Chicago Title EXAMINER

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MECHANICS' AND MATERIALMEN'S LIENS - A FEW MORE COMMENTS

CTIC UNDERWRITING TEAM

Eighteen months ago we were in an economy where sales were brisk, access to capital was available, and most builders were able to pay those providing labor, services or materials in a timely manner. In the face of a significant economic downturn and its negative impact on real estate-related transactions, "the normal course of business" is suddenly the main course in a feast of problems for buyers, lenders, attorneys, and title insurers. To some it seems the point is belabored; but again we are talking about the potential for mechanics' and materialmen's liens and their impact on what otherwise might be a smooth closing.

Recognizing that sorting through the multitude of differing lien forms available to closing attorneys from title insurers plays a roll in complicating the closing process, Chicago Title Insurance Company has adopted use of the three new North Carolina Land Title Association standard lien forms. Those forms are the

•NCLTA Form 1: Owner Affidavit and Indemnity Agreement (No Recent Improvements);

•NCLTA Form 2: Owner/Contractor Affidavit, Waiver of Liens and Indemnity Agreement (Construction Recently Completed); and

•NCLTA Form 3: Owner/Contractor Affidavit, Indemnity and Lien Subordination Agreement (Construction in Process or Immediately Contemplated).

These forms are available in the Bulls, Bulletins, Articles & Forms/Forms section of our website at www.northcarolina.ctt.com. Each form includes an instructions section that will be helpful in determining which form is appropriate and what parties should execute.

A few common (or maybe not so common) situations involving mechanics' and materialmen's liens follow accompanied by some thoughts on how to best protect all parties involved. References to the new NCLTA lien forms will be included where appropriate.

(1) John Doe Homes, LLC (Owner) is the owner of a lot. John Doe Construction, LLC (Contractor) is the sole contractor dealing directly with Owner. John Doe is the sole member/manager of both entities. In dealing with the subcontractors, John Doe says that he has acted as manager of Contractor. John Doe signs a title affidavit at the time of closing on behalf of both entities saying Contractor has been paid in full by Owner and Contractor waives any rights to claim a lien on the property. Is this sufficient?

If there is a bona fide separation of the entities, then this might be ok, especially if all contracts are written and specifically list the parties to the contract. However, neither a purchaser nor a title insurer wants to buy into a fight to determine whether the contracting entity is actually distinct from the owning/selling entity. Lien claimants would most likely immediately name both entities as the parties they contracted with and would assert a direct lien on the property. Buyers would be served with intimidating lawsuits and title insurers would become obligated to defend.

A more conservative approach (and what is becoming the standard where there is a relationship between the owner and the contractor) is to have the parties that have directly contracted with either entity acknowledge full payment and completion of their portion of the project and sign a lien waiver. While it is recognized that this increases the workload on all involved, the climate of today's economy and the terms of N.C.G.S. §44A often make this necessary.

Most attorneys recognize the significant risk that mechanics' and materialmen's liens pose to their clients and are making diligent inquiries in situations where the owner and contractor are closely related. Many will prudently treat all such situations as if the owner IS the contractor (i.e. all "sub" contractors will have direct lien rights). Pure reliance on an unsecured indemnity form (which essentially is an affirmation from the owner stating that all contractors have been paid in full and work has been completed) in the face of direct lien possibilities and stiff economic situations for builders is currently not accepted by most major title insurers. When recent construction (construction within the last 120 days) is involved, attorneys should get waivers from all parties that have contracted, or might assert to have contracted, directly with the owner.

SEE **LIENS / PAGE 3**

WHAT'S INSIDE!

March 2009

Chicago Title EXAMINER

VOLUME 3 / ISSUE 1

SOAP BOX

Nancy Ferguson

Senior Underwriting Counsel

Nancy Ferguson has been selected again for inclusion in the North Carolina Super Lawyers® list for 2009. The selection process is based on rigorous methodology, including independent research of candidates, peer recognition and professional achievement. She is one of only approximately 60 lawyers in the state under "Real Estate", and one of only 2 title insurance counsel. (See SuperLawyers.com) Nancy is currently co-author of the upcoming book, North Carolina Real Estate With Forms, Second Edition to be published by Thomson-Reuters in 2009.

NCLTA LIEN FORMS

Chicago Title has adopted for use as its standard lien forms the three new North Carolina Land Title Association lien forms. The forms are available to download from our website at www.northcarolina.ctt.com.

More information about these forms is available on the NCLTA website at www.nclta.org/forms.html.

NEW GFE, NEW HUD-1, NEW CHICAGO TITLE NATIONAL RATE CALCULATOR

The US Department of Housing and Urban Development's new Real Estate Settlement Procedures Act (RESPA) includes provisions for use of a new standardized Good Faith Estimate (GFE) and HUD-1/1A Settlement Statement (HUD-1) beginning January 1, 2010. Designated lines on the HUD-1 include a reference to the relevant line from the GFE allowing borrowers to easily compare estimated charges with final charges.

Though use of these new forms is not mandatory until January 1, 2010, the period between January 16, 2009, and December 31, 2009, is a transition period in which the lender has the option of using the new GFE. If the lender uses the new GFE during the transition period, then the attorney preparing the HUD-1 is required to use the new GFE-based HUD-1.

Chicago Title's National Rate Calculator available to the public by link (Online Calculators/Premium Calculator) on our website at http://www.northcarolina.ctt.com provides itemized loan and owner's title insurance policy information needed to complete portions of the new GFE and HUD-1.

View and download the new GFE and HUD-1 at:

http://www.hud.gov/content/releases/goodfaithestimate.pdf
http://www.hug.gov/content/releases/hud-1.pdf

More on the new RESPA rules coming in our next newsletter.

PRACTICE PITFALLS

....and how to avoid them

CORRECTING ERRORS IN RECORDED DOCUMENTS

With the revision of G.S. 47-36.1 (effective October 1, 2008), questions on how to properly apply it have been streaming in to title insurance companies. Most common are two inquiries: 1) what constitutes a minor error, and 2) does the invocation of this statute permitting filing of an affidavit giving notice of typographical or other minor error (commonly referred to in the industry as an "affidavit of correction") actually correct anything? Essentially these roll into the same question: When can I use this?

The threshold question is whether or not the document containing the error is sufficient to transfer the intended interest or establish the intended priority at the time of initial recording. If you feel it is sufficient but recording of a notice of the typographical or other minor error would help clarify the intent, use of an affidavit of correction would be appropriate. If there is any possibility that the document was insufficient to create the priority and enforceability necessary to protect your client's interest, then a true corrective (re-executed and re-acknowledged) document should be recorded and title should be updated through the date of its recording.

While the old G.S. 47-36.1 contained language that the change effected by the re-recording pursuant to this statute was actually effective to correct truly minor errors (many a conversation has been had as to what that meant), the word "corrected" was removed from the meat of the statute as of October 1. Thus, the affidavit referenced in the revised G.S. 47-36.1 purely gives notice of the error and does not make a substantive change to the document, or priority, especially as to the effect on rights of third parties. While you should always contact your title company to discuss situations where the affidavit of correction might be appropriate if you are unsure of its efficacy, their willingness to insure does not necessarily make the decision to use the affidavit in the best interest of your client. Thus, the following, non-minor, situations should be closely examined and rarely corrected in a form other than a full effective correction document: Missing, wrong or additional parties (even if functionally related); improper execution by the parties or notary; substantive changes to the legal description of the property (even if only a few keystrokes); and substantive changes to the terms of a deed of trust, such as changing the amount or obligation secured.

It appears that the scope of errors meant to be addressed by the revised statute fall into the same arena as those that were corrected by the pre-October 2008 version of G.S. 47-36.1. However, the effect of the "corrections" has been refined and reduced to the clear level of simply providing notice.

For more detail, see Chicago Bull Vol. 1, Edition 39, "Corrections, Re-recordings & Cures: 2008 Edition" and forms related thereto, posted on www.northcarolina.ctt.com --> Legal --> Bulls Bulletins Articles and Forms --> Recording.

LIENS / CONTINUED FROM PAGE 1

Contacting your title insurer and discussing the facts would be a good idea and might result in an alternative solution. (NCLTA Form 2 is appropriate when construction has recently been completed.)

(2) Buyer, in anticipation of purchase of a tract of land, has employed a surveyor, architect, and an engineer to do preliminary work for the site. Title is still with seller at the time that the work commences. Buyer takes out a $5,000,000 loan of which $1,000,000 is advanced at closing for the lot purchase with the remainder to be used for construction.

The attorney representing the buyer and closing this transaction (as well as any other parties to the transaction) is at significant risk if he/she has failed to get subordinations from the surveyor, architect, and engineer. Under Dalton Moran Shook, Inc. v Pitt Development Company, 113 N.C. App. 707, 440 S.E.2d 585 (1994), it was held that the liens of these contractors will take priority over the portion of the proceeds reserved for construction. (NCLTA Form 3 is appropriate when construction is in process or immediately contemplated.)

Most developers, and even some attorneys, do not realize that these types of contracts can give rise to potential lien rights under North Carolina law. They will execute lien affidavits stating that work has not commenced when in fact that is not the case (probably because they think of commencement as an actual visual undertaking on the property). The new NCLTA lien forms include definitions of "Owner" and "Contractor" which should help to alleviate this misconception. It is important that North Carolina attorneys are involved not only in the prevention of situations where these lien rights could arise, but also in the education of parties to these type transactions. It is crucial that those executing lien affidavit and indemnity agreements have a complete understanding of what they are signing. Title insurers are relying on the certifications and representations in these agreements and those executing are typically indemnifying specified parties for loss resulting from misrepresentations.

When part of the loan proceeds will be advanced post-closing for construction, attorneys should use extra caution in checking buyer judgments (yes, those judgments and federal tax liens that might already be filed against the purchaser). If such judgments exist, the priority of the lien of those funds advanced post closing may be at risk. Contact your title insurer to discuss what requirements, if any, they will have in your particular fact situation.

(3) Seller/builder client (an LLC entity) is signing lien affidavits that the closing attorney knows to be inaccurate; but seller/builder is (historically) financially viable and has always paid those it contracted with directly immediately after closing. Seller/builder runs into financial trouble and multiple direct liens are filed against the property. The closing attorney closed the sale while representing the seller/builder, buyer, and lender.

Aside from the criminal penalties that are provided for in N.C.G.S. §44A, which should be deterrent enough, there is the potential for significant civil liability to be incurred by not only the entity that provides the false statement, but also the individual signing on behalf of the entity, and the attorney that knowingly provided title certification to the insurance company and representation to the buyer.

Individuals who have knowledge that a statement they are making on behalf of the entity in which they hold a managerial position is false should be concerned about claims against them that assert them to be individually responsible for the fraudulent representations. Attorneys that have knowledge of this fraud not only have potential malpractice liability to their buyer clients, but also could be found complicit in the perpetration of fraud. Worst case for attorneys could include the attorney being the only one held responsible if they advised clients (and clients reasonably relied on the erroneous advice) to sign lien affidavit forms with statements of fact inconsistent with those in the transaction or advised clients that obtaining the signatures of certain parties that provided labor, services or materials was not necessary. Aside from general theories of fraud, liability for any party involved could arise under N.C.G.S. §75-1 et seq. That includes liability for insurance fraud, fraud against a federal lending institution, civil liability as is available on any indemnity, as well the status of a general contractor's license.

It is also imperative to note that situations where dual representation is proper are limited and the Bar's Formal Ethics Opinion on this matter covers those (see 97 FEO 8). Of significant interest is Inquiry and Opinion #4 therein which states in part: Inquiry 4 - "Attorney is aware that Seller is having financial difficulties and…Seller has instructed Attorney not to disclose this information." Opinion 4 – "Attorney cannot reasonably conclude that his responsibilities to Seller will not interfere with his responsibilities to Buyer."

(4) Owner/Builder is attempting to protect itself by having contractors provide interim lien waiver. Will these waivers be effective?

This varies significantly based on the form of the lien waiver and what you expect it to do. Most lien waivers that are interim in nature are only going to be beneficial as evidence of what the total outstanding amount due could be, should a lien be filed. These provide important information to lenders, title insurers, and owners giving some comfort as to the viability of the project to satisfy those providing continued financing, insurance, and payments. However, they typically do NOT provide limitation on the relation back of priority under N.C.G.S. §44A-10. Some attorneys have made attempts to create an interim lien waiver that strives to redefine the first furnishing date. This has the potential to be an effective method of protecting parties in interest to the transaction, but this has not been tested in our courts.

The above situations (and the thousands of factually diverse possibilities) are easily theorized but difficult to resolve practically. Clients rely on closing attorneys to protect their best interests, and information is the attorney's key weapon. The information necessary to protect a client's interests against mechanics' and materialmen's liens is obtained by inquiring with each closing about construction status, who contracted with whom, and what is the relationship, if any, between all these parties. To borrow a catchphrase from "Dragnet", an attorney needs "Just the facts, ma'am." Then armed with proper affidavits, waivers and subordinations, he can begin his quest for triumph over *claim of lien* evil.

March 2009

Chicago Title EXAMINER

VOLUME 3 / ISSUE 1

TALES FROM THE VAULT - CLAIMS (PREVENTION) STORIES

Your client is purchasing raw land and obtaining a purchase/construction loan. What do you do to assure priority and protection for your lender?

1. Check buyer judgments (yes, those judgments and federal tax liens that might already be filed against your client)!
2. Obtain appropriate affidavit, indemnity and waiver from the seller (new NCLTA Form 1, if no recent work, or Form 2, if any recent work such as an infrastructure developer selling).
3. Obtain subordinations (new NCLTA Form 3) from any providers of labor, services or materials (as defined under GS 44A, Article 2) who have already contracted with your client, the purchaser. See Dalton Moran Shook v. Pitt Development Co., 113 N.C. App. 707, 440 S.E.2d 585 (1994).
4. Make sure the deed of trust contains a complete (and completed) future advance provision in compliance with G.S. 45-68 et seq., including present obligations secured, maximum principal amount and the period of future obligations (no more than 15 years).
5. Notify your title insurer that construction and / or future advances are involved ASAP to discuss requirements, appropriate endorsements, owner's coverage amount and terms.

LEGISLATIVE CORNER

In this 2009 Long Session of the NC Legislature, watch for legislative proposals on the following, among an increasing list:

1. *Railroad Corridor*
2. *Partition Actions*
3. *Sales Information Reports - for tax departments*
4. *Good Funds - clarify ability to prosecute & impose criminal penalties for embezzlement of closing proceeds*
5. *Homeowners Association Foreclosure*
6. *Joint Tenancy with Right of Survivorship*
7. *Substitution of Trustee on Deed of Trust or Mortgage - where no trustee named*
8. *Limited Liability Company Amendments*
9. *Business Trust Amendments - GS 39-44 to 39-46*
10. *Creation of Trust by Judicial Order & Special Proceeding*
11. *Elective Share*
12. *Caveat - effect on estate*
13. *Estate Administration Procedures*
14. *Personal Representative Sale/Conveyance*
15. *Future Advance Statute Proposals*
16. *Presumed Termination of Deed of Trust without Maturity Date*
17. *Renunciation*
18. *Private Access Relocation*

Please be sure to volunteer to participate in any particular items that are of interest to you by contacting Katherine Wilkerson, the Real Property Section Legislative Chair, at kbw@lyncheatman.com. Some drafts are available on the Governmental Affairs website of the NC Bar Association, ncbar.org. Once drafted, bills and status will be available on www.ncga.state.nc.us --> Legislation/Bills.