

North Carolina Updates its Construction Lien Laws

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Introduction

Gary is a commercial office space builder. Olivia owns a vacant parcel of real property in North Carolina and hires Gary to build an office building on the parcel. Olivia and Gary sign a contract by which he agrees to do the work, and she agrees to pay him \$400,000. Gary hires Steve, a subcontractor, to do the plumbing work on the building. Steve doesn't have a contract with Olivia, but he does have one with Gary by which Gary commits to pay Steve

\$100,000 when plumbing work is finished.

This common arrangement among an owner, a general contractor, and a subcontractor forms the basis of North Carolina's construction lien regime. Unfortunately, a system designed to provide security for contractors and subcontractors has blossomed into a complex framework of rules and regulations that govern the rights and obligations of all three of these parties.

Olivia wants to make sure that she doesn't end up owing more money than she originally committed to, and wants to stay out of any disagreements between Gary and Steve.

Gary and Steve are going to be spending time, materials, and labor improving Olivia's property. They need to make sure that they comply with the timing rules and, if appropriate, the Lien Agent laws, so that if they need to file a construction lien they have preserved their place in line.

A contractor or subcontractor who improves real estate located in North Carolina ("Real Property") can obtain a secured interest in that property, or in the funds in the hands of, or due to be paid to, the contractor at the top of their contractual "chain" or a subcontractor higher in their chain, as security for their work or supply of materials. This security interest is commonly called a "mechanic's lien," "contractor's lien," or, as in this article, a "construction lien," and North Carolina has an evolving set of laws that govern who can get one, how to get it, and what responsibilities the parties have to each other once a construction lien exists.

New legislation passed in July 2017 has added additional wrinkles to the system but also clarifies some existing problems. This article serves as a review of the construction lien framework in North Carolina and provides a guide to navigating the lien process whether you are an owner, a contractor, or a subcontractor.

Who is Involved?

The first step to understanding the North Carolina construction lien system is recognizing the different parties and the roles

they play;

- An Owner is the person who owns Real Property that is being improved.
- A "contractor" under the statutory scheme, commonly referred to as and referred to in this article as a "General Contractor," is the contractor who has a direct contractual relationship with the Owner to complete the improvements.
- Other contractors hired by the Contractor to complete smaller portions of the work are either First-Tier Subcontractors (meaning they have a contract directly with the General Contractor but no contract with the Owner) or Lower-Tier Subcontractors hired by the First-Tier Subcontractor (a Second-Tier Subcontractor), or hired by the Second-Tier Subcontractor (a Third-Tier Contractor, and so on.). The relationship between these parties can be visualized as a ladder with the Owner at the top, the General Contractor on the first step down, and each level of subcontractor below them.

The General Contractor's Direct Lien on Real Property

There is an important distinction between a General Contractor's lien on Real Property, and a subcontractor's lien on funds due from the Owner to the General Contractor or in the hands of, or owed to, a subcontractor higher in their contractual ladder. A General Contractor's lien on Real Property ("Direct Lien") is a security interest in the Real Property itself, not unlike a mortgage or a deed of trust. To qualify for a Direct Lien the General Contractor has to meet four elements:

- The General Contractor must perform work or furnish labor or design services;
- Pursuant to a contract;
- That the General Contractor has with the Owner of Real Property;
- For the purpose of constructing an improvement on the Owner's Real Property.

An "Improvement" covers traditional construction activities like building, repair, alteration, and even demolition. But it also applies to grading work, excavation, landscaping, and providing materials like lumber or shrubbery for the Real Property. Even some unexpected services like providing rental equipment to a job-site or supplying design advice can qualify for a construction lien.

A Direct Lien is secured not only by the improvements themselves, but extends to the title of the Real Property on which the improvement is constructed (assuming the Owner has an interest in the title to the Real Property rather than a lesser interest such as a tenant under a lease of the Real Property, in which case the Direct Lien would be secured by the tenant's interest in the "leasehold"). So even though Gary is only building a single bedroom, his construction lien will be a lien against Olivia's entire home and lot; the Real Property.

The timing and procedure necessary to file a construction lien are important. They determine if the lien has been properly created and if it has, what priority the General Contractor has against other security interests on the same Real Property.

A construction lien is "perfected" when the General Contractor:

- Follows the statutory Lien Agent notice requirements discussed below;
- Serves a copy of the lien on the Owner of the Real Property; and,
- Files a lawsuit to enforce the lien.

But, a critical point is that the priority of the General Contractor's Direct Lien with respect to the priority of the liens with other lienholders, such as a bank that has a recorded construction deed of trust, may be determined based on a date well before the date all the steps above are completed!

A construction lien, called a "claim of lien," has to be filed within 120 days after the last furnishing of work, materials, or service to the construction project. If it's filed within that time, the priority of the General Contractor's lien will "relate back" to the

latter of the date the General Contractor first furnished work, materials, or services to the Real Property or the date the General Contractor filed a Notice to Lien Agent, which is discussed below—meaning that the lien will be perfected from that time and "jump in front of" liens, including deeds of trust, filed or recorded after that relation backdate.

Work, materials, and services are "last furnished" when they are last provided as required by the General Contractor's contract with the Owner. The deadline cannot be extended by doing additional work or providing additional materials that were not originally required.

A claim of lien cannot be amended under the rules except to partially release a portion of the claim if the amount due to the claimant is determined to be a lower amount, but it can be canceled and refiled assuming the claimant's new filing is also made within the 120 day period after the last furnishing of labor or materials.

General Contractors should be aware of the requirement that they serve their claim of lien on the Owner by personal delivery or a properly identified and postpaid letter. E-mail, fax, or regular mail will not accomplish proper service.

Enforcing a Direct Lien requires a lawsuit against all the necessary parties. The lawsuit must be filed within 180 days of the last furnishing. It's important to note that this is **not** 180 days after the claim of lien is filed. However, once filed, the lawsuit can be voluntarily dismissed and then refiled within one year after the dismissal without the claim being lost.

A Subcontractor's Claim Upon Funds

North Carolina law treats subcontractors differently from General Contractors. The General Contractor's Direct Lien on Real Property is a direct security interest in the Real Property, but subcontractors can typically—with some specific exceptions—only obtain a lien on the funds that are in the hands of, or still owed to, a party higher on their "ladder" than they are ("Lien on Funds"). Subcontractors are also tiered; there's no limit to the number of tiers, but funds flow down a particular ladder in order, although subcontractors lower than the third-tier have limited rights.

Generally, to qualify for a Lien on Funds a subcontractor must:

- Have a contract with the General Contractor or another subcontractor higher up their ladder;
- To improve Real Property; and,
- The subcontractor must furnish labor or materials to the site of the improvement.

If a subcontractor meets the requirements for a Lien on Funds, then a lien securing funds they are owed will "attach to" any funds in the hands of, or owed to, the General Contractor or subcontractor with whom the subcontractor contracted. Put another way, a subcontractor's Lien on Funds is a lien on the funds in the hands of, or owed to, the contractor on the next rung up the subcontractor's ladder. Thus a First-Tier Subcontractor will get a lien on the funds owed to the General Contractor, and a Second-Tier Contractor will get a lien on the funds owed to the First-Tier Contractor.

Liens on Funds will create a security interest in the applicable funds as of the time that the labor or materials are furnished and are perfected upon delivery of notice to the Owner or the General Contractor and subcontractors higher in the ladder in writing that the subcontractor is asserting a Lien on Funds in the hands of, or due to a higher-level contractor in the ladder leading up to the Owner. North Carolina provides a statutory form in North Carolina General Statutes, Section 44A-19 for that notice.

Liens on Funds are not filed in the office of the Clerk of Court like Direct Liens on Real Property, but they must still be served on the party against whom the subcontractor is asserting the Lien on Funds. Unlike a Direct Lien, there is no specific time frame within which a subcontractor must serve a claim of Lien on Funds, but it must be served within all applicable statutes of limitations and delay may result in funds being paid and disbursed, so subcontractors need to consult an attorney as soon as possible to ensure compliance with the law and to prevent the loss of a viable claim.

Enforcing a Lien on Funds depends on the willingness of the up-the-ladder parties to voluntarily comply with the lien. If the Owner or up-the-ladder contractor pays the subcontractor in order to remove the lien, there's no need for additional legal action. However, if the parties do not resolve the issue on their own, the subcontractor is left to file a lawsuit to foreclose the Lien on Funds.

In some cases, there may be multiple subcontractors asserting claims of a Lien on Funds against the same funds. In those situations, the funds will be distributed on a pro-rata basis.

Subcontractors and Subrogation

Subcontractor liens also introduce the concept of "subrogation." Simply put, subrogation allows a subcontractor to "step into the shoes" of an up-the-ladder party (or parties) and assert the higher-positioned party's rights against an even higher rung party. Critically, although subrogation may allow a lower party to assert rights of higher parties, it can never improve or enlarge the rights of the subrogating party. This means that a particular claimant's Lien on Funds will only exist to the extent of the amount of funds the subrogating party is owed. For example, in our hypothetical scenario, Steve is only owed \$100,000 for his work, so any claim of Lien on Funds against the money Olivia owes Gary will be capped at a maximum of \$100,000.

As discussed in the next section, subrogation is also the method by which a subcontractor, originally limited to a claim of Lien on Funds, can assert a Direct Lien on Real Property by "stepping into the shoes" of the General Contractor and asserting the General Contractor's right to a Direct Lien the Real Property.

This right to assert a Direct Lien by way of subrogation is contingent on the subcontractor complying with all of the Lien Agent rules discussed below, and file a claim of Direct Lien on Real Property with an attached Notice of Claim of Lien upon Funds that has been served on the Owner and any other appropriate party, as well as an affidavit demonstrating proper service.

The 'Double Payment Problem'

A subcontractor's Liens on Funds presents a unique, and dangerous, problem for Owners that has been termed the "double payment problem." The double payment problem occurs when an Owner receives notice that a subcontractor has claimed a Lien on Funds owed by the Owner to the General Contractor.

Once an Owner has received that notice, they have an obligation to withhold from their payments to the General Contractor with whom they contracted sufficient funds to pay the subcontractor's Lien on Funds.

Returning to the case of Gary, Steve, and Olivia, if Steve asserts a lien on the unpaid funds that Olivia owes to Gary, Olivia has a duty to keep the amount of funds claimed by Steve back from any payments she makes to Gary. If she attempts to wash her hands of the matter entirely and pays Gary the full \$40,000 she owes him, she will become personally liable to Steve if Gary fails to pay him.

That "double payment" presents a scary scenario for an Owner or any higher-tier contractor who may think they have fully discharged their obligations by paying the funds they received to their subcontractors after they have received notice of a claim, only to find out they still owe a down-the-ladder party money. If an Owner or contractor pays the amount they are owed in full but remain obligated to a subcontractor because they paid with notice of a claim of Lien on Funds, the Owner or contractor will have a right to seek reimbursement from the contractor they paid, but that right may not be much solace if the contractor has disappeared or spent the money and doesn't have replacement funds available.

Even more dangerous for an Owner is the fact that if the Owner fails to comply with a Lien on Funds, the subcontractor's Lien on Funds can become a Direct Lien on the Real Property and threaten the Owner's entire ownership of the Real Property

unless the Owner makes the "double payment" before the subcontractor forecloses on its new Direct Lien. This concept is discussed further below.

Double payment can be avoided by careful attention to notices and proper withholding after notice is received.

Lien Agent Requirements

Because of the fact that a construction lien had the ability to "relate back" to the date of first furnishing of work or materials to improve real property, and that date would not appear in any public record, real property titles in North Carolina, particularly for lenders expecting first lien deeds of trust, were bedeviled by the "hidden" or "secret" liens available to contractors.

In 2012, North Carolina created the concept of a Lien Agent. A Lien Agent is required to be appointed for construction projects having an estimated cost over \$30,000 at the time the building permit is issued. An exception exists for improvements to an existing single-family residence which do not require the appointment of a Lien Agent regardless of the cost of the improvements.

The Lien Agent process was discussed in detail in a previous Ward and Smith article .

Conclusion

Olivia, Gary, and Steve all have responsibilities and rights under the North Carolina construction lien laws. By knowing the rules and following the guidelines, they can put themselves in the best possible position.

Construction liens can seem like a complex system, but with attention to detail and help of an experienced attorney, each party can ensure themselves the best chance at securing all of their rights.

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