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Evolving Issues in Secret Liens

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MR POTTER: The term mechanic's lien in Georgia means something different than it does in most other states. So you are going to find me using the term materialmen's lien here because that is what we call it in Georgia. Just to start out I am going to give an overview of how materialmen's liens work.

The one piece of advice I would like to give everyone here is if you are ever taking any commercial cases on a contingency, the materialmen's lien work is never on a contingency because all you get is a lien against some property. More than likely, the lien is going to be behind a mortgage, and it is a bargaining chip to get somewhere. Simply explain to your client very clearly that you will do the lien work for an hourly fee, and the rest for a contingent. Try to get it all hourly if you can.

Secret liens have existed for a long time. The first instance of them in the United States was for the suppliers of the materials for the White House. They were a little bit worried that this nation did not have good credit and then were not going to get paid for building the White House. So, they talked to Thomas Jefferson about getting something going so that they could have a way to protect themselves. That is essentially how it all started. Now, all of the fifty states have materialmen's lien, or mechanic's lien, laws. They vary so much that once you learn your state's law, do not cross the state line, because it is going to be completely different across the state line.

Generally, this is for privity of contract between the general contractor and the owner of the property. The general contractor then goes out and hires subcontractors, the subcontractors hire sub-subcontractors, and then they purchase rock, pipe, brick, mortar, and all sorts of things supplied by materialmen. However, you usually have at least one unscrupulous subcontractor in most large construction jobs, who does not want to pay his materialmen because he likes to keep the money.

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These unscrupulous contractors that do not want to pay are the things that keep me busy and enable me to support my family. So I get the call and I have got to go file a lien. There are different levels of what you go through to file a lien, but essentially in almost all jurisdictions, what you have to do first is identify the property that you are looking at. You want to physically look at the property, go to the tax assessor's office, look at the maps, go to the real estate records, get a legal description of the property and attach those to your lien. In most states, just a general description of where it is will be enough, but I do not like to have that kind of liability hanging over me. I make sure I get a legal description of the exact property. Then the lien has got to be filed, and it is filed in different places all throughout the United States, which generally can be in the real estate records of the county.

Our state has just formed a new lien index, which is kind of nice because we have 159 counties and you never knew where they were going to tell you to file anything. Then you have to perfect your lien. Perfecting a lien consists of bringing suit against the general contractor and the entity with which you did business. Furthermore, there is a certain amount of time that you have to do this. In California you have ninety days from the date you file the lien to file a suit to perfect. In Texas, Illinois, Iowa, Nebraska, and New Mexico you have two years. Some states get very strange. There is one where it is either thirty days or three years depending on how you go about it. So it is something that you make sure you know your Ps and Qs on before you start filing liens. There is also a notice of suit in many states that has to be filed. There are bankruptcy issues that go along with this. In Georgia you have within fourteen days of filing suit against the contractor who may be located anywhere in the state, to file notice in the real estate records of where you filed the lien against the property. This is called a notice of suit pending. In many states, it is called *lis pendens*, which means a notice of suit pending in Latin. Now, this, once again, gives notice. At the time you file the lien, most states require you to send a certified letter to the owner of the property telling them you filed this lien. You are going to send it because you want to fulfill your goal of collecting money from the client. The notice lets everybody know about this lien and puts them up in arms worrying about it. This also establishes public notice in the real estate records, of the existence of this lien. Then, once you obtain a judgment against the general contractor, you can move to perfect the lien or the lien becomes permanent. However, the lien still sits behind the mortgage, and until the mortgage is paid off, you are never going to collect any money on the lien.

Luckily, when most people are building places they want to sell them. When it comes time to sell, they have to pay off the lien. That makes your client very happy. But there is more notice that has come into existence over the years. In fact, there are two new areas. One is a preliminary notice of lien rights. You come on the job and you see you are not getting paid, so you send off a preliminary notice of lien rights declaring your intention to lien the property, if you do not get paid.

Another thing that has become pretty prominent throughout the United States is called a notice of commencement. Essentially, in a certain number of days from when the general contractor comes on the job, the general contractor files a document called a Notice of Commencement. This document gives information as to who the general contractor on the job is, who the owner of the property is, what the legal description of the property is, and whether there is a bond or a surety on the property. This triggers something from each subcontractor and materialman What you now have to do as a subcontractor and materialman is give notice to owner, notice to contractor, or notice of furnishing, depending on the state. You have to send this within a certain number of days to the owner and general contractor that you are on this job and you are supplying materials. If you do not send that notice, you cannot file a lien later. So now, the secrecy of this lien is very much going away because you are mailing out notices to people all of the time to tell them what is going on. The notice of commencement is an area in which litigation in many of the states is in cases of first impression.

In your materials, I have attached a ruling from the state of Georgia that was not appealed, and a ruling from Ohio. Both Georgia and Ohio have Notice of Commencement statutes. These statutes require a description of the location of the property and a legal description of the property. We have come to two different results. First, the general contractors that file the Notices of Commencement usually do not have a legal description of the property, either because they forget to attach the legal description or they think a legal description is merely "123 Broad Street." So a lot of materialmen do not go through the trouble to send this notice on every project. However, more of them are following our recommendation and allowing us to file liens for them. If there has been a notice of commencement filed, I can call my client, ask them if they sent the notice to the contractor. If the client did not, I have to find some way to make the Notice of Commencement not defeat the lien that I want to file. The methods that we have used include saying that if there is no legal description, we cannot tell what property it is. Since the lien laws are often strictly construed in various states, we argue that under strict construction, the failure to attach the legal description of the property invalidates the Notice of Commencement.

In *Lynnworth Lumber v. ZLH*,[1] an Ohio court determined that as long as there was an address to send the notice to, the Court would not require the legal description of the property, since it is a notification statute. In the case I had in Georgia, they listed the true owner of the property as the Greek Orthodox Cathedral. That is not an entity but a building. It is hard to send a letter to a building, because it does not have the capacity to receive notice. This is an issue of first impression in many states. Thus, if you end up in this line of work, you are going to pay very close attention to the notice of commencement law.

Another area that is quite old is offsite work. I am finding that this is becoming more and more of an issue in trying to get a lien against a particular property for work that was performed off the property. The two areas in which this has become most apparent have been in the area of high speed cabling and sewers. In terms of high speed cabling, you may have some cable that was purchased that you have taken to your building as the owner. When that cable is stretched through underneath the right of way, power easements in Georgia, the work is not done on the property. That cable is not installed on the property in question. Yet the entity that owns the streets did not order the installation. Therefore, the supplier of the cable cannot lien the property, because it is on the power easement, which is frequently owned by the state or the federal government. Things that are installed on state or federal government property are handled under the Miller Act. Since this project was not instituted by the state or the federal government, there is no bond for you to make a claim under the Miller Act.

The second area is sewers. As we become a more and more urbanized culture, we have to hook up sewers, not just in urban areas, but in metropolitan areas as well. Counties often require a sewer be within a certain amount feet from the property. Now, it is easy to lien for all of the pipe that was laid in the subdivision because it is on the property. However, what has happened in many cases is contractors develop property, then tie it into the sewer later after the County decides how they want that to be done. All of that work is underneath the road.

1. 126 Ohio Misc. 2d 56, 802 N.E. 2d 736 (2003).

The question becomes whether or not the sewer that is laid under other people's property or under right of way easements is improving the property.

Case law in this area is rather old. In Georgia our most recent case on this is from 1897, and it dealt with the sidewalk. It is a very interesting decision to read. It is a very long discussion about whether the sidewalk and the right of way benefit the property owner or whether it benefits the general public. The Georgia Supreme Court came to a decision that it benefited the general public and not the property owner, because the property owner did not care if people walked up and down in front of their property. The sewer, however, is a different thing. The sewer is under the ground. The cable is under the ground. It is not benefiting the general public in any way, except for the fact that the fluid is not freely flowing out of these houses and ruining the water table. Several of these cases are pending at the moment trying to argue that the sidewalk analogy is no longer valid.

An Alabama case from the 1970s, *Shelby Contracting v. Pizitz*,[2] analyzes all of the various jurisdictions and how they ruled on this issue. Alabama determines that the property owner's right in the sidewalk is at best a right of reverter, and, therefore, they are not going to allow a lien on a right of reverter.

The case *JR Christ Construction v. Willow Associates*[3] has a quote that essentially sums up where we seem to be going in this area. It states "[i]t is much too late in these modern times to embrace arguments that the gutters and sanitary sewers ought not be treated as essential to the comfortable and convenient use of the dwellings. Dwellings without efficient sewer systems are just no lon" This is the Court's rationale for allowing a sewer that was under the public streets to be liened to the property in question.

Now, these are very technical issues. In most jurisdictions, the lien laws are construed against the materialmen. They make the materialmen jump through a bunch of hoops. One of those hoops is called the Notice of Suit Pending that I talked about earlier. In Georgia, after you file the suit, you have fourteen days to file a Notice of Suit Pending in the real estate records. Now, what happens when you file the suit and a bankruptcy is filed? Well, I know somebody who has had to deal with that recently, his name is Mark Duedall. I am going to turn it over to him to handle the remainder of that issue.

2. 285 Al. 301, 231 So. 2d 743 (1970).

3. 47 N.J. 473, 221 A.2d 538.

MR. DUEDALL: As a precursor, what you have probably seen or heard from this discussion, and what you probably know from your own practice, is secret liens are all about "got ya." They are about finding a well known law, or sometimes very arcane law, and using that to their client's get paid from an insolvent debtor.

There are lots of ways to out "got ya" the "got ya" creditor. Paragon Trade Brands ("Paragon"), a manufacturer of diapers, had a plant in Macon, Georgia and was subject to a lien. A party had properly perfected his mechanic's lien. However, Paragon filed for bankruptcy, and the lienor filed a proof of claim in the bankruptcy case. The moral of the story from Paragon, discussed below, is that if you are going to be dealing with secret liens, mechanic's liens, or any kind of statutory or regulatory scheme that has a lot of rules and exceptions, know your stuff very well or go to an expert.

With respect to Paragon, however, Georgia law also provides that within fourteen days after filing such action to preserve a mechanic's lien, the party claiming the lien shall file a notice with the clerk of the Superior Court. You may ask yourself what does the superior court have to do with the bankruptcy court? Why should that provision be in there at all? However, here had not been any law on that issue. Now, we wanted to knock out this mechanic's lien with Paragon. I wanted to out "got ya" the secret lienor, and support the equality of distribution among creditors. Therefore, we fought the mechanic's lien on the grounds that the opposing side did file their lien but did *not* go down to Bibb County Superior Court to file their notice or file their proof of claim within fourteen days. This argument won. The other side did not get their mechanic's lien. I kind of out got ya'd the mechanic's lien and provided more money for Paragon's creditors. The bottom line is do not mess around with this stuff. Learn it inside and out or do not do not do it at all.

Setoff is not a secret lien; everyone knows it is out there. Curiously, it is treated like a lien under the Bankruptcy Code. Under section 553 of the Bankruptcy Code, setoff rights are preserved when you represent a creditor that has setoff rights against a debtor. Those setoff rights are preserved until the bankruptcy. Under section 506(a) of the Bankruptcy Code, setoff rights are treated as a secured claim. That kind of makes sense. The creditor says to the debtor "I do not have to pay you because you owe me money, I have setoff rights or you did some harm to me that gives rise to my setoff rights. The collateral for that claim is the money that I owe you." So I guess it is okay to treat it as a secured claim. However, if you are going to treat it like a secured claim, which the Bankruptcy Code does under section 506(a), we have to look at what happens to claims in bankruptcy.

Claims in bankruptcy get discharged under section 1141. However, a setoff is not really a claim, even though the Bankruptcy Code treats it as such. It is a defense. "I do not have to pay you because of something you did to me, or because of some money you owe me." How should a bankruptcy remove that? The cases have said that setoff survives bankruptcy which makes sense, since setoff is, at common law, not a claim, but instead a defense. Those cases are cited, including some cases from Illinois and New York. However, what a lot of debtors are doing these days is putting a provision in the plan saying that the discharge provision does apply to setoff rights.

There are a lot of bankruptcy cases holding that you can put something in a plan that is not valid, and if the creditor does not object to it, too bad. Many debtors are doing this; they are putting provisions in the plan that violate existing law. The creditors don't object to it because the creditors are thinking that their setoff rights survive bankruptcy. They should have read the discharge provision in the plan a little more closely. This is another example of the secret lienor being out got ya'd.

Another interesting item relates to Delaware where a lot of bankruptcy cases emerge. It also relates to setoff rights. We represented a client that received services from a debtor. The debtor did not provide some of those services pre-bankruptcy, giving rise to various claims. We were supposed to pay for the services. We had a contract that said we would continue to pay for the services that the debtor rendered to us, so the debtor was accruing a receivable from us. However, we were also accruing various setoff rights because the debtor was not providing the services to our client. Our client had to go elsewhere and pay more money. This was classic setoff. Post-petition, the debtor did not provide those services. Finally, the debtor rejected the contract giving rise to a rejection damage claim. So we had pre-petition setoff rights and post-petition setoff rights. Our client owed money pre-petition and post-petition. Setoff rights are a secured claim, and the post-petition, or debtor-in-possession ("dip") lender is now senior to our client, who has a secured claim by virtue of setoff. In essence, even though we have a right of setoff preserved in bankruptcy by section 553, that right of setoff is also preserved under state law and gives us the absolute right not to pay the debtor. Now the secured lender says it trumps that because there is an order from the Bankruptcy Court saying it has a senior lien. We were able to get around this because this is wrong from the due process standpoint.

We were not served with that dip financing order, and, therefore, it is not binding on us, and the dip lender eventually backed down. Now that dip lender has learned it should serve the dip financing order out on all of these unsuspecting trade creditors that might have setoff rights. If the dip lender had served that dip financing order, then our client would have been bound, and our client would have lost its setoff rights. It is ridiculous. However, by treating setoff as a secured claim, you have this weird treatment of setoff rights within the Bankruptcy Code. It really makes no sense. The debtor's rights against our client were the right to be paid if it had provided the services. Now somehow the dip lender received better rights than the debtor had by virtue of providing dip financing.

So the bottom line is there is two got ya points on setoff. Number one, do not let your client sit on the sidelines and just assume that setoff rights pass through bankruptcy. Go ahead and file the motion for release of stay and preserve the setoff rights; you will not be stuck by a provision in the plan that discharges your setoff rights. The second item is take a look at those dip financing orders. Those dip lender lawyers are a sharp bunch, and they are starting to do this and we need to stop it.

Let's talk a little bit about presumptions. I do not know how much courts take this into account. You have courts going a few different ways. On the one hand many of these statutes are in derogation of the common law. They have given special preferences to a certain type of creditor who did not exist at common law. Mechanic's liens did not exist at common law. They were a creature of statute. Any statutes in derogation of the common law must be narrowly construed. As a result, you have a lot of courts that kind of put their thumb on the side of the debtor on the scales of justice and take it away from the mechanic's lienor.

MR. POTTER: Some of the mechanic's lien statutes in the northeast and some out in the west, instead of saying it is in derogation of the common law and therefore must be strictly construed, have taken a different approach. They say it is a remedial measure and therefore, must be liberally construed because they are trying to remedy a problem. It is all how the Court looks at the situation. In terms of a mechanic's lien, if you are looking at it as if this entity provided the materials or did the completely satisfactory work. The only reason they did not get paid is that something happened in the chain from when the money was going from the owner, to the general contractor, to the subcontractor, to the sub-subcontractor. Luckily, I am in a state where it is a strict construction. It is interesting that in some of the cases, the Court will just turn it on its head in order to do whatever the Court wants in terms of result.

In the *Lynnworth Lumber* case, the Court goes through a long discussion of how strictly construed everything has to be and how everything must be done in a very particular fashion. However, the Court wants the notice of commencement to obviate the lien. Therefore the Court decides in the end that there is enough for notice. That is one of the problems you can run into in these cases. Is that how you think the law is going to be changed?

MR. DUEDALL: The *Reeves Brokerage*[4] case out of the Fifth Circuit discussed this very issue. In that case, the Court uses this rule of construction to rule for the Perishable Agricultural Commodities Act ("PACA") vendor saying that PACA is a remedial statute; PACA is intended to benefit the fruit and vegetable merchants, and so in a close case, you should rule in favor of finding a PACA priority. This is very different from the Georgia mechanic lien laws, but very similar to what they do up North on some of these mechanic lien's. So *Reeves* is a case that cuts the other direction in the PACA context. *Reeves* is also a good case to read because it is a true sale case. The issue in that case was whether the debtor sold its receivables to a lender. If the debtor did sell those receivables to its lender, then the PACA creditor has nothing to go against. The debtor does not own the receivables anymore. However, if it was not a true sale, but rather a secured loan, then the PACA creditor trumps the secured creditor because the secured creditor only has a lien. The PACA creditor has a benefit of trust interest because the stuff does not belong to the debtor. In that case, the Court ruled it was a secured loan, not a true sale, in part because of a PACA policy.

4. REAVES BROKERAGE CO. V. SUNBELT FRUIT & VEGETABLE CO., 336 F.3D 410 (5TH CIR. 2003).