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A Periodic Legal Update from the Construction & Surety Law Practice Group

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No Suit for You!

N.C. Lien Action Properly Dismissed Where "Owner" Owned Nothing When Work Began.

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In a controversial 2-1 decision released on October 2, 2012, the North Carolina Court of Appeals ("COA") affirmed a trial court's dismissal of a mechanic's lien claim asserted by contractors who did not have a contract with the "Owner" of the improved real property as of the date of first furnishing – even though the "Owner" ultimately acquired title to the land during the course of the contractors' performance.

Photo credit: tvland.com

The *John Conner Construction, Inc. v. Grandfather Holding Co., Inc.* decision is significant to the construction industry because it limits the reach of the term "Owner" as that term is used in North Carolina's mechanic's lien statutes. Since there was one dissenting vote from the three-judge panel, however, the case is likely to be reviewed by the N.C. Supreme Court, which could elect to expand who qualifies as an "Owner" for the purposes of the lien law.

An exploration of the facts, holding, dissent and practical implications of the *John Conner Construction* decision follows:

FACTS:

John Conner Construction, R&G Construction Co. and Eggers Construction Co. (together, the "Plaintiffs") entered into an oral "handshake deal" with Grandfather Holding Company, LLC

("GHC") in 2004 for the furnishing of all labor and materials required for infrastructure improvements needed to develop nearly 42 acres of land between Banner Elk and Linville. Plaintiffs began performing the work before GHC purchased the land in October 2005. Mountain Community Bank (the "Bank") financed the purchase and development of the property, and GHC executed a deed of trust on the land in favor of the Bank to secure the loan.

For reasons that are not apparent from the COA's opinion, Plaintiffs waited years before submitting a bill to GHC, finally requesting a payment of approximately $1.34 million in October 2007. GHC's president sought a draw from the Bank, but was informed that all but $262,000 of the loan balance had been expended. A partial payment in that amount was made to Plaintiffs, leaving over $1 million owed.

The Bank began foreclosure proceedings on the property in November 2008 and acquired title to the land shortly thereafter. Plaintiffs filed a $1.77 million claim of lien against the property in January 2009 and sued shortly thereafter, including the Bank in the suit as GHC's successor-in-interest to the land. The claim of lien upon which the suit was based alleged that materials were first furnished in May 2004. Plaintiffs' complaint alleged that formal land purchase negotiations did not begin between GHC and the prior owner until June 2005, ultimately culminating in an October 2005 purchase.

After a period of procedural maneuvering, the Bank filed a motion to dismiss Plaintiffs' complaint in December 2010 for failure to state a valid lien claim. That motion was granted by the trial court in February 2011, resulting in the dismissal of all claims Plaintiffs had asserted against the Bank and against the subject property. Plaintiffs appealed.

COA's ANALYSIS and RULING:

The appeal turned on whether Plaintiffs had a statutory right to file a claim of lien against the subject property under the facts and circumstances Plaintiffs had alleged in their claim of lien and complaint. The COA held that Plaintiffs had no such right and affirmed the trial court's dismissal of the claims against the Bank and the property.

The COA began its analysis considering the definition of "Owner" in the mechanic's lien statutes: a "person who has an interest in the real property improved and for whom an improvement is made and who ordered the improvement to be made." N.C. Gen. Stat. § 44A-7(3). The Court then noted it had previously held that a person who had entered into a purchase and sale agreement, but who hadn't yet acquired legal possession of the land subject to the P&S, possessed a sufficient equitable interest to qualify as an "owner" under the lien law. *Carolina Builders Corp. v. Howard-Veasey Homes, Inc.*, 72 N.C. App. 224, 324 S.E.2d 626 (1985).

Turning to the complaint's allegations, which the COA treated as admissions, the Court noted that GHC had no interest – legal or equitable – in the subject property at the time materials were first furnished in May 2004. These facts effectively meant that Plaintiffs did not have a contract with the "Owner" of the property, as that term is defined in the lien statutes and interpreted by

the *Carolina Builders* decision; as a result, Plaintiffs could not maintain a mechanic's lien action against the property. Addressing *Carolina Builders* directly, the COA stated that it was declining Plaintiffs' "implicit invitation to extend the holding of *Carolina Builders* to cases in which the party against whom a lien is sought was not yet under a contract for sale at the time an alleged contract for work/materials was entered into."

THE DISSENT

One of the three COA judges to consider the John Conner Construction case, Judge Robert N. Hunter, was troubled that GHC would not be considered an "Owner" in light of the fact that it acquired a legal interest in the property during the course of Plaintiffs' performance. Judge Hunter therefore wrote a dissenting opinion "in the hope that our Supreme Court will clarify" that a "subsequently acquired interest" in real property would support a mechanic's lien "even where no enforceable interest existed when the contract was made or [when] the work commenced." Judge Hunter further wrote that the majority opinion "produces a result contrary to the remedial nature of the lien statute," calling this result "inequitable" and "particularly troublesome" in light of the constitutional protections afforded mechanic's liens under Article X of the North Carolina Constitution.

In dissent, Judge Hunter states that the majority opinion is "inequitable" and "produces a result contrary to the remedial nature of the lien statute."

Should Plaintiffs desire further review of the case at the N.C. Supreme Court, the very existence of Judge Hunter's dissent provides them with a right to such review. Time will tell if Plaintiffs decide to exercise that right.

PRACTICAL IMPLICATIONS

In the interim, the COA's opinion in *John Conner Construction* is the "law of the land," and contractors may want to exercise a good deal of caution before entering into construction contracts with persons or entities lacking either a legal or equitable interest in the real property to be improved. Unless the N.C. Supreme Court reverses *John Conner Construction* – or the General Assembly modifies the definition of "Owner" – the lien law will provide no payment security to contractors in such instances.

Accordingly, and when presented with a contracting opportunity for which there may be no statutory payment security, contractors should consider a range of financial protections, including without limitation the following:

- No matter how well you know the owner, your financial risk is almost always too great to rely on a handshake deal. Always insist on a written contract that includes terms requiring payment on a periodic basis. Any subsequent failure by the owner to honor a

contractually compliant periodic payment request would constitute a breach of contract entitling you to suspend or terminate performance, minimizing your loss exposure.

- Try to negotiate for contract terms requiring the owner to disclose information regarding its financial condition, and make the disclosure obligation a continuing one until final payment is made.

- Try to negotiate for an alternative security mechanism, such as a personal guarantee. While I'd rather have a first-priority mechanic's lien over a personal guarantee every day of the week and twice on Sunday, the security of a personal guarantee is certainly better than no security at all.

*This article is adapted from a post originally published on Matt Bouchard's blog, **"N.C. Construction Law, Policy & News,"** which can be found at **www.nc-construction-law.com**.*