan to value ratio has dropped so it goes into default. The lender typically has 60 days to cover the loan or set aside reserves, meaning that the lender looks to the collateral to get paid. But the subcontractors frequently have filed mechanic's liens, taking advantage of the

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statute that gives them all the same priority, often based on a start date prior to the recording of the mortgages on the property.

"It's a perpetual problem," Collins said.

For example, Collins pointed to one of his cases involving a condominium project that was carrying a $10 million construction loan and the property value dropped to $5 million. Only three units out of 67 sold, although many purchase agreements had been signed to make the financing happen. The lender foreclosed and asserted a clean title to the property. The general contractor claimed priority based on an early start date, which was the date of the excavation. It was awarded $1.3 million including attorney fees.

Early start date cases result from a common real estate practice to start the construction work before the financing was in place, lawyers say. Lenders were willing to finance even though the mechanic's liens would take priority because title insurance companies were willing to write early start coverage to protect the lender. That was possible because the developers were required to indemnify the insurer and the developers were good for the money.

"There were loan practices that became common when times were good. The risks didn't mature because people got paid," Eidson said.

Now, the title insurance industry is in complete turmoil because it has been hit with so many early start claims and the developers are broke, Eidson said.

"Nobody's writing early start coverage anymore," said Minneapolis attorney Michael Lapicola.

Pre-lien notices

Another problem that arises when the deal collapses is that the pre-lien notices required by Minn. Stat. sec. 514.011, subd. 4(b) haven't been given by the subcontractors who expected get the contractor to pay them. Generally speaking, smaller projects require pre-lien notices but some subcontractors were surprised when the Court of Appeals ruled in 2008 that notices were required when the work was done only on a leased portion of a larger piece of property (See Wallboard v. St. Cloud Mall).

And they were further started last January when the Supreme Court in S.M. Hentges and Sons v. Richard Mensing, et al., said that builders on single-family lots must give pre-lien notices. That's a new requirement that many builders will be unaware of, said Minneapolis attorney Tim Nolan. "Lawyers representing contractors need to sit down with their clients and come up with a procedure for dealing with the pre-lien notice requirement," he said.

> "[Litigation over liens] is stretching the law into corners we don't usually visit,"
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> —Minneapolis attorney Gary Eidson

When preparing those notices, Nolan added, "It's worth a couple of hundred bucks to do a title exam. You may be looking at a million-dollar mortgage that has priority over you."

Common industry practices at issue

Two cases last July involved common industry practices that may need to change.

One involved the use of subordination agreements to attempt to alter the priority of the creditors. In Kraus-Anderson Construction Co. v. Superior Vista LLC, et al., the subordination agreement went too far and amounted to a lien waiver, which is contrary to the statute.

But the result in that case turned on the language of the agreement. The agreement was interpreted favorably to the lien claimant because it specifically mentioned liens and thus could be interpreted as a waiver, Collins said. But many contracts don't refer to liens, leaving open the argument that the subordination under the contract was valid, Collins said.

"Subordination agreements are done all the time and usually it's the lender's counsel drafting them," Behrendt said. "The lawyer has to be careful when drafting and be cognizant of all the limitations on them or the lender could lose priority. You could end up actually harming your client."

The inability to use subordination agreements could really slow deals down, said Lapicola. "If lenders can't use subordination agreements that make it difficult for projects to go forward," he said.

Kraus- Anderson also shows that parties are unlikely to be able to contract their way around the mechanics lien law. "The courts aren't going to let us get too creative," Eidson said.

Blanket liens

Another common practice, filing blanket liens against large pieces of unplatted property, was upset by Premier Bank Premier Bank v. Becker Development, et al., (See sidebar.) The Minnesota Supreme Court said that a blanket lien applied to 59 lots, not just the three lots where the contractor had first priority.

It unclear how to advise clients in light of Premier, Collins said. "There is no clear right to amend the lien after the land is platted. I would record against the big piece and the little piece to be safe, but that may be a problem because you have to give notice of the liens when the lots are sold. It may not be feasible to start work before the platting," he said.

Behrendt advised, "Make sure your clients understand what a blanket lien on a large development means. The blanket lien statute was designed for the convenience of the lienholder but claimants are harmed by it. The client should analyze the project and if the improvement is only going to a few lots, just file on those lots," she said.