SESSION FOUR

Payment Security Device # 1: The Mechanic's Lien

Nature of a Mechanic's Lien

* A mechanic's lien is a legal claim against real property to which the claimant has made improvements.

* A mechanic's lien claim is not based on contract, but is rather a statutory right that arises out of the supply of labor or materials for the improvements to the property without corresponding payment.

* The law gives the holder of a mechanic's lien the right to sell the property in order to obtain monies with which to obtain payment for the work performed.

* When a holder of a mechanic's lien arranges the sale of the property in order to satisfy the lien, the proceeds are distributed according to state law priorities. Construction lenders, mortgage holders, holders of tax liens, and others often have priority to the proceeds of the sale of the property over mechanic's lien holders. Under some circumstances, it is possible to enforce a mechanic's lien and not recover any money.

* The extent of a mechanic's lien is limited by the nature of the property interest owned by the person who contracted for the improvements. Thus a lien for improvements to leased property is against the leasehold interest only.

Scope of Coverage and Nature of Lien Granted

* There are widespread variations among the states as to the scope of coverage and the nature of the lien granted.

* Many states only permit prime contractors and first-tier subcontractors to obtain mechanics' liens.

* There are two main types of mechanics' lien laws: those based on the "direct" system, and those based on the "derivative" system.

* Under the direct system, the claim is against the property itself, and hence the limit which all mechanics' lien holders can recover is the proceeds of the judicial sale after other, higher priority claimants have been paid.

* Under the direct system, an owner can end up paying twice, in the situation where a payment for work done by lower-tier parties is made to the prime contractor and the monies are not passed on to the those parties.

* The states which recognize the direct system include Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Indiana, Louisiana, Maryland, Minnesota, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.

* Under the alternative type of mechanic's lien system -- the derivative system -- the total amount of liens all mechanics lien claimants can recover is the amount due from the owner to the prime contractor at the time the claims are made.

* Under the derivative system, the lien is against the funds yet unpaid under the owner's contract with the prime contractor or construction manager.

* Under the derivative system, the owner is not at risk of paying twice.

* The states which recognize the derivative system include Alabama, Connecticut, Delaware, District of Columbia, Florida, Georgia, Illinois, Iowa, Kansas, Kentucky, Maine, Massachusetts, Michigan, Mississippi, Nebraska, New York, North Carolina, North Dakota, Oklahoma, South Carolina, South Dakota, Texas, and Virginia.

* There are also wide variations among the states as to the procedures used in establishing and enforcing a lien. These matters can be highly technical, and it is recommended that they be performed by an attorney with prior experience in such work.

* In most states it is necessary to obtain a title search in order to obtain a legal description of the property and to determine if there are any other mechanics' lien claimants.

Enforcement of a Mechanic's Lien

* Obtaining a mechanic's lien is generally a two step process, the first step being the filing of a notice of intent to lien, and the second step being the filing of a lawsuit to enforce the lien.

* Like payment bond claims, the time within which a mechanic's lien claim must be filed is usually tied to the claimant's last day of work.

* The last day of work for mechanic's lien purposes is the last day on which materials or labor called for under the claimant's contract were supplied to the job.

* A few states require some form of legal notice to be filed prior to performance of any work, in order to maintain mechanics' lien rights.

Distribution of Proceeds of a Foreclosure Sale

* There is a wide variation among the states as to the priorities of distribution of the proceeds of a foreclosure sale to enforce a mechanic's lien.

* The general rule is that secured lenders and mortgage holders have priority as long as their interests were perfected prior to significant, visible work being performed on the site.

* Mechanics' lien holders usually have priority over judgment holders and tax lien claimants whose claims were adjudicated after the construction of the project commenced.

* Among mechanics' lien holders themselves, laborers usually get paid first, then lower-tier parties, then higher-tier parties, with each class sharing pro rata among themselves.

* As a practical matter, what this means is that if it actually comes down to selling the property at foreclosure sale, the mechanics' lien holders may see only a portion of their money, or possibly none at all.

* Actual foreclosure sales in fact rarely occur. The standard practice is to bond off potential liens, well before a lien attaches.

The Dangers of Mechanics' Lien Waivers

* There are three documents in which mechanics' lien waivers can occur:

  -- Lien waivers may be contained in your subcontract or purchase order.

  -- Partial lien waivers are normally submitted with progress payment requisitions.

  -- Lien waivers are frequently required at time of final payment.

* Waivers in contract documents should be stricken.

* Partial lien waivers submitted with monthly progress payments are

standard business practice and are not objectionable, but they should be applicable only to monies earned up to the end of the period for which the requisition is made rather than the payment date. Lien waivers should also not be applicable to pending change orders and claims, and should not become effective until the payment in question is actually received. Final lien waivers should be amended to exclude pending or known claims.

Payment Security Device # 2: Common Law and Statutory Trust Fund Provisions

The Nature of "Bankruptcy Bypass"

*An example of the problem that trust fund provisions address is as follows: monies are due from an owner to a prime contractor, for work performed and materials delivered primarily by subcontractors and suppliers. The prime contractor files for bankruptcy protection, and the trustee in bankruptcy claims the money as an asset of the prime contractor's bankruptcy estate, which would leave the subs and suppliers as general unsecured creditors -- with little hope of obtaining much more than a fraction, if any, of the amount due, with payment made years later. Since in reality the money was "earned" by the subs and suppliers, how can the subs and suppliers get paid by the owner, thereby bypassing the bankrupt intermediate party?

* The same principles apply, of course, where a subcontractor files for bankruptcy and a sub-subcontractor or supplier to the subcontractor seeks payment from either the owner or the prime contractor.

The Nature of a Bankruptcy Preference

* The same problem can also exist in reverse, where a payment is made to a lower-tier contractor, and then the upper-tier party files for bankruptcy within 90 days of the date of the payment. In such cases, the bankruptcy trustee can claim that the payment was not made in the ordinary course of business, and therefore constitutes an unlawful preference, which must be paid back.

Solutions to Bankruptcy Bypass, and Bankruptcy Preference Claims

* If there are "live" mechanics' lien rights outstanding, the owner can pay the lower-tier parties to satisfy those rights, and deduct the payments made from the amounts that would be due to the bankrupt prime contractor.

* If there is a payment bond on the job, the unpaid subs and suppliers can claim against the surety and obtain payment.

* The key to a successful bankruptcy bypass (or the avoidance of a bankruptcy preference claim) is the identification of an independent obligation on the part of the upper-tier party to the lower tier party that would justify ignoring the obligation to the bankrupt intermediate party, and which would permit a direct payment.

* Payments by third parties are normally made in order to satisfy outstanding mechanics' lien rights or bond rights.

* If the subs or suppliers are not covered by the states' mechanics' lien law or if their rights have expired, and there is no payment bond, an alternative method of bankruptcy bypass may be found in either common law trust funds, state trust fund statutes or private, contractual trust fund provisions placed in your contract terms.

* The courts of a few states where the issue has arisen have recognized that payments due on a construction project to a lower-tier contracting party for work performed by that party's lower-tier subcontractors or suppliers have in reality been earned by the those parties two tiers down the chain, and not be the party to whom the payment is technically due. In our example above, the monies would be payable to the prime contractor, but most of the amount due would actually have been earned by the subcontractors and suppliers.

* Those courts have reasoned that while bare legal title to the funds belongs to the prime contractor, "equitable" title belongs to the lower-tier parties who actually performed the work or delivered the supplies, and therefore the common law would deem the money "trust funds" which should be paid to the subs and suppliers, rather than kept by the bankruptcy estate.

* In North Carolina, New Jersey, Arkansas, Mississippi, Maryland and Virginia, there are state statutes which recognize trust funds under the circumstances specified, upon the issuance of a notice of non-payment.

* Alaska, California, and Rhode Island have stop-lending statutes, under which an unpaid subcontractor or supplier can impose obligations of payment on construction lenders.

SESSION FIVE

Payment Security Device # 3:
Miller Act Payment Bonds

Coverage

* If the owner of a project is the Federal government, by law there must be a payment bond covering labor and materials supplied to the project.

* Miller Act payment bonds are required on all Federal projects exceeding $100,000. The amount of the bond is a percentage of the contract price.

* The fact that a project is funded by the Federal government is not enough to invoke the Miller Act payment bond requirement. The owner must be an agency of the Federal government.

* Miller Act payment bonds cover the costs of labor and material (including mark-up) provided to a project by subcontractors, sub-subcontractors, suppliers to the prime contractor, and suppliers to a subcontractor.

* Third-tier subcontractors and suppliers to second-tier subcontractors are not covered.

* The term "subcontractor" under the Miller Act is defined as a party who takes on the obligation of performing a part of the prime contractor's scope of work.

* Manufacturers of specially-fabricated materials for use on the particular job in question are deemed subcontractors, rather than suppliers.

* Costs of materials used up or consumed in the course of construction -- for example the cost of fuel, tires for earth-moving equipment, etc. are covered.

* Costs of purchasing capital equipment, costs of borrowing money to finance equipment or project cash flow, or insurance premiums are not covered.

* Materials which are delivered to the site for intended use in the project are covered, despite lack of proof of actual use.

* Additional costs over the contract price which arise out of delays to the project caused by the claimant's upper-tier contractors are covered by Miller Act bonds.

Interest and Attorneys' Fees

* Recovery of interest in Miller Act lawsuits is governed by state law.

* Attorneys' fees are not covered, unless payment of such fees is provided for in the contract between the claimant and its contracting party.

Notice Requirements

* Where a project participant has a contract directly with the prime contractor, there is no notice requirement prior to filing a Miller Act suit.

* For all other parties, Miller Act rights are lost if they fail to send a written notice, by registered mail, to the prime contractor within ninety days of the date on which they last supplied labor or materials under their contract.

* The Miller Act notice much be actually received by the end of the ninety day period.

* A Miller Act notice must be from the claimant itself. A letter from a subcontractor on behalf of a supplier, for example, is not adequate.

* The existence of a joint check agreement between a prime contractor and a sub-subcontractor does not create a direct relationship with the prime contractor which would avoid the need to file a Miller Act notice.

* It is necessary to obtain a return receipt from the post office to document the delivery of the notice. If the party refuses its mail you may need to serve the notice by a process server, so don't wait until the last minute to send the notice.

* For purposes of determining the date of the last work from which to count the ninety day notice requirement, replacement work, corrective work, warranty work, or other types of "comeback" work do not generally start the 90 day time period running again.

Note: See Appendix 6 for Miller Act Coverage Chart, and Appendix 7 for a sample Miller Act Notice.

Lawsuits to Enforce Miller Act Bonds

* Suits to enforce Miller Act payment bonds are brought in the name of the United States.

* The suit must be filed in the jurisdiction in which the contract was performed.

* The suit <u>cannot</u> be filed prior to the expiration of ninety days from the date of the last work.

* The suit <u>must</u> be filed before the expiration of one year from the date of the last work.

Defenses to Miller Act Claims

* A pay-when-paid clause in the claimant's subcontract or purchase order is not a valid defense in a Miller Act suit, since liability exists by statute despite non-payment by the government.

* A surety can assert any defenses available to its principal, including offsets for damages alleged to have been inflicted on the principal by the claimant.

* A claimant is barred from suit where the amount sought was available to it in the form of a joint check, where the claimant did not deduct the portion due it from the proceeds of that check.

Pointers on Miller Act Litigation

* Where your contracting party has filed bankruptcy, file the suit against the payment bond surety only.

* Once a bankruptcy has been filed, the automatic stay provision of the Bankruptcy Code prohibits you from taking any action to seek payment from the debtor itself.

* Where you fear your contracting party may file for bankruptcy, attempt to reach an agreement as to the amount that is due to you, even though you are fully aware that that party itself has no money to pay you.

* If your contracting party files for bankruptcy and lists you on its schedule of debts with an undisputed amount, you can use that list as evidence for your claim against the Miller Act surety.

Payment Security Device # 4:
Little Miller Act Payment Bonds

Introduction

* Just as construction subcontractors and suppliers should have an automatic association between federal government projects and Miller Act payment bonds, where a state government entity is the project owner, there should be a similar association with Little Miller Act bonds.

* While the payment bond statutes of most states track the Miller Act, and rely on Federal case law to interpret the state statute, the statutes of some states differ in scope of coverage and in notice requirements.

Enforcement of Little Miller Act Bonds

* In most states, suits in Little Miller Act cases are filed in the claimant's name, not in the name of the state.

* In most states the same notice requirements apply as used in the federal Miller Act, but be sure to have your attorney check your state's statute on this point.

* Implied contracts, where a general contractor assures a second-tier subcontractor or supplier that it will be paid, do not create a contractual relationship that would avoid the requirement that a second-tier party must give timely notice of its claim to the general contractor.

* Where there is a conflict between the notice requirements of the statute and notice requirements set forth in the bond itself, the statute controls.

* Sometimes the wording of a payment bond is broader than that required by statute. In such cases, the wording of the bond controls, and the expanded coverage is available.

* Many cities, counties and other municipal governments have statutes or ordinances which track the state's Little Miller Act, requiring payment bonds on local projects over a stated dollar limit. Most of these statutes and ordinances contain similar notice and time requirements as the state Little Miller Act statute.

Payment Security Device # 5:
Private Payment Bonds

Introduction

* Many private owners require general contractors or construction managers to purchase payment bonds for their projects.

* A subcontractor or supplier should inquire when negotiating its contract whether a job is bonded.

* The fact that a construction project participant has mechanic's lien rights in effect does not bar the filing of a claim on the project payment bond.

* A bond claim is generally more effective than a mechanic's lien claim.

Enforcement of Private Payment Bonds

* Many of the rules applicable to enforcement of Miller Act and Little Miller Act bonds apply as well to private payment bonds.

* Where a private payment bond contains a notice requirement and a limitation on when suits must be filed, such provisions must be complied with.

* Payments made to subcontractors and suppliers in the normal course of business are not payments "under" a payment bond which would have the effect of reducing the obligation of the surety.

* It is always good practice to obtain a copy of the project payment bond well before payment disputes arise.

* The general contractor or construction manager has an obligation to provide a copy of the bond when requested to do so.

* The fact that a prime contractor has paid a subcontractor in full is no defense to a claim on a payment bond by sub-subcontractor or other lower-tier party.

* A mechanic's lien waiver does not automatically waive payment bond rights, absent specific language to the contrary.

* Where a joint venture takes out a payment bond, a contract with a member of the venture constitutes a "direct contract" so as to place the contract within the scope of coverage of the bond.

* If your contract on a project is terminated, you may proceed against the payment bond surety on a theory of quantum meruit -- that is, the value of the labor and materials supplied to the project.

* A payment bond only covers work performed under the scope of the contract for which the bond is written.

Nature of Payment Bonds, and Comparison to Performance Bonds

* The purpose of a payment bond is to assure that parties who supply labor and materials to a project are paid (that is, the bond is obtained by an upper-tier party, to protect lower-tier parties from default on payment).

* The purpose of a performance bond is to assure that a lower-tier party will properly and timely complete its work.

* Where a bonded participant in a construction project is unable to perform, its upstream contracting party can rely on that party's performance bond surety to take over the contract, to engage another contractor for the completion of the project, and to cover any damages incurred by the upper-tier party as the result of the default.

* The scope of the performance bond surety's obligations is established by the particular wording of the bond. Some broadly-worded performance bonds take on obligations by the surety to lower-tier parties which are similar in nature to those covered by payment bonds. Thus performance bonds should be explored as an alternative source of payment where no payment bond is in effect.

* Where a claim is made against a performance bond surety, the surety is obligated to investigate the claim, and fully inform the insured of its assessment of the matter.

* The surety has an obligation to advise the insured of the potential for excess liability on the part of the insured above the limit of the bond, and to advise the insured of any settlement offers.

* Where the insured contests a payment made by a performance bond surety, the legal standard is whether the surety acted in good faith.

Note: See Appendix 8 for a sample Payment Bond, and Appendix 9 for a sample Performance Bond.

SESSION SIX

Payment Security Device # 6:
Joint Check Agreements

* A Joint Check Agreement can be a useful method of obtaining payment security, even where other methods are also available.

* A Joint Check Agreement should be signed by three parties -- your customer, your customer's upstream party, and yourself.

* The Agreement should obligate your contracting party to designate in its payment requisitions what portion of the requisition should be paid to you, and should obligate the upstream party to pay your portion of each requisition in the form of a separate joint payee check to your customer and to you.

* The likelihood that the courts will regard the joint check as belonging to you increases the more all parties treat the money as yours. For example, it is best if the check is mailed to you, and you take it to your customer for endorsement. As an alternative, a Joint Check Agreement can call for your immediate customer to go to its upstream party's office to sign the joint check before it is sent to you.

* The existence of a Joint Check Agreement can be helpful in overcoming a bankruptcy preference claim.

* If a Joint Check Agreement was entered into less than ninety days prior to the date on which the upper-tier party files for bankruptcy it will not act as a protection against a preference claim.

* The upper-tier party is only obligated to make payments which are requisitioned by the intermediate party. If due to backcharges or offsets no monies are requisitioned, then the upper-tier party has no payment obligation.

* A Joint Check Agreement does not create an independent obligation on the part of the upper-tier party to pay the lower-tier party. Its obligations are governed by the contract between the other two parties.

* Failure to honor a Joint Check Agreement gives the right to the unpaid party to claim against the upper-tier party if it suffers losses as a result.

* The signing of a Joint Check Agreement does not void the lower-tier party's Miller Act payment bond rights.

Note: *See Appendix 10, 11 and 12 for sample Joint Check Agreements.*

Payment Security Device # 7:
Contractual Bypass Clauses

* An alternative theory to support a bankruptcy bypass can sometimes be found in clauses in the contract between the insolvent firm and its contracting party. These contract provisions can be quite helpful in supporting a by-pass payment where "live" bond or mechanics' lien rights exist, and significantly less helpful but yet potentially important where such rights do not exist or after such rights have expired.

* Typical of the types of clauses I am referring to would be a provision that requires, say, the prime contractor to submit proof to the owner that the prime has paid all of its subcontractors and suppliers on a current basis as a condition precedent to entitlement to its monthly progress payments. Even better is the following clause which was at issue in a Hawaii bankruptcy case, involving a claim by a sub-subcontractor against a subcontractor:

> Subcontractor will promptly make payments to all persons supplying labor, materials and supplies; Contractor may make any payments which Subcontractor fails to make, the amounts thereof deducted from any monies earned or due the Subcontractor under the Subcontract.

* While it is an open question whether such a clause, absent live payment bond or mechanics' lien rights, is sufficient to justify a by-pass payment, it provides an argument for such a payment, and a basis for payment if the Contractor wishes to be cooperative. If the clause set forth above had said "shall make any payments" rather than "may make any payments," there would be no question that the payment would be proper. However, use of the term "may" indicates that the payment is voluntary, and could be so construed by a judge as a means of making a preference payment. In a pinch, your contracting party's contract with its upstream party should be carefully examined for this type of clause.

Payment Security Device # 8:
Novations

* There may come a time in performance of a lower-tier contractor's work on a project where it would be advantageous for it to withdraw from its contractual relationship with its immediate contracting party and to form a new contract with the owner (or the contractor at the next tier up). This is possible, if you can obtain the cooperation of the parties, by means of what is known as a novation.

* A novation involves the cancellation of one contract, and the formation of a new contract, in which one of the contracting parties agrees to perform its obligations to a third party. A novation agreement requires three parties.

* For example, say a subcontractor is having difficulty on a job, and is not paying its sub-subcontractor on a timely basis. The sub-sub fears that the sub will file for bankruptcy, or perhaps just fold and go out of business. For a worst case scenario, further assume that there is no payment bond, and that in the state in which the project is located sub-subs have no mechanic's lien rights. Further assume that at the start of the job the sub-sub, having not taken this course, didn't realize that it might have been able to obtain a joint check arrangement with a private trust fund clause as assurance that it would be paid. The sub-sub can see disaster looming. He asks you for advice, and you having taken this course, handily advise him: do a novation.

* In order to follow your advice, sub-sub first goes to sub and persuades him to let him out of his contract, conditioned on the prime accepting a novation. He then goes to the prime and says "look, I am getting ready to walk off this job because my customer isn't paying me, leaving you with a major-sized problem. But, if you would like to hire me directly to perform my work, I have been advised that the subcontractor will release me."

* The parties then enter a three-way agreement, in which prime agrees to release sub-sub from that portion of its contractual obligations which sub-sub agreed to perform, sub-sub agrees to perform the balance remaining of its work directly for prime, and prime agrees to pay sub-sub (actually new sub would be more accurate) both the amounts that are past due from sub plus the balance remaining on the contract. The full amount payable under the novation from prime to former sub-sub would, of course, be deducted from the prime-sub contract.

* There are sample novation agreements in the Apppendix.There are a number of circumstances in which novation agreements are to the benefit of `all three parties, and this device should be kept in mind for use in appropriate circumstances.

Note: See Appendix 13 for a sample Novation Agreement.

Payment Security Device # 9:
Accounts Receivable Assignments

* There is another payment security device which may be used when you are desperate and nothing else is available. Accounts receivable assignments can work one of two ways. First, in exchange for an assignment of uncollected accounts as additional security for payment, you may choose to agree not to sue a party that owes you money. This first method does not involve a release of the debt to you, but only provides you with a source of money, as a form of collateral, in exchange for a stated period of time for forbearance from suit.

* The second method involves giving up a claim against your creditor in exchange for an assignment of one or more of his accounts receivable. It is also possible, of course, to do a combination of these two, or even stranger arrangements, which I have also been involved with, where a substantial number of accounts were assigned, with an agreement of cooperation and a schedule for sharing of proceeds.

* The more a firm owes you the more likely it is that you can do better by cooperating with it instead of suing it. You also get the advantage of a jump on the other creditors, who will likely take the much slower and more cumbersome method of suing on their debts.

* Say, for example, you are a sub-subcontractor which is owed a substantial amount from a particular subcontractor. You meet with the sub and inquire whether there are accounts that the sub is having problems collecting that you could take off his hands, at a discount, to be applied to your debt. You might even agree that after some level of recovery on his debts you will pay him back a stated percentage of future collections, after deducting your legal fees.

* Solid claims often go unpursued because the claimant lacks the funds to hire counsel to pursue the claim, or lacks the expertise to put the claim together. If you see one of your contracting parties going down the tubes, and you have no chance of collecting from any of the third parties on the horizon, accepting an assignment of a claim is better than nothing.

Note: See Apendix 14 for a sample Accounts Receivable Assignment.

Payment Security Device # 10:
Personal Liability for Corporate Debts

* When the party you are dealing with is incorporated, you may collect any debts owed to you from the corporation only. There is a doctrine in law that permits a creditor of a corporation, under very limited circumstances, to ignore the corporate form of the debtor and to collect against the corporation's owners. The burden of proof in such cases is, however, very high. You must show that the owner used the corporation as a shield for the perpetration of a fraud, or treated the corporate property as its own and the owner himself disregarded the corporate form.

* Another avenue of approach where a corporation is abandoned and its assets transferred to another entity is to attempt to follow the assets. Where you can prove that assets were transferred to a new entity without full consideration, you can attack the transfer as being a fraudulent conveyance.

* Because the law imposes liability on a general partner for a limited partnership's debts, you may collect against any general partner when a limited partnership defaults on a contract. Beware, however, that there is no legal obligation on the part of the principals of a limited liability company to pay the debts of the company.