

## Securing Payment for Your Work and the Priority When Equitable Subrogation Applies

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How do you secure payment for the work you do on a construction project? Most states have mechanic's lien laws which are statutory remedies that protect the rights of contractors, subcontractors, material suppliers, and certain professionals who add value to the property of another. Given the fact they are statutory, subcontractors will need to be aware of the specific details of mechanic's lien statutes in their state. However, the concept is that those that improve private property should be protected because they have improved the property and they should have a secured position given the fact that they have incorporated labor and materials into the project and should be allowed to be paid out of the sale of the property that they improved.

The essence of a lien is that if a contractor, subcontractor, or supplier to whom the obligation is owed remains unpaid for work performed, the lien claimant or subcontractor who records the lien can foreclose their mechanic's lien. Through the foreclosure process, the improved property is sold and the contractor is paid out of the net sale proceeds. Many states require a notice before work begins to be given to the owner of the property and construction lenders that may have recorded deeds of trust on the property. Each state has different requirements and subcontractors are advised to know those requirements and prerequisites so that they have the ability to record a mechanic's lien if they are unpaid.

Clearly, this elevates an unsecured payment claim to a secured claim in the real property that has been improved.

### Liens on Leasehold Interests

Mechanic's liens are also available to claimants that perform tenant improvement work and may serve as liens against not only the landlord's fee interest but a mechanic's lien against the tenant's leasehold interest.

The right to claim a mechanic's lien on the landlord's fee interest extends to everyone who, at the instance of the owner or its agent, furnishes services or materials for construction on the property. The contractor, architect, and others having control of construction are considered agents of the owner for this purpose. Thus, a subcontractor or materials provider on a tenant improvement project with no contract with the owner may still claim a mechanic's lien against the fee if the claimant provided services or materials at the instance of the owner. In addition, that claimant could lien the leasehold and sue the party with whom the claimant was in privity for breach of contract. An analysis is required on whether or not the specific lease requires a tenant to perform some of the construction or if the lease merely permits the construction. If the owner has knowledge of the tenant improvements, a mechanic's lien would extend only to the tenant's leasehold interest in the property

and not the underlying property of the owner. Each state has specific law relating to not only mechanic's lien claims relating to the underlying real property or fee interest in the property, but may also have different laws and applications as it might relate to the leasehold interest in the real property. Subcontractors should seek counsel about the state laws with regard to not only mechanic's liens on the real property, but mechanic's liens on the leasehold interest. Once that information is obtained, a subcontractor can determine whether it can lien both the real property and the leasehold interest.

### Priority and Equitable Subrogation

Subcontractors should also be aware that their mechanic's lien rights and the property that they improve may be subservient to the Deed of Trust lien of the lender on the project. For example, in Arizona, a construction lender has priority over a mechanic's lien claimant if the construction lender records its Deed of Trust prior to or within 10 days of the date that the lien claimant began work. Each state may have difference statutory rules with regard to that priority position. What a subcontractor may not realize is that the original lender's Deed of Trust lien may survive and remain senior to all mechanic's liens, even though the Deed of Trust has been released. This concept is known as equitable subrogation.

The Doctrine of Equitable Subrogation is widely recognized in American Juris Prudence and allows a creditor who satisfies or pays a prior creditor's lien to acquire that lien priority position based on the payment made. Again, each state may have specific rules and regulations that have been adopted as this doctrine has been evolving since the downturn in 2008.

The four primary elements for contractors to be aware of with regard to equitable subrogation in general are: 1) the party claiming subrogation has paid the debt; 2) the party was not a volunteer; 3) the party was not primarily liable for the debt; and 4) no injustice or prejudice will be done to the other party by allowing the subrogation.

Equitable subrogation may then be extended to elevate a junior deed of trust holder to a position superior to the subcontractor's mechanic's lien to the extent that the junior interest satisfied a senior lender's interest.

Part of the analysis involves the prejudice to the intervening lienholder, which would be the mechanic's lien claimant. The reason this doctrine has been evolving, especially after the downturn, is there were many cases where a mechanic's lien claimant's work started before the priority date of the Deed of Trust. The mechanic's lien claimant was then the intervening lienor, and whether or not the doctrine of equitable subrogation applies depends on whether or not there was prejudice to the mechanic's

lien holder. If the junior lienholder is elevated to the senior lienholder position through the Doctrine of Equitable Subrogation, then the mechanic's lien claimant would not have priority. However, the analysis also involves how much was paid for that position and what the value in the property is.

Thus, the advice to subcontractors is that it is always wise to follow the statutory prerequisites to perfect the mechanic's lien regardless of the potential equitable subrogation doctrine that may or may not apply to the particular project.

The position of the mechanic's lien from a priority position may need to be analyzed, but most states' analysis addresses the commencement as what was visible activity at the project site. The subcontractors that do work on the building, but not necessarily the original excavation ultimately will have the same priority position as the date the first shovel turns the dirt on the property. It is important for subcontractors to know what the law of the state is with regard to the priority position of the mechanic's lien and the best advice for subcontractors is to obtain legal advice to perfect the mechanic's lien and get legal advice with regard to the priority position.

Because the law is an evolving doctrine regarding the priority position of mechanic's lien and each state has its unique laws, the subcontractor should perfect the mechanic's lien so they have

the potential of not only a secured position in the underlying real property but potentially a leasehold interest and even a potential for a secured priority position to be able to be paid for the work that they did to improve the value of that property.

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