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Title Notes Article August 2004

What Every Realtor Should Know about New Construction Liens

from the desk of David M. Touchstone

The last two years have seen an unprecedented amount of residential construction. Though I haven't yet seen any statistics on new home sales versus existing home sales, my personal experience speaks loudly for the proposition that at the moment new home sales have assumed a larger than ever proportion of the site built home market. For many realtors this has required mastering some of the rules related to the filing of liens by unpaid laborers and suppliers.

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Laborers, contractors, subcontractors, architects, surveyors, building consultants, engineers, lessors, and suppliers who have worked on a construction and who have not been paid the amount due them have a right to record an act of privilege (lien) with the parish clerk of court. This right is created by the Louisiana Private Works Act. I am frequently called upon by realtors to give an opinion involving the Private Works Act. I find that the answers I give often surprise or even shock realtors. Furthermore, inasmuch as the Louisiana courts have held that the standard of malpractice to which realtors should be held is that realtors must give competent advice about any real estate matter which they undertake to handle, it behooves all realtors who are assisting clients with transactions involving new construction to learn the rules.

Realtor involvement in new residential construction generally arises in two contexts. The more common circumstance is the purchase of a newly constructed home. The second circumstance arises when a prospective homeowner is assisted by a realtor in the purchase of a lot or tract of land upon which the purchaser intends to construct a home or other building. A variation on this second circumstance may occur when the purchase is made of an existing structure to which renovations or additions will be made. Each of these situations is fraught with danger to the purchaser.

Realtors rely on title companies to perform title searches at the courthouse for the purpose of assurance that purchasers will obtain "good title" to the property which they are purchasing. There is implicit in this assumption that the information needed to make a determination that title is either good or requires curative work is actually available from review of the public records. In nearly all contexts, this is a valid assumption. In

fact, Louisiana has a legal doctrine known to lawyers as the "public records doctrine". In effect, the public records doctrine requires that any act which would affect title to real estate must be filed with the parish clerk of court in the parish in which the real estate is located. The public records doctrine is so strong in Louisiana that, absent participation in a fraud, a person who knows of a document which would otherwise affect a title but which has not been filed with the parish clerk will not be bound by the existence of that document. For instance, if Smith and Jones agree that Smith will sell Blackacre to Jones and Jones knows that there is a mortgage on Blackacre in favor of Brown, but Brown has failed to record the mortgage with the parish clerk, then Jones can safely purchase Blackacre without requiring Brown's mortgage to be paid off. But assume for the sake of argument that Brown finds out about the impending sale, suddenly realizes he had never recorded his mortgage with the parish clerk, and races to the courthouse as fast as his Chevy will get him there, beats Jones to the clerk's office, and records his mortgage with the clerk before Jones records his deed, then Jones definitely has a problem with his title.

The above hypothetical scenario illustrates what is known as a "race" system. The term comes from the notion that rights are established in the public records by which documents are recorded earlier in time, hence the "race to the courthouse". Sometimes legal writers refer to this as "first in time, first in right". Because "first in time, first in right" is such a pervasive general rule, persons who transact business with real estate often make the mistake of thinking that it is always the rule. It isn't. And in no area of real estate transactions is there a more spectacular exception to this rule than new construction.

First in time, first in right is based on a public policy assumption that the public ought to be able to rely on what has been filed at the courthouse. In other words, if you want to protect your right all you have to do is file the appropriate document with the clerk. If you don't, shame on you; the system will not allow injury to innocent persons because you failed to take care of your business. While this is a very powerful public policy, the law has made a determination that it should sometimes be trumped by an even more important public policy. This second policy is the notion that those persons who add value to real estate by contributing labor or materials should not be cheated out of the value of that labor or the value of the materials. This second policy seeks to prevent injury to those who add value to real estate even though they have not won the race to the courthouse.

The Private Works Act allows up to 70 days from the date of substantial completion of construction for the filing of liens by unpaid suppliers. Actually, there are different deadlines for different classes of claimants, but from the perspective of a prospective purchaser, the time of exposure to claims does not fully elapse until 70 days after substantial completion. As to any real estate upon which new construction has been underway, transactions such as sales or mortgages made before commencement of or during the running of the 70 day period will be subject to and subordinate to the rights created by the filing of liens. Example: Contractor completes house and 10 days later Homeowner, desperate to escape the confines of mother-in-law's home closes on the new house and, blithely liberated from mother-in-law's clutches, moves into his new home only to start receiving in his new mailbox over the next 60 days letters from not very friend-

ly lawyers informing him that his new home is burdened with liens filed AFTER the purchase was completed. Homeowner, in a panic, calls his Realtor who advises him to go see the lawyer at the title company that closed the sale. The lawyer gently explains that all of the liens were filed after the title search, indeed after the recordation of Homeowner's deed, and, therefore, there was no way that the title search would have revealed any of these liens. Despondent, Homeowner goes home, checks his mail to find that he has a letter from the Contractor's attorney advising Homeowner that Contractor has filed bankruptcy and that Homeowner is prohibited by bankruptcy law from even making any contact with Contractor, much less trying to collect any of the money necessary to pay the unpaid suppliers and laborers. Homeowner goes back to Realtor seeking advice as to his next step. During this discussion the issue of owner's title insurance comes up and Realtor reminds Homeowner that he declined to purchase a policy at closing and there is no way a title insurance company will write a policy now. Realtor now gives Homeowner the only advice he can: hire a lawyer and do the best you can. This unhappy scenario is not outlandish. It happens somewhere every day. What was supposed to be the joyful experience of owning a new home turns into a nightmare for the homeowner.

How could the nightmare have been prevented? Well, it could have been prevented by some good advice by you, the Realtor. The first thing you can do to protect your buyer is to do business with reputable builders. Make some inquiries about the builder before your client signs the dotted line. Does this builder follow through on promises? How long has he been in business here? What is his general reputation? You might call a few homeowners who purchased homes from this builder; you can identify them by looking in the public records. At closing, make sure the closing agent has the builder sign a "builder's affidavit." A builder's affidavit is a SWORN statement by the builder that he has paid everyone connected with the construction. While a builder's affidavit is no guarantee that everyone has been paid, it is a strong lever on the builder. Signing such an affidavit when everyone hasn't been paid is a felony and could result in real jail time for such a builder, even if he files bankruptcy. When this is explained to the defalcating builder by his lawyer, he has a strong incentive to get the money from his mama or his rich Aunt Matilda to pay the laborers and suppliers who have filed liens. But the most important advice you can give the buyer is to BUY OWNER'S TITLE INSURANCE. When the sale involves new construction, title insurance companies require an increase in the amount of the premium. This add-on to the standard premium is referred to as the "lien fee" and is to compensate the title insurer for the increased risk that the insurer is exposed to by the possibility of liens. Nevertheless, owner's title insurance is the only sure fire way of protecting buyers and is worth the cost. As such, I am continuously mystified when realtors who assist buyers advise their clients against buying an owner's policy. If I were a realtor, not only would I advise my clients to buy owner's coverage, I would strongly urge them to, both before closing and at the table. For new construction, I would come close to insisting on it. If the buyer declined, I would have him sign a statement that I had advised him to purchase owner's title coverage. Louisiana law provides that in each instance in which a lender's title policy is being written in conjunction with a purchase, the buyer is to be provided with a written no-

tification of his right to purchase an owner's policy. In many instances I have witnessed realtors advising their clients "you don't need that, they've done a title search and, besides, the lender is getting a policy." There is so much wrong with this that I don't know where to start. As set forth above, in the case of new construction (but also in some other circumstances), things can happen which a title search would not have detected. Reliance on the lender's policy is truly ignorant. Think about it. Lenders couldn't give a fig about the status of a title. All lenders really want is repayment of their principal along with as much interest as they can bargain for. The ONLY time lenders care about title to the property is if they have to take it back in a sheriff's sale. By the time lenders claim on their title policies, buyers are already up the creek without a paddle. But the really dumb thing about the advice as given above is that it was given to start with. Think about this: how much does it cost you to advise your client to purchase owner's coverage? The answer is that it costs you nothing. On the other hand, how much does it cost you to advise the buyer not to purchase owner's coverage? The answer is that it could cost you a lot. At a minimum, if the buyer has a big problem that could have been prevented by an owner's policy; you're going to feel pretty bad. You'll probably lose that client and never get any more deals or referrals from him. But even worse, you may get sued; if you give bad advice which costs the buyer a lot of money, maybe you deserve to be sued.

With respect to protecting purchasers from liens filed by unpaid laborers or suppliers, there is one other line of defense. Simply wait the 70 days and have the public records checked to determine that no one has filed a lien. 70 days from when? The answer is 70 days from substantial completion. The best way to know what day the 70 days commenced to run is if the owner of the property filed a certificate of completion or a notice of termination. Either of these documents, when filed in the parish mortgage records, signals that work has been substantially completed and that the lien period has begun running from the date of recordation. For most constructions, neither a certificate of completion nor a notice of termination is ever recorded. As a practical matter, in these situations it is the act of substantial completion itself which gives rise to the commencement of the 70 day lien period. Substantial completion is effected when the only items remaining to be done are "minor or inconsequential" matters, the kind of things that are referred to in the trades as "punch list" items. If you are representing a buyer or even the builder in a deal in which the house has not been completed, it is a good idea to encourage the owner of the property (usually the builder) to file the certificate of completion at the earliest moment after substantial completion. The sooner the lien period starts to run, the sooner it will be over.

Well, I started this article by stating that there are two basic situations in which you as the realtor may need to give advice to buyers regarding new construction. Situation one simply involves the purchase of a new construction which we've covered above. The second situation involves the purchase of a lot or tract on which the buyer intends to build. One of the aspects of the Private Works Act involves lien ranking as between material suppliers (not laborers) and interim construction lenders. Interim construction lenders (nearly always banks) are extremely eager to achieve a higher lien ranking than material suppliers. Example: Contractor completes house but fails to pay five laborers

who file liens totaling $5000.00, ten material suppliers whose liens total $100,000.00 and fails to pay the bank which financed construction to the tune of $200,000.00. Bank forecloses and the property is sold at sheriff's sale, which sale produces net cash in the amount of $200,000.00. All creditors vigorously assert their respective claims in a lien ranking hearing in court and the court determines that the bank took the proper steps to perfect its mortgage so that the mortgage outranks the suppliers' liens. Under this scenario, the laborers would be paid the entirety of the $5000.00 due to them and the bank would get the other $195,000.00, leaving the suppliers twisting in the wind. On the other hand, had the bank failed to timely perfect its mortgage interest, the laborers would still get the first $5000.00, but the suppliers would get the next $100,000.00, leaving the bank the residue, i.e., $95,000.00.

In order to prevent material suppliers from outranking them, banks have to do this: obtain and record a mortgage and advance some funds against the mortgage ($1.00 will do), all of which must take place before any work has taken place on the worksite. With certain minor exceptions, if any work at all has been performed or any materials at all have been delivered to the worksite, the claims of all material suppliers will outrank the bank's mortgage, even suppliers who delivered supplies to the worksite months after the bank's mortgage was recorded. Banks are desperate to prevent this from happening and that's where you come in. Oftentimes, the future homeowner gets excited and wants to get to work right away. I have personally witnessed a number of instances in which this has happened. When the homeowner jumps the gun, he makes it very difficult, if not impossible, to obtain the necessary construction financing. Sometimes these mistakes occur before the future homeowner has even talked to his banker, and, thus the banker never has a chance to advise against this error. That means that you, the realtor, may be the only person in the process who has a chance to prevent this costly error. When we at the title company are aware of the buyer's plans to construct, we counsel buyers against this error, but oftentimes we are not privy to the purpose of the purchase.

I've saved the biggest surprise lurking in the Private Works Act for last. Think back to the most frequent of the unhappy scenarios confronting the new homeowner. Homeowner buys house after which liens start getting filed. In this situation, the homeowner is not personally liable to the lien claimants; the homeowner's only exposure is the house itself. As to the lien claimants, the homeowner can simply walk away from the house and let all the creditors carve it up. Of course, the homeowner may still have a problem with that promissory note he signed when he borrowed the money from his lender. But even worse than the pickle this homeowner is in is the one in the following scenario: Homeowner buys his lot, hires a contractor, but does not transfer ownership of the lot to the contractor. Homeowner borrows the money in his own name and pays periodic advances to the contractor as agreed upon. Unknown to Homeowner, the contractor is seriously upside down on the last five houses he has built and is taking Homeowner's money to pay off suppliers on the other houses. The housing market slows down and the contractor is unable to line up any new suckers (er, homeowners) to get money from to pay the suppliers on Homeowner's deal. The contractor finishes the house (or not) but fails to pay most of the money owed to suppliers and laborers. Lien filings start flying around faster than chips and salsa at Trejo's.

But here's the kicker, not only does Homeowner have to deal with all the liens, he is PERSONALLY LIABLE to each of the lien claimants. In other words, Homeowner can't just walk away and leave the creditors to fight over the house. Wow! That's pretty rough! Why does the law treat Homeowner so harshly? Because there is a mechanism by which Homeowner can protect not only himself but all the workers and suppliers also. There are two things Homeowner must do to give himself sure fire protection. First, he must enter into a written contract with the contractor for the construction; for obvious reasons this should be done with respect to every construction and, as a practical matter, most contractors will not agree to build a house without a written contract. After the written contract is signed, it must be recorded in the parish mortgage records. In addition to this, Homeowner must obtain a performance or payment bond from a commercial surety company and record the bond in the mortgage records. If Homeowner records both the bond and the contract, then Homeowner cannot be personally liable to lien claimants unless Homeowner served as the general contractor. If the bond is large enough, then any liens that get filed will be paid off by the surety company. Even though bonds add a layer of expense on the construction process, many sophisticated persons consider them to be well worth it. Furthermore, Homeowner might be able to negotiate a better deal with the interim lender if the interim lender knows there will be a bond. Whether or not a bond is arranged, another line of defense available to Homeowner is to handle the money himself instead of letting the contractor handle it. Homeowner should find out who all the subcontractors will be and arrange to pay them directly. Of course, this will require the cooperation of the interim lender (bank), and although it's a real pain, it's pretty effective. If Homeowner elects to make direct payment, he should consider obtaining the services of a civil engineer or other knowledgeable professional to make periodic estimates of the rate of completion. The goal here is to avoid payment to subcontractors at a rate faster than their rate of completion. For instance, if the electrical subcontractor applies for a payment and the civil engineer advises that the electrical work is only 37% complete, Homeowner would not want to pay the electrical subcontractor more than 37% of the amount due for the electrical subcontract. Finally, when Homeowner is also the owner of the property during construction, he should file the certificate of completion or notice of termination as soon as the work is substantially complete.

Remember, realtors have malpractice exposure for any real estate matters in which they give advice, so learn these rules well not only to help your clients but also to protect yourself.