

Making the best of what's Left: Lien priority disputes

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Subcontractor: Misti Beanland

Owner: Amy Wolfshohl

What Causes Lien Priority Disputes?

- Focus of this presentation is Subcontractor disputes with Owner where:
 - GC abandons
 - GC files bankruptcy
 - GC is terminated
 - GC/Owner Disputes over change orders or defective work resulting in large withholding by owner and non-payment of Subs
- We will reach other issues as time permits

Hypothetical # 1 – Short Reserve, Change Orders & Common Law Bond

- On January 3, 2022, GC and Owner enter into a contract for a data center in Corpus Christi with an original value of \$30 million.
- GC is telling the Owner it can no longer pay Subs.
- Owner and GC disagree on whether GC is entitled to \$6 million in change orders.
- Owner has held 5% retainage.
- Owner terminates GC for cause on July 2, 2022 after the Owner has paid GC \$20 million.

Hypothetical # 1 Continued

- At the time of the termination, GC has invoiced \$22 million but no change orders.
- Many Subs file liens. Some Subs served pre-lien notices with fund trapping language before termination but only one Sub served a valid notice before the final payment to the GC of \$2 million. Total liens exceed \$10 million.
- There is a payment bond in the amount of \$5 million furnished by the GC.
- Subs have begun to file suit against the surety, Owner and GC.
- GC is defaulting on the lawsuits and telling Subs it has “gone out of business.”
- Liens continue to get filed until 8 months after termination.

- Owner
 - Send Subs surety information
 - Interpleader
 - Calculate Liability to Subs
- Subcontractor
 - Obtain copies of notices, liens, proof of mailing of other Lien Claimants to determine if they were properly and timely sent and perfected
 - Obtain the Contract and Change Orders, if any, Payment Bond, copies of all payments to the GC and other Subs, if any

How is the pot of money for subcontractors established under Chapter 53?

- Reserved fund (f/k/a statutory retainage)**
- + Fund Trapping Liability**
- Pot of Money**

Stolz v. Honeycutt, 42 S.W.3d 305, 310 (Tex. App.—Houston [14th Dist.] 2001, no pet.)

Calculating the Reserved Fund

- Section 53.101(a) requires an owner to comply with (a)(1) or (a)(2):
 - (a) During the progress of work under an original contract for which a mechanic's lien may be claimed and for 30 days after the work under the contract is completed, the owner shall reserve:
 - (1) 10 percent of the contract price of the work to the owner; or
 - (2) 10 percent of the value of the work, measured by the proportion that the work done bears to the work to be done, using the contract price or, if there is no contract price, using the reasonable value of the completed work.
- Disputes between the Owner and Lien Claimants can arise where subsections (a)(1) or (a)(2) would arguably arrive at different numbers.

Calculating the Reserved Fund

- Mediator - Things not worth fighting about
 - 5% v. 10% of pre-termination payments
 - Reserve fund is not a calculation of remaining post-termination payments
 - Bond does not relieve Owner of Chapter 53 obligations
- Owner perspective – Reserved fund calculation should not consider
 - Invoiced amounts not yet due
 - Unapproved change orders
 - Amounts attributable to engineering services

Calculating the Reserved Fund

- Subcontractor perspective - Consider GC invoiced items and unsigned change orders
- Mediator perspective

Calculating Fund Trapping Liability

- Mediator - Things not worth fighting about
 - Existence of fund trapping liability when a notice was properly served and lien is perfected
 - Funds used for completion and paid to the completion contractor are not trapped under *Marton Roofing* and Texas Prop. Code § 53.084(b).
- Owner perspective
 - No invoiced unpaid amounts are “trapped” because no payment was made to GC. § 53.084(b)
- Subcontractor perspective
 - Amounts paid to GC after notice v. amounts owed to GC but not paid
 - Your client sent a notice with fund-trapping language and other Subs did not

Pot 1 – The Sub that Trapped Funds

- In the hypothetical, one Sub trapped \$2 million
- That Sub's claim gets paid first and if the Sub's lien is for more than the amount trapped, for the remaining amount owed, the Sub shares pro rata with other perfected Lien Claimants to Reserved Funds
- If fully paid, the Sub does not need to share in Reserved Funds
- Other Subs do not share in the funds trapped by the single Sub

Pot 2 – Reserved Funds

Owner Position	Subcontractor Position
<p data-bbox="741 511 1156 686">\$20,000,000 (paid) <u>X 10%</u> \$2,000,000</p>	<p data-bbox="1505 511 2007 815">\$22,000,000 (invoiced) <u>\$6,000,000 (changes)</u> \$28,000,000 <u>X 10%</u> \$2,800,000</p>

Bond - Just another pot

- If the Owner obtains §53.202 Payment Bond, the Owner is relieved of the requirement to reserve funds and cannot be held liable for failing to trap funds
- Unfortunately for this Owner, this is not that type of bond
 - Not in the full amount of the contract
- What does that mean for our hypothetical?
 - A determination, through discovery, will need to be made whether the Sub's work/materials were the type covered by the Payment Bond. If so, only those Subs would be entitled to a claim under the Payment Bond.
 - Because it is a common law bond, the Sub will need to look at the language of the Payment Bond to determine the notice requirements in order to recover against the Surety

Strategies for Quick Resolution

- Mediator
 - Summary motions to remove invalid liens
- Owner
 - Disclose information relating to reserved fund and fund trapping
- Subcontractor
 - Early v. late perfection issue arising from 5% reserved fund - *McKalip v. Smith Building & Masonry Supply, Inc.*, 599 S.W.2d 884 (Tex.Civ.App. Waco 1980)
 - Amount Interplead
 - Summary judgment to remove invalid liens or obtain agreement for all Lien Claimants to complete the Lien Perfection Chart and knock out Subs that did not timely or properly perfect

Strategies for Final Resolution

- Mediator
 - Homework (everyone needs to prepare a perfection analysis)
- Owner
 - Attempt to interplead and obtain a release
- Subcontractor
 - Analyze Lien Claimants' notices, Lien Affidavits, proof of mailing, invoices, pay applications to eliminate Lien Claimants that did not timely or properly perfect their Lien Claim and file Motions to Remove Invalid Liens
 - Determine Owner's Liability under both Trapped Funds and Reserved Funds methods and object to funds Interplead if less than amount required under both

Hypothetical #2 – Figuring Pro Rata Share of Reserved and Trapped Funds Interplead by Owner

- 1/3/22 Owner and GC enter into contract for Hotel project in the amount of \$30 million providing for 5% retainage to be withheld.
- 6/15/22 **ABC Sub** sends 1st fund-trapping letter received by Owner on 6/18/22 for **\$5 million** (work performed in March and April)
- 6/22/22 **XYZ Sub** sends an email to the Owner that it is owed **\$10 million** (work performed in March, April and May)
- 6/27/22 Owner makes final payment to GC in the amount of **\$2 million** for a total paid to GC of **\$20 million**.
- 7/2/22 Owner terminates GC and sends **ABC Sub** notice of termination

Hypothetical #2 – Figuring Pro Rata Share of Reserved and Trapped Funds Interpleaded by Owner

- 7/15/22 **ABC Sub** files a Lien for **\$5 million** (work last performed in April)
- 7/15/22 **XYZ Sub** mails 1st and only fund-trapping letter and files a Lien for **\$10 million** (work last performed in May)
- 10/15/22 **123 Sub** mails 1st and only fund-trapping letter and files a Lien for **\$2 million** (work performed in July)
- 12/15/22 **789 Sub** mails 1st and only fund-trapping letter and files a Lien for **\$3 million** (work performed in July)
- 12/20/22 Owner files an Interpleader Action interpleading **\$5 million** (**\$2 million** – Trapped Funds and **\$3 million** – Reserved Funds)
- **789 Sub** files a quantum meruit claim in Interpleader action against the Owner

- Owner: There's always that one Sub that thinks his relationship with the Owner was special...it was not.
 - No quantum meruit claim with express contract. *Pepi Corp. v. Galliford*, 254 S.W.3d 457, 462 (Tex. App.—Houston [1st Dist.] 2007, no pet.).
- Subcontractor: The GC is in trouble and the Owner instructs the Sub to continue working and the Sub will be “taken care of”.
- Mediator: The majority need to agree as to perfection so a deal or mediators proposal has a chance of success. Mediators has to know the statutes and case law to facilitate this process.

**Pro-Rata
Distribution Chart**

Lien Claimants	Lien Amounts	Timely Perfected	Share of Trapped Funds - \$2 million	Liens Amounts entitled to share of Retained Funds - \$3 million	Pro Rata Share of Retained Funds \$3 million	Total Paid from Interplead Funds
ABC	\$5,000,000.00	\$5,000,000.00	\$2,000,000.00	\$3,000,000.00	\$600,000.00	\$ 2,600,000.00
XYZ	\$10,000,000.00	\$10,000,000.00	\$0.00	\$10,000,000.00	\$2,000,000.00	\$ 2,000,000.00
123	\$2,000,000.00	\$2,000,000.00	\$0.00	\$2,000,000.00	\$400,000.00	\$ 400,000.00
789	\$3,000,000.00	\$0.00	\$0.00	\$0.00	\$0.00	\$ 0.00
Total	\$20,000,000.00	\$17,000,000.00	\$2,000,000.00	\$15,000,000.00	\$ 3,000,000.00	\$ 5,000,000.00

**Interplead
Funds**

Pro Rata %
\$3 mill/\$15 mil
= .20 share

Case Style									
<u>FIRST TIER CLAIMANT LIEN SUMMARY</u>									
1	Name of Lien Claimant:								
2	Total Amount of Lien: \$								
3	Date Lien Recorded:								
4	<p>For the amounts claimed in the Lien, identify each month in which all or part of Claimant's labor was performed or material delivered and the amount unpaid for each month.</p> <table border="1" style="width: 100%;"> <tr> <td style="width: 30%;">Month:</td> <td>Amount: \$</td> </tr> <tr> <td>Month:</td> <td>Amount: \$</td> </tr> <tr> <td>Month:</td> <td>Amount: \$</td> </tr> <tr> <td colspan="2" style="text-align: center;"><u>Total: \$</u></td> </tr> </table>	Month:	Amount: \$	Month:	Amount: \$	Month:	Amount: \$	<u>Total: \$</u>	
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5	<table border="1" style="width: 100%;"> <tr> <td style="width: 80%;">Have you attached the invoices, pay applications, receipts, and other documentary evidence identifying each month in which all or part of Claimant's labor was performed or material delivered and the amount unpaid for each month?</td> <td>Yes: _____</td> </tr> <tr> <td></td> <td>No: _____</td> </tr> </table>	Have you attached the invoices, pay applications, receipts, and other documentary evidence identifying each month in which all or part of Claimant's labor was performed or material delivered and the amount unpaid for each month?	Yes: _____		No: _____				
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	No: _____								
6	<table border="1" style="width: 100%;"> <tr> <td style="width: 80%;">Was written notice given to Owner and GC "not later than the 15th day of the third month following each month in which all or part of the Claimant's labor was performed or material or specially fabricated material delivered" in accordance with Tex. Prop. Code § 53.056?</td> <td>Yes: _____</td> </tr> <tr> <td></td> <td>No: _____</td> </tr> </table>	Was written notice given to Owner and GC "not later than the 15th day of the third month following each month in which all or part of the Claimant's labor was performed or material or specially fabricated material delivered" in accordance with Tex. Prop. Code § 53.056?	Yes: _____		No: _____				
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	No: _____								
7	<p>If the answer to #6 is yes, list the date(s) the notice(s) was were sent and the bates/exhibit number of the notice(s).</p> <table border="1" style="width: 100%;"> <tr> <td style="width: 30%;">Notice Date:</td> <td>Bates/Exhibit No.:</td> </tr> </table>	Notice Date:	Bates/Exhibit No.:						
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8	<table border="1" style="width: 100%;"> <tr> <td style="width: 80%;">Have you attached each notice identified in response to #7?</td> <td>Yes: _____</td> </tr> <tr> <td></td> <td>No: _____</td> </tr> </table>	Have you attached each notice identified in response to #7?	Yes: _____		No: _____				
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	No: _____								

9	If the answer to #6 is yes, was "the notice sent by registered or certified mail" in accordance with Tex. Prop. Code § 53.056(e)?	Yes: _____ No: _____
10	If the answer to #6 is yes, was the notice "addressed to the owner or the reputed owner or the original contractor, as applicable, at his last known business or residence address" in accordance with Tex. Prop. Code § 53.056(e)?	Yes: _____ No: _____
11	<p>If the answer to #6 is yes, what address(es) were the notices sent?</p> <p>Address(es): To the Owner at: _____ To</p> <p>Original Contractor at: _____</p>	
12	If the answer to #9 is yes, have you attached the certified mail return receipts/green cards?	Yes: _____ No: _____
13	Total timely noticed:	\$ _____
14	Total not timely noticed:	\$ _____
15	Did the notice(s) contain the fund-trapping language as set forth in Tex. Prop. Code § 53.056(d)(1)&(2)?	Yes: _____ No: _____
16	If the answer to #15 is yes, have you highlighted fund-trapping language on the attached notice(s)?	Yes: _____ No: _____
15	<p>Identify "the last month in which the labor was performed or the material furnished" by Claimant for KPE pursuant to Tex. Prop. Code § 53.053(c).</p> <p>Month: _____</p>	

16	Have you attached a recorded copy of the Lien?	Yes: _____ No: _____
17	Was the lien affidavit filed with the _____ County Clerk in accordance with Tex. Prop. Code § 53.052(a)?	Yes: _____ No: _____
18	Does the Lien contain "a sworn statement of the amount of the claim" in accordance with Tex. Prop. Code § 53.054(1)?	Yes: _____ No: _____
19	If the answer to #18 is yes, state the sworn amount identified in the Lien. Amount: \$	
20	Does the Lien contain "the name and last known address" of Owner in accordance with Tex. Prop. Code § 53.054(2)?	Yes: _____ No: _____
21	If the answer to #20 is yes, list the addresses of Owner stated in the Lien. Address(es):	
22	Does the Lien contain "a general statement of the kind of work done and materials furnished" in accordance with Tex. Prop. Code § 53.054(3)?	Yes: _____ No: _____
23	If the answer to #22 is yes, state "the general statement of the kind of work done and materials furnished" that is in the Lien. General Statement:	
24	Does the Lien contain "a statement of each month in which the work was done and the material furnished for which payment is requested" in accordance with Tex. Prop. Code § 53.054(3)?	Yes: _____ No: _____

25	If the answer to #24 is yes, list the months stated in the Lien.	
	Months:	
26	Does the Lien contain the name and address(es) of Original Contractor in accordance with Tex. Prop. Code §53.054(4) & (5)?	Yes: _____ No: _____
27	If the answer to #26 is yes, list the addresses of Original Contractor contained in the Lien.	
	Address(es):	
28	Did the Lien contain "a description, legally sufficient for identification, of the property sought to be charged with the lien" in accordance with Tex. Prop. Code §53.054(6)?	Yes: _____ No: _____
29	If the answer to #28 is yes, provide the property description contained in the Lien.	
	Property Description:	
30	Does the Lien contain "the Claimant's name, mailing address and, if different, physical address" in accordance with Tex. Prop. Code §53.054(7)?	Yes: _____ No: _____
31	Does the Lien contain "a statement identifying the date each notice of the claim was sent to the owner and the method by which the notice was sent" in accordance with Tex. Prop. Code § 53.054(8)?	Yes: _____ No: _____
32	If the answer to #31 is yes, provide the notice dates and notice methods as they are stated in the Lien.	
	Notice Dates & Methods:	

33	Did the Claimant "send a copy of the affidavit by registered or certified mail to the owner or reputed owner at the owner's last known business or residence address not later than the fifth day after the date the affidavit is filed with the county clerk" in accordance with Tex. Prop. Code § 53.055(a)?	Yes: _____ No: _____
34	If the answer to #33 is yes, state the owner's address(es) to which a copy of the Lien was sent. Address: _____	
35	If the answer to #33 is yes, state the date that the notice of Lien was postmarked. Postmark Date: _____	
36	If the answer to #33 is yes, are the proof of mailing and certified mail return receipts/green cards attached?	Yes: _____ No: _____
37	Does the Lien include any amounts for labor performed or material delivered on or after _____ (date of completion/termination/abandonment as applicable)?	Yes: _____ No: _____
38	If the answer to #37 is yes, state the amount claimed in the Lien for labor performed or materials delivered on or after (date of completion/termination/abandonment as applicable) Amount: \$ _____	
39	Does the Lien include any amounts for labor performed or material delivered for other projects?	Yes: _____ No: _____
40	If the answer to #39 is yes, state the amount claimed in the Lien for labor performed or materials delivered for other projects. Amount: _____	

41	Did Claimant receive notice from Owner under Tex. Prop. Code § 53.107? If yes, attach a copy of the Notice.	Yes: _____
		No: _____
42	Did Claimant file its Lien within 30 days after the date of (termination/abandonment/completion) (DATE) per § 53.057(f)?	Yes: _____
		No: _____
43	Did Claimant file its Lien by the 15th day of the 4th month after the last day of the last month in which labor was performed and/or the material furnished per §53.052(a)?	Yes: _____
		No: _____
44	If the answer to #44 is yes, what is last month in which labor was performed and/or material furnished?	
	Month: _____	
45	Did Claimant record any supplemental liens, amended liens, or partial lien releases?	Yes: _____
		No: _____
46	If the answer to #46 is yes, generally explain why the supplemental lien, amended lien, or partial release was recorded and list the filings, if any, that that can be disregarded.	
	Answer: _____	
47	Total Amount of Lien Perfected:	\$ _____
48	Total Amount of Lien Unperfected:	\$ _____

Hypothetical #3 – Sham Contract, GC lien & Arbitration Rights

- Developer/Owner undertakes \$50 million master planned community (hotels, apartments, retail, office space, parking garage)
- Developer builds apartment and garage w/ Prime #1 for \$20 million
 - Prime #1 is owned by the Developer
- Developer builds hotel, retail, and office with additional primes for \$30 million
- Payment disputes arise regarding apartments and parking garage
- Subs file liens on apartment and garage
- Precaster sub files liens on garage but has not delivered precast columns
- Prime #1 files arbitration demand against Precaster

Sham Contract – Developer/Owner & Prime 1

- A subcontractor with a contract with a purported original contractor is considered to be an original contractor for purposes of perfecting a mechanic's lien. Tex. Prop. Code § 53.026
- A purported original contractor means an original contractor who can effectively control the owner or is effectively controlled by the owner or who was engaged by the owner without a good faith intention of the parties that the purported original contractor was to perform under the contract. *Id.* at 53.001 (7-a).

- Owner/Developer perspective – Resist sham argument because it means no limit of liability
- Subcontractor
 - The first tier subcontractors are treated like original contractors and not limited to reserved funds + trapped funds
- Mediator – Have to solve the interplay of what is the “real” pool of funds or is this a true multi-prime scenario

Arbitration Rights Asserted by Prime #1 against Precaster

- The FAA's mandatory stay applies to a non-signatory to an arbitration agreement if (1) the arbitrated and litigated disputes involve the same operative facts, (2) the claims asserted in the arbitration and litigation are “inherently inseparable,” and (3) the litigation has a “critical impact” on the arbitration. *In re Devon Energy Corp.*, 332 S.W.3d 543, 547 (Tex. App.—Houston [1st Dist.] 2009, no pet.); *Zuffa, LLC v. HDNet MMA 2008 LLC*, 262 S.W.3d 446, 450 (Tex. App.—Dallas 2008, no pet.).
- Debt underlying a lien claim is the contractual debt owed by a prime contractor to a subcontractor.
- Courts often stay litigation in favor of the arbitration proceeding first.

Arbitration Rights Asserted by Prime #1 against Precaster

- Owner/Developer: Helps with the sham argument
 - If there are other subs, does everything get stayed?
- Subcontractor: I just lost my leverage against the owner for 8 months and I may have to litigate twice. Issues with foreclosure of a Subcontractor's Lien issued by an Arbitrator's Award
- Mediator: Does not change Mediator's tasks – need global settlement

Hypothetical #4 Mineral Liens

- On January 5, 2022, GC and Owner enter into a \$20 million contract for a salt water disposal well in Pecos, Texas. GC is entitled to two payments: \$5 million for mobilization and \$15 million for final completion.
- On January 15, 2022, Owner pays GC \$5 million to mobilize.
- Subs incur well in excess of \$5 million in debts between January and March 18 that GC does not pay. GC abandons the work on March 18 having never reach final completion.
- After abandonment, 5 subs file mineral lien claims, 5 file mechanic's lien claims and one sub files a combined mineral and mechanics lien claim.
- Owner has held not held any retainage/reserved fund.

Which Statute Applies?

- "Mineral activities" means
 - digging, drilling, torpedoing, operating, completing, maintaining, or repairing
 - an oil, gas, or water well, an oil or gas pipeline, or a mine or quarry
- But what about a salt water disposal well?

Which Statute Applies?

- Chapter 56 is the exclusive statute governing liens against mineral property
- Persons entitled to liens under this statute are not entitled to liens provided by other statutes.

Noble Expl. v. Nixon, 794 S.W.2d 589, 597 (Tex. App.—Austin 1990).

- Owner perspective – Chapter 56 applies, no reserved fund, no fund trapping, no lien
 - But because the mineral lien statute only permits the lien to attach to the extent that the mineral lease holder has not paid its contractor, and here the contractor was paid in full under its contract, the statutory lien is unavailable.

Pearl Res. Operating Co. LLC v. Transcon Capital, LLC, 08-19-00288-CV, 2022 WL 484546, at *1 (Tex. App. Feb. 17, 2022)

- Mediator perspective

- Sub's perspective – maybe Chapter 53 applies?
 - Obtain a copy of the Prime Contract between the Owner and Contractor – analyze Scope of Work to determine if the project falls under Ch. 53, 56 or both
 - Best to perfect under both Ch. 53 and 56 – remember under Ch. 56 a notice must be “received” by the Mineral Owner 10 days prior to the Mineral Lien being filed
 - Then reserved fund must be distributed to subs
 - Fund trapping - not available under these facts
 - Determine if the Owner wants your Sub to continue its work on the Project and negotiate payment to Sub of unpaid work under prior contract and payment of additional work by Sub under new contract directly with the Owner