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Can You Fix An Early Construction Start?

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CAN YOU FIX AN EARLY CONSTRUCTION START?

Introduction

A construction project can involve various types of "Work" to be done under a timeline. For example, an office building is planned where an older, obsolete building is standing. Before real plans for the construction or even a concept for a new building are in place, the old building is torn down; or torn down and some preliminary foundation work performed such as soil stabilization. Later, the concept plans are finalized, working drawings are prepared, and a construction loan secured, closed with a recorded deed of trust, before any of the contemplated new construction is started, or a construction contract to build the new building signed. Several months after the building construction starts (after the filing of the construction deed of trust), one of the subcontractors files a mechanics lien affidavit (MLA) and later a lawsuit to judicially foreclose the mechanics lien; others follow. Then, the general contractor files bankruptcy and the construction deed of trust foreclosure is initiated. The subcontractors' attorneys say their clients' liens have inception when the old building was torn down and the soil stabilized for new construction, not when the construction contract was signed or the building work was started but long before the construction deed of trust was filed.

This paper discusses various title insurance "cures" for this scenario and other issues involving MLA's in relation to both the construction deed of trust or a subsequent "permanent" loan deed of trust, and how the title insurance regulations contained in the Texas Title Insurance Basic Manual (Manual) can be utilized to insure titles with outstanding MLA's.

Subcontractors Favored By The Courts

Subcontractors (especially the smaller ones) are favored under the law and the courts, and lawsuits involving mechanics liens are complex and filled with descriptions of uncertain facts, many of which are hard to prove. If the statutes are truly followed, the proof in court requires significant record keeping and attention to all kinds of details such as phone conversations, emails, discussed and partially signed or documented change orders, and other "facts", including retainage. If you really intend to do all of this, you would be unable to hire good subcontractors in the first place as they require prompt payment, disdain retainage in the smaller companies, and do not have, or want to spend the money or time, to adhere to all the details involved. Accordingly, it is difficult to ascertain whether or not any filed claim is within the statutory timeline unless a significant period of time has passed.

What is Priority and Broken Priority?

When the word "priority" appears in this paper, it is being used to describe a situation where a construction project has clearly not started, nor a general contract for the construction has been executed. No work has been done. No bulldozers are moving earth around; no construction fencing or screening erected; no fill dirt brought to the site or soil stabilization performed. Any of those actions before the construction loan deed of trust is filed could result in a "broken priority" which means that every subcontractors' mechanic's lien rights under the *Texas Property Code* are a prior right to the subsequently filed deed of trust which collateralizes the construction loan with the land and the improvements being constructed. A foreclosure of a deed of trust in which priority is broken does not "wipe out" the non-removable, subsequently filed

MLA's lien rights in the real property and improvements secured by the deed of trust. Couple this consequence with the fact that P-8 of the Basic Manual of Rates, Rules and Forms (the "Manual") provides no title insurance coverage for these unfiled (inchoate) liens, and it is not hard to understand that the lender cares a great deal about its priority, even if such lender priority does not trump removable mechanic's lien claims.

Construction Title Insurance Policies

Although we are concerned with the Texas common law and statues concerning the legal relationship between the lien rights of a contractor or subcontractor and the secured lender providing the money to pay them, the critical question is whether a title insurer will issue owner and loan policies to the owner and its construction lender providing some form of indemnity to protect the owner's title and the construction lender's lien priority with respect to those mechanics and materialmen's lien rights. In Texas, the answer is a partial, "Yes", but the indemnity provided is not what either the owner, the lender, or lender's counsel sometimes expect or really want.

In Texas, a construction loan deed of trust for a commercial development is insured with the promulgated loan policy called the T-2. There is nothing in that policy, as promulgated, that limits the indemnity provided to the lender with respect to mechanics and materialmen's liens, but the regulations governing title insurance found in the Manual require that two special provisions be included in all construction owner and loan title policies under Procedural Rule P-8. (See Appendix A.)

In the P-8 owner and loan policies, the indemnity provided to the insured owner and lender are limited to only "such liens . . . filed with the County Clerk . . . prior to the date hereof" (emphasis added) . The indemnity desired by the insured lender is for the unfiled, inchoate liens that might arise by subsequent filings during the course of construction, all of which are now excluded from the coverage of the construction loan policy by P-8, but the Down Date Endorsement later discussed provides a process to uncover and perhaps insure against filed MLA's.

In addition, the "Pending Disbursement" exception creates conditions to the coverage provided as follows:

> 1. The amount of insurance provided in the P-8 loan policy is not the face amount of the policy. It is the amount of the loan disbursed "in good faith", without knowledge, and then only if the Down Date Endorsement is provided.
>
> 2. The coverage increases as disbursements are made "in good faith" without knowledge (Actual knowledge, not constructive or imputed knowledge. See definitions in the P-8, T-2 loan policy under Conditions and Definitions of "knowledge".) of any defects in, or objections to the title which is limited primarily to the lender's actual knowledge of the borrower's failure to pay bills timely, failing financial strength of the borrower or a financially weak general contractor. However, it can include actual knowledge of any "defect" or "objection" to the title.

The bottom line is the owner and its lender may have actual knowledge of inchoate lien claims, primarily from the statutory notices required of subs to be provided to the owner/borrower before being filed or by virtue of emails, phone calls, or other collection attempts. See Section 53.056 of the *Texas Property Code*.

Title search: Can You Fix an Early Construction Start?

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