

**PRESENTED AT**  
**53<sup>rd</sup> Annual William W. Gibson, Jr.**  
**Mortgage Lending and Servicing Institute**

September 12-13, 2019  
Austin, Texas

## **Lien Priority and Subordination: Mitigating Risk in Commercial Lending**

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## I. INTRODUCTION

In Texas, both by statute and under the Constitution, mechanics and materialmen are entitled to a lien for labor and/or materials provided. This entitlement to lien is broad, and virtually anyone who provides labor or material in connection with a construction or repair project involving improvements on privately owned real property may be entitled to a lien.<sup>1</sup> As a matter of public policy, lien claimants, especially less sophisticated ones, are favored by the courts, and a properly perfected mechanic's lien often gives such claimants meaningful leverage over a property owner. However, a lien claim does not have to be properly perfected to create issues for a property owner, particularly a would-be borrower. When construction has commenced, whether intentionally or inadvertently prior to lender financing being in place, the result is what is commonly referred to as "broken priority." In this situation, it is potential ("inchoate") mechanic's liens, not perfected mechanic's liens, that are the more challenging risk to mitigate.

This paper will provide an overview of mechanic's lien laws in Texas. First, it will offer a general introduction to mechanic's liens and how they function, answering common questions about who can make claims, what these claims cover, and what property can be burdened by these claims. Second, it will discuss some of the technical rules for filing and perfecting different types of claims, addressing certain perfection pitfalls to be aware of. Third, it will provide an overview of lien priority in Texas, with a focus on specific issues that arise when construction starts before lender financing is in place. Finally, it will provide practical guidance on how to mitigate the risks mechanic's liens pose in the context of construction lending. The scope of this paper will be limited to private commercial construction projects, and will not provide guidance on government construction contracts.

## II. MECHANIC'S LIENS AND HOW THEY WORK

There are two types of mechanic's liens in Texas: constitutional liens and statutory liens. The Constitutional lien is the original mechanic's lien, legally grounded in Article 16, Section 37 of the Texas Constitution which provides:

*Mechanics, artisans and material men, of every class, shall have a lien upon the buildings and articles made or repaired by them for the value of their labor done thereon, or*

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<sup>1</sup> TEX. PROP. CODE § 53.021

*material furnished therefor; and the Legislature shall provide by law for the speedy and efficient enforcement of said liens.*<sup>2</sup>

Chapter 53 of the Texas Property Code, hereinafter referred to as the “Property Code,” codified the public policy underlying the constitutional lien and created the statutory lien; it did not however supersede the constitutional lien. Constitutional liens are self-executing and do not require compliance with the notice and filing provisions in the Property Code. Thus, where an eligible claimant may have lost eligibility for a claim under the Property Code, because, for example, it missed a deadline to give notice or file an affidavit, such claimant may still have a claim under the Texas Constitution. Statutory liens are governed Chapter 53 of the Property Code. Perfection of a statutory lien requires strict adherence to the Property Code. What is specifically required for perfection depends on what type of claim is being made and whether it is being filed by an original contractor or a derivative claimant.<sup>3</sup>

This section will provide a general overview of mechanic’s liens broadly covering lien function, eligibility and the value of a claim as well as a discussion of derivative claims.

**A. Function of a Mechanic’s Lien.** A mechanic’s lien secures a debt owed by a property owner to a person or entity that has provided either labor or materials in the construction or repair of certain types of improvements to privately owned real property.<sup>4</sup> Like any lien against real property, when properly perfected it burdens both the improvements and the real property upon which they sit. The real property encumbered by a mechanic’s lien can be quite expansive: when the improvements are located on only a portion of a lot in an urban area, the entire lot is subject to the lien;<sup>5</sup> when the improvements are located on rural land, there is a fifty (50) acre maximum on the amount of land that can be burdened.<sup>6</sup> It is a recommended best practice that potential lenders and purchasers obtain title reports as part of their standard due diligence on real property, a mechanic’s lien functions to notify these potential lenders and purchasers of an owner’s obligation to the lien claimant. These liens can therefore directly impact a property owner’s ability to sell or

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<sup>2</sup> TEXAS CONST., Art. 16, Sec. 37

<sup>3</sup> TEX. PROP. CODE § 53.052(a)

<sup>4</sup> TEX. PROP. CODE § 53.021.

<sup>5</sup> See *Williams v. Owen*, 111 S.W. 2d 1182, 1183-84 (Tex. Civ. App. —Fort Worth 1937, no writ).

<sup>6</sup> TEX. PROP. CODE § 53.022(d).

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First appeared as part of the conference materials for the  
53<sup>rd</sup> Annual William W. Gibson, Jr. Mortgage Lending and Servicing Institute session  
"Lien Priority and Subordination"