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Mechanics' Lien and Stop Notice Options on Private Projects
By Scott Green, Esq.

*** Preliminary Notices – The First Step to Secure Your Right to Payment**

California law provides contractors, equipment and material suppliers, design professionals and others in the construction industry with the ability to secure their right to payment for their services with mechanics' liens and stop notices. However, unless you have contracted directly with the owner of the property, you must provide the property owner, general contractor and construction lender with a *Preliminary 20-Day Notice* to protect your right to either record a mechanics' lien and/or serve a stop notice. To fully secure your lien and stop notice rights, preliminary notices should be personally served or delivered by certified mail within 20 days of the date you start work and/or deliver materials or equipment to a project. The best and most efficient practice is to deliver your preliminary notices via certified mail.

*** Better Late than Never, but Better Never Late**

If your Preliminary Notice is not mailed or served on time, a late notice may still preserve a portion of your claim and help you get paid. But a late notice will only put you in a position to secure payment for the work performed in the 20 days preceding the mailing of your preliminary notice and thereafter. For example, if you start work on March 1, but don't mail your preliminary notice until March 30, you can only secure the value of the work you performed with a lien or a stop notice from March 10 forward.

Avoid losing your rights by establishing a practice of mailing your preliminary notices as soon as you enter into a contract for a new project. This simple practice makes it less likely that you will lose your lien and stop notice rights because someone in the office forgot to serve a preliminary notice.

The primary reason to preserve your lien and stop notice rights with a preliminary notice is to put the general contractor, property owner and construction lender on notice that if you are not paid in accordance with your contract, that you have secured the right to record a lien against the property and/or make a claim against the construction loan funds with a stop notice. In my 30 years of practice as a construction law attorney and as the owner of a nationwide construction notice service, claimants who use preliminary notices to secure their right to payment collect significantly more of their receivables and write off far fewer bad debts.

* **Mechanics' Lien – Secure Your Claim against the Real Estate**

When you record a mechanics' lien against property improved with your work, you are creating a "temporary" encumbrance or lien against the property. The encumbrance created by the mechanics' lien secures your right to payment with the equity, if any, in the property.

The encumbrance is only temporary because unless you are either paid and release your lien or file a lawsuit to enforce it, the lien will expire and become null and void 90 days from the date it was recorded. If your lien expires, check with an experienced construction law attorney to determine whether or not you have the option of recording a new lien. Generally, lien claimants have up to 90 days from completion of the entire project to record a mechanics' lien. On a lengthy project lien claimants may record and release successive liens during the course of construction and thereby delay the need to file suit to foreclose and enforce their lien. Please note that multiple unit projects such as new tract home developments have slightly varied guidelines.

* **If the Construction Lender Forecloses – Your Lien may be Wiped Out**

Construction lenders secure their loans by recording construction deeds of trust before construction starts on a new project. Deeds of trust and mechanics' liens are encumbrances and encumbrances recorded first in time have priority over later recorded encumbrances. Construction lenders usually make sure their loans are recorded before the start of construction so that they can establish priority over any subsequently recorded mechanics' liens.

The priority date for all mechanics' liens is measured from the first day that physical construction work starts on a project. If a construction lender records its loan before construction starts and forecloses on its loan because the borrower defaults, the lender's foreclosure will wipe out the mechanics' lien claimants. The mechanics' liens are wiped out because they were recorded after the date the construction loan was recorded and are therefore "junior" to the more "senior" construction loan. A junior encumbrance (a mechanics' lien claimant) can prevent a senior encumbrance (construction lender) from foreclosing and wiping out their interest by purchasing the senior claimant's security interest, (paying off the loan) or by stepping into the shoes of the borrower on the construction loan and bringing the loan current to cure the borrower's default. Although legally possible, these options are generally not financially feasible.

* **Bonding Your Stop Notice**

When a construction lender is served with a valid bonded stop notice, the lender must set aside 125% of the amount claimed. The funds are then earmarked as security for the stop notice claim and are unavailable for use on the construction project. Construction lenders are not obligated to set aside funds in response to a stop notice unless undisbursed funds remain in the account and the stop notice is bonded.

Although some lenders will withhold funds in response to an unbonded stop notice, they are not legally required to do so. Therefore, make sure that you serve your stop notice with a **stop notice bond** to fully secure your claim against the construction funds.

* **How to Obtain a Stop Notice Bond**

Stop notice bonds are issued by sureties. A surety is a company which pledges or guarantees that another's obligations will be met in case of default. For instance, a payment bond surety on a public works project guarantees that it will pay claims from subcontractors, material suppliers and others working on the project in the event of the prime contractor's default. In order to qualify for the payment bond, the prime contractor has to convince the surety that it has the financial strength to repay the surety in the event the prime defaults on its contract obligations and the surety is forced to step in and pay those obligations on behalf of the prime.

Applying for any kind of bond is like applying for a loan. The applicant will have to provide the surety with financial and other business information and the approval process may take several weeks. Plan ahead and avoid losing an opportunity to secure your right to payment with a bonded stop notice by working with a surety to determine your bonding capacity in advance of the need to obtain a bond. Sureties issue many types of bonds including contractors' license bonds, mechanics' lien release bonds, payment bonds, performance bonds, and stop notice release bonds. In addition to ensuring that you meet the surety's financial qualifications for a bond, the surety will also charge a percentage of the bond amount as a fee. Bonding fees typically range from 1.5 to 3 percent, depending upon the applicant's credit and the amount of the bond.

The purpose of the stop notice bond, and the obligation assumed by the stop notice surety, is to reimburse the borrower and the construction lender for any damages they might suffer from an overstated or fraudulent stop notice.

* **Good News – Bonded Stop Notices Survive Foreclosure**

A mechanics' lien is a recorded claim against land. In contrast, a bonded stop notice is a claim against money held in the construction loan account. A bonded stop notice is served upon the construction lender and secures your right to payment against the funds remaining in the construction loan account at the time you served your bonded stop notice. Bonded stop notices should be filed early to minimize the risk of service after all the funds in the construction loan account have been disbursed.

If a construction lender forecloses on its loan, as noted above, mechanics' liens are usually wiped out because the lender's loan was recorded before the mechanics' liens. Bonded stop notices however are not wiped out when a lender forecloses. For this reason, whenever you consider recording a mechanics' lien to secure a past due debt, consider serving the lender with a stop notice as well.

* **Recover Attorneys' Fees**

Besides surviving a lender's foreclosure, another advantage to serving the lender with a bonded stop notice is that in the event you prevail in a suit to enforce the stop notice the amount awarded will include interest at the legal rate, currently 10%, calculated from the date the bonded stop notice was served and attorneys' fees from the party held liable for the claim. This means that as long as you prevail (win) in the litigation you may be able to recover your attorneys' fees and interest from the project owner. On the other hand, if you lose you may end up paying the property owner's attorneys' fees.

* **Stop Notices on Owner Financed Projects**

On projects where the property owner is financing the work without a construction loan, stop notice claimants can serve their stop notices directly on the property owner without a bond. Theoretically, in response to the stop notice, the owner is required to carve out 125% of the stop notice claim from the funds he or she is using to finance the construction and set those funds aside for the benefit of the stop notice claimant. Practically speaking, this does not generally happen. Serving an unbonded stop notice on the property owner still benefits the claimant because it gives the claimant the right to file suit directly against the property owner to enforce the claimant's stop notice.

* **Successful Construction Collections**

One of the keys to successfully collecting what you earn is to take full advantage of all the available legal remedies. When your customer breaches your contract by failing to pay you in accordance with the terms of your contract, you can file suit against your customer for breach of contract. But what if your customer goes bankrupt or simply does not have the funds to pay you? Backing up your breach of contract claim against your customer with a mechanics' lien recorded against the property brings the property owner into your lawsuit and gives you another potential pocket from which you might be paid. Adding a bonded or unbonded stop notice claim creates another potential source of recovery. License bonds and payment bonds although not discussed in this article, are also potential sources of recovery which should be investigated and considered for each of your claims.

The moral to this story is when you are not paid in accordance with your contract, investigate every possible avenue of recovery and if you have to file suit to enforce your right to payment include all your potential claims and all the potential defendants in one lawsuit.

The above information is general in nature and does not completely cover the subject areas. For specific questions regarding your particular claim, email Scott Green, the managing partner for Green & Campbell, LLP at scott@gdclawyers.com. Green & Campbell, LLP limits its practice areas to business, construction and real estate law.

