

**PHASE THREE:    PROTECTING AGAINST AND LITIGATING  
CONSTRUCTION LIENS**

**Matthew C. Norris, Esq.  
Freeman, Cotton & Norris, P.C.  
33 Bloomfield Hills Parkway, Suite 100  
Bloomfield Hills, Michigan 48304  
(248) 642-2255  
(248) 642-6460 fax  
e-mail: [mnorris@fcnlaw.com](mailto:mnorris@fcnlaw.com)**

# **PROTECTING AGAINST AND LITIGATING CONSTRUCTION LIENS**

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## **Introduction**

The Construction Lien Act provides security for enforcement of claims which arise through contract. Those contracts may be in writing and may be multi-page, negotiated contracts; the contracts may be multi-page written contracts not subject to negotiation; contracts may be a one-page proposal, or there may be enforceable verbal contracts. Also, many of the contracts which give rise to disputes between parties involve extras, or additional work to the contract.

The rights described in these materials under the Michigan Construction Lien Act apply to various methods to enforce contract disputes by parties.

This discussion will focus on the small-to medium- sized commercial or industrial construction project. This discussion does not address issues involving the homeowner's protections afforded in the residential construction arena.

### **I. Applicability - The Michigan Construction Lien Act applies to private projects, not public projects.**

The Michigan Construction Lien Act is contained at MCL 570.1101, et seq. 1980 Public Act No. 497. The Construction Lien Act enacted in 1980 completely overhauled the former, 1890's-era "Mechanics Lien Act".

The Michigan Construction Lien Act is much more codified than the former Mechanic's Lien Act. Nevertheless, many of the ambiguities or contradictions contained in the Construction Lien Act are resolved by appellate decisions.

The Construction Lien Act applies to private projects, only. The Depression – era legislation which required payment bonds on public jobs was concerned with lien claims being filed on public properties owned by the taxpayers. The legislature addressed the concern that, in the event of a shortfall on a public construction building, the taxpayers would be asked to subsidize any loss in the project.

Therefore, as to those “public” projects, various statutes require the issuance of a Performance Bond and labor and material Payment bond, prior to a contract being issued. [Those statutes are not discussed in detail here, but include the state Construction Public Building Act, MCL 129.201 et seq. (The “Little Miller” Act); the Miller Act dealing with Federal projects 40 U.S.C. 270a et seq.; and the Michigan statute governing state highway contracts, MCL 570.101 et seq.]

The determination of what constitutes a “private” job lies at the fee ownership of the real estate. In Milbrand Co. v Department of Social Services, 117 Mich App 437 (1982), the Court of Appeals ruled that, where a state entity was leasing space in a privately owned shopping center, the Michigan

Construction Lien Act applied. Therefore, the Public Payment Bond Statute was not applicable.

Even in those situations where labor and material payment or performance bonds are not required by statute, parties to contracts on larger projects may agree to labor and material Payment and Performance bonds prior to issuance of the contract. For example, some projects have construction financing which is contingent upon occupancy by a non-negotiable deadline. In those situations, owners may require a Performance bond, so that if the contractor is not able to meet the strict construction deadline, the owner may have a bond surety to rely upon to complete the project. Such Performance bonds are often issued simultaneously with labor and material Payment bonds. These bonds are contractual in nature and are not required by the public building statute. Therefore, any additional notice or other requirements contained in those contractual bonds may be enforceable. These additional notice requires may be enforceable, even beyond the minimal notice requirements contained in the public bonding statute, because the projects are private and the bond is a contractual (not statutory) requirement.

**II. Preliminary considerations and the use of a Notice of Commencement to facilitate the flow of information.**

The Notice of Commencement is used to facilitate information regarding the ownership and legal description of the project. The statutory Notice of

Commencement form is attached. For commercial projects, the residential disclaimer “Warning to Homeowner. . .”, may be deleted from the form.

A Notice of Commencement should be completed as part of the standard financing documentation. The Notice of Commencement should be executed by an authorized representative of the project owner. The Notice of Commencement should be recorded in the County Register of Deeds in the county where the project is located, as soon as possible. Provision is also made in the statute for posting a copy of the Notice of Commencement at the project location.

The Notice of Commencement must contain the legal description for the construction project. The Notice must also list the name of the fee owner and the general contractor for the property. Optional items for the notice include a “Designee,” and the identity of a party with less than fee ownership interest, but contracting for improvement.

A complete Notice of Commencement should also include such parties such as land contract purchasers, optionees, tenants, or other parties with a substantial interest in the completed project.

A complete Notice of Commencement should list a Designee, as one in capacity for a project owner to receive Notices of Furnishing and other notices. For example, a large development entity (or an out of state entity) may use a local attorney or title insurance company to handle receipt of notices and act as Designee.

The Notice of Commencement is a “directory” of information regarding the project, which subcontractors, suppliers and other lower-tier parties may not have otherwise had regarding the identity and legal description for the property.

The recording of the Notice of Commencement provides notice to potential lien claimants of the project ownership. The Notice of Commencement will also force potential lien claimants to adhere to the Notice of Furnishing requirements regarding the service of a Notice of Furnishing. Where an ownership party does not record a Notice of Commencement (or records a Notice of Commencement long after construction of the project has commenced), a lien claimant may not have its lien defeated by its tardy service of Notice of Furnishing. [There are other factors affecting the ultimate lien validity and priority, including use of Sworn Statements, discussed below.]

Parties who have more than one contract to build multiple units may wish to record several Notices of Commencement (one for each lot or unit or separate project). Combining several projects under one Notice of Commencement may lead to confusion as future disbursements are made and lien issues are considered.

Also, in the event a contractor is terminated (or abandoned) its contract with the project owner, the owner may want to consider preparing and recording a termination of Notice of Commencement, memorializing that the relationship with the previous general contractor has been terminated.

### **III. Periodic payment draws: Sworn Statements and Notices of Furnishing**

The contract between owner and general contractor may provide for periodic payments from the owner to the general contractor, such as on a monthly basis. Such periodic payments may be made pursuant to a Future Advance Mortgage. If such payments are made pursuant to a Future Advance Mortgage, the relation between notices of furnishing and sworn statements become more significant.

Pursuant to Section 119 of the Construction Lien Act, MCL 570.1119(4) provides that:

An advance made pursuant to the mortgage, but subsequent to the first actual physical improvement shall have priority over construction lien if, for that advance, the mortgagee has received the contractor's sworn statement as provided in Section 110, has made disbursements pursuant to the contractor's sworn statement, and has received waivers of lien of the contractor and all subcontractors, laborers, and suppliers who have provided notices of furnishing. The construction lien of any lien claimant not set forth on the sworn statement upon which an advance was made shall be subordinate to the lien or the mortgage, including the advance, unless prior to the advance the lien claimant has provided the designee a notice of furnishing if required by Section 109 or has recorded a claim of lien.

Therefore, there are two documents involved in periodic payment draws which both involve the priority of a lien claimant relative to a mortgage advance: The Sworn Statement and the Notice of Furnishing.

The **Sworn Statement** is discussed in section 110 of the Construction Lien Act. The Sworn Statement shall be provided when payment is due to the contractor or when a demand for the Sworn Statement has been made by or on behalf of the owner (or lessee). MCL 570.1110(1).

The general purpose of the Sworn Statement is that an owner or lender may rely upon the names listed in the Sworn Statement corresponding to periodic payment draws, when that owner or lender issues payment. The statutory form of the Sworn Statement is contained in the statute. The statutory Sworn Statement form should be used whenever possible. However, the Eastern District of Bankruptcy Court has interpreted the provisions of the Sworn Statement liberally, In re Craft (120 BR 84) (Bkctcy, E.D. Mich. 1989).

On larger construction projects, the AIA Pay Application may be used, although the pay application has different descriptions of its columns listed, (including materials stored, percentages of completion, and retainage). A better course would be to use the AIA Pay Application document **combined with** the Sworn Statement form provided in the Construction Lien Act.

Falsifying a Sworn Statement amounts to a felony if for more than \$100, if the contractor or subcontractor intended to defraud, MCL 570.1110(10). Also, falsifying a Sworn Statement has given rise to personal liability of a corporate

officer Au Bon Pain Corp. v Artect, Inc., 653 F.2d61 (2<sup>nd</sup> Cir., NY, applying Michigan law 1981).

On the issue of the form of the Sworn Statement, the AIA Pay Application forms may satisfy the Sworn Statement requirement, because the Pay Application form is notarized and therefore meets the requirement that it be “sworn”.

The form of the Sworn Statement should not be so liberal as to state “see attached,” with a loose format, giving rise to possible clerical and other errors. At least one case of personal liability of a building contractor has turned on whether the Sworn Statement was in fact notarized. Therefore, an unnotarized document sent via facsimile should not be relied upon.

The obligation of an eventual lien claimant (subcontractor, supplier or laborer) is first addressed in the **Notice of Furnishing**. A subcontractor or supplier shall provide a Notice of Furnishing to the designee and general contractor by certified mail, within 20 days after furnishing the first labor or materials. MCL 570.1109(1). This 20 day requirement is subject to several exceptions.

A general contractor working pursuant to a contract directly with an owner or lessee need not provide a Notice of Furnishing. The Notice of Furnishing and Notice of Commencement requirements for a residential project are slightly different and are not discussed here. Also, the time requirements for a “laborer” to provide a Notice of Furnishing are also not discussed here.

The Notice of Furnishing form is also contained in the statute and is attached to the materials.

The interplay between Sworn Statement, Notice of Commencement and Notice of Furnishing is shown by the exceptions to the time requirements within which to furnish a Notice of Furnishing. That is, the failure of a lien claimant to provide a Notice of Furnishing within the time specified in MCL 570.1109 *shall not defeat* the lien claimant's right to a construction lien for work performed or materials furnished before the service of the Notice of Furnishing, **except** to the extent that payments were made on behalf of an owner to the contract or pursuant to a Sworn Statement (or lien waiver given by the lien claimant). The payment by an owner or a lessee to a contractor pursuant to the Sworn Statement takes on heightened significance when viewed with the exception to the time requirements contained in MCL 570.1109(6).

Two cases have acted to liberalize the requirement of the Notice of Furnishing. First, in Vugterveen Systems, Inc. v Olde Millponde Corp., 454 Mich 119 (1997), the Michigan Supreme Court held that the Notice of Furnishing requirement was to be liberally construed. The subcontractor providing drywall was not held to the Notice of Furnishing statutory time frame, where the owner had personally walked the property with the subcontractor. (At the time, the owner was having problems acting with the general contractor, and the project was being built in separate phases or buildings.) The Court held that the actual verbal notice, via the meeting between owner and subcontractor, constituted

statutory substantial compliance with the Notice of Furnishing requirement. Therefore, the Construction lien was upheld.

The Vugterveen case begs the question, what else could constitute actual notice to an owner, for giving the Notice of Furnishing requirements? Many large projects have preconstruction meetings at which attendance is taken: could that attendance sheet satisfy the Notice of Furnishing requirement? Could a subcontractor's bid, given to the owner, satisfy the requirement? Could verbal or other notice given to an owner's representative or architect satisfy the requirement?

The case of MPC Cashway Lumber Co. v Hall, 238 Mich App 441 (1999), further liberalized the Notice of Furnishing requirement for lien claimants. Although a residential case, the decision is illustrative. In MPC Cashway, a lumber supplier had requested a Notice of Commencement on the first day it delivered materials for a home improvement project, but the homeowner made no response. The court held that the lumber supplier's failure to provide a timely notice of furnishing did not preclude collection by the lumber supplier, except to the extent that the homeowner had paid the contractor pursuant to a valid Sworn Statement.

The Vugterveen and MPC Cashway cases both demonstrate liberalization of Notice of Furnishing requirements in order to meet the purposes of the Construction Lien Act.

Technically, Sworn Statements are also required to be provided by a subcontractor when payment is due (or when demand for a sworn statement is made upon a subcontractor). In those situations, the same rules governing Notices of Furnishing, payment pursuant to Sworn Statements and priority involving general contractors, will also apply to subcontractors.

Closely monitoring receipts of Notices of Furnishing, and making payments pursuant to Sworn Statements, can avoid or minimize financial problems which may only mushroom later in the project. An owner who is concerned that its general contractor is either not financially viable, or underbid the project, should closely monitor Sworn Statements and receipt of Notices of Furnishing, so as to not be later “surprised” if there are unpaid subcontractors and suppliers filing Claims of Lien.

#### **IV. Lien waivers.**

The use of lien waivers is an integral part of construction financing. The statutory forms attached to the materials include four different lien waiver forms: Partial Unconditional; Partial Conditional, Full Unconditional; and Full Conditional Waivers. The statutory forms are attached.

Unlike other states, a contract which provides for an advance waiver of lien rights, is not enforceable in Michigan. MCL 570.1115(1). Nevertheless, there are out of state general contractors, doing business in Michigan, whose contracts provide such advance contractual lien waiver language.

Lien waivers are carefully scrutinized and are disfavored at law: waivers obtained as part of the contract are contrary to public policy and shall be invalid (except to the extent that payment is actually made to the to the person giving the waiver). MCL 570.1115(1). The statute also provides that merely accepting a promissory note or other evidence of indebtedness does not of itself serve to waive or discharge otherwise valid construction lien rights.

The statute provides for issuance of a full or partial lien waiver upon payment being made to a lien claimant. Under the former Mechanics Lien Act, a supplier who executed a lien waiver voluntarily in anticipation of receiving full payment, when payment proved worthless, did not affect the validity of the lien waiver. The lien waiver was effective even though the check bounced, Pooler-Dickie v Strother Co., 60 Mich App 321 (1975).

One way to prevent a waiver from becoming effective is for the lien claimant to provide written notice that the consideration for the waiver has failed under Section 115(6) of the Construction Lien Act.

Also, retainage is not waived by submission of a lien waiver pursuant to MCL 570.1115(5).

The time/dates stated on partial lien waiver forms provide a potential trap for the unwary.

Many contracts provide for payment of construction “lag” draws, whereby material or labor completed through the end of one month, is approved and submitted for billing the next month, but not paid until the month thereafter. For

example, work completed through December 30, 2001 may be submitted for billing by January 25, 2002 and not paid until February 15, 2002. In this situation, the difficulty is with the language of the partial waivers:

“ . . . hereby waive our construction lien to the amount of \$ \_\_\_\_\_ for labor/materials provided through \_\_\_\_\_(date). This waiver, together with all previous waivers, if any (circle one) does/does not cover all amounts due us for contract improvement as provided through the date shown above.”

In our example, the lien claimant should state that the labor and materials have been paid through December 30 (if that is the case) and circle “does” cover all amounts due for contract improvement provided through the date shown above. The partial lien waiver form itself has a line for the document to be dated, which often leads to confusion when the “through date” is also executed as the date of the waiver having been signed.

**V. If a dispute is not yet resolved, then a Claim of Lien is filed.**

If payment to a lower tier subcontractor, or supplier, or final payment to the general contractor is not resolved, resort may be made to the Claim of Lien. Section 107 of the Construction Lien Act governs who is entitled to a construction lien, and Section 111 of the Construction Lien Act governs the specifics of recording a Claim of Lien.

One who is entitled to a construction lien is one who provides a “improvement”, broadly defined in Section 104(7) of the Act, and including surveying, engineering, architectural planning, construction management, clearing

demolishing, excavating, constructing altering, repairing, ornamenting, landscaping, paving, leasing equipment and other construction labor and material.

The definition of “actual physical improvement”, contained in Section 103(1) of the Construction Lien Act, is more narrow than merely an “improvement”. The interpretation of the definition of “actual physical improvement” is relevant when priority of lien claimants relative to the mortgage encumbrance interest is litigated.

The Claim of Lien must be recorded *within 90 days* of the lien claimant’s *last* furnishing labor or materials to the project. A lien claim extends to the entire interest of the owner or lessee who contracted for the improvement, including subsequently acquired legal or equitable interests. However, when a person contracting for the improvement as land contract vendee or lessee has its rights forfeited or otherwise terminated, the lien claimant may perform the covenant contained in the land contract or lease within 30 days from receiving actual notice of the forfeiture or termination in order to preserve its rights.

In disputes between owners (whose lessees have been terminated) on one hand, and lien claimants on the other hand, a secondary issue is also often examined – whether improvements were made at the requirement of the lessor, therefore the terminated lessee became the implied agent of the lessor, requiring the improvements.

A Claim of Lien must be recorded within 90 days of the last furnishing of labor or material, MCL 570.1111(1). If the last day is a Saturday, Sunday or

holiday, the lien may be recorded the next day the court is open, Superior Products Co. v Merucci Bros., Inc. 107 Mich App 153 (1981).

A common issue is what constitutes “last providing of labor or material”, for purposes of the lien recording deadline. The Court of Appeals held that returning to work to perform “warranty” work does *not* make qualify for work under the original contract. However, the Court in Woodman v Walter did not describe the facts of that case as to what constituted “warranty” work.

A lien claimant who twice mailed its Claim of Lien to the Register of Deeds and had it returned as insufficiently recordable, did not substantially comply with the statute and did not have a valid lien claim. The scope of analysis to determine whether a lien claimant has substantially complied with the recording requirements of the statute is done on a case by case basis of the following factors: the overall purpose of the statute; the potential for prejudice or unfairness when the apparent clarity of the statutory provision is replaced by the uncertainty of a “substantial compliance” clause; The interests of future litigants and the public; the extent to which the court can reasonably determine what constitutes “substantial compliance” within a particular context; and the specific language of the statute. Northern Concrete Pipe, Inc. v Sinacola Companies-Midwest, Inc., 461 Mich 316 (1999).

**VI. Litigation of a Claim of Lien.**

Once a Claim of Lien has been recorded, suit for lien foreclosure must be filed within one year of the date that the Claim of Lien was recorded. MCL 570.1117(1).

A party who files suit must name all parties who have an interest in the real property involved in the action which interest would be divested or otherwise impaired by the lien foreclosure. Practically, this means that one lien claimant should bring in all other lien claimants as necessary parties defendant, as well as the mortgagee, owner and other parties with an interest in the property. In the event more than one case is filed, the Court will likely consolidate actions so the property is not foreclosed more than once. In those instances, where a lien claimant does not specifically object to another lien claimant's lien claim, it is not necessary for lien claimants to answer complaints and crossclaims of other lien claimants, unless one of them disputes the validity or the amount of the lien of the other, MCR 3.412.

In those cases where there is a contractual arbitration clause between the parties, the right of parties to proceed to Circuit Court with lien foreclosure must be reconciled with the right of the parties to a contract containing a clause for mandatory arbitration. In those cases, it is often practical to submit the matter to arbitration (if required by contract) while putting the case on a 90- or 120-day administrative stay, and leaving the liens in place so that the Court need only enforce the arbitration award by later foreclosure of liens.

Also, if the case is submitted to Case Evaluation (formerly “mediation”), parties may stipulate that no evaluation award is appropriate against a mortgagee. Where a mediation figure was accepted by all parties, the contract damages were fixed, while the court was still required to address the lien foreclosure aspects, Dane Construction, Inc. v Royal’s Wine and Deli, Inc., 192 Mich App 287 (1991).

In those cases where a project is not complete and appointment of a receiver may be helpful to complete the project, Section 122 of the Construction Lien Act provides for appointment of a receiver. A receiver may not be appointed under that provision of the Construction Lien Act for any residential structure nor for an apartment building containing four or fewer apartments. Section 118 of the Construction Lien Act provides that the Court *may* award reasonable attorney’s fees to a lien claimant who is the prevailing party and that the court may allow reasonable attorney’s fees to a prevailing Defendant if the Court determines that the lien claimant’s action was vexatious.

**VII. Issues regarding priority of lien claimants over mortgage and other interests.**

The priority of construction liens over the mortgage encumbrance interest is addressed in Section 119 of the construction Lien Act. The importance of the priority of the construction liens over mortgage encumbrances is critical when there are problems with the project and there is no equity in the project (the lien claims plus mortgage(s) exceed the value of the property). The priority of the lien

claim over the mortgage may also trigger title insurance coverage, if a lender had obtained a title insurance policy.

The important provisions of Section 119 of the Construction Lien Act are that as between parties entitled to claim construction liens, all valid lien claims are treated as having equal priority. MCL 570.1119(1). Therefore, the painting subcontractor will have the same lien priority as the excavation subcontractor, although the painter may have performed its work long after the excavator.

A construction lien has priority over a subsequent recorded mortgage encumbrance, when the mortgage is recorded **subsequent to** the first actual physical improvement. Therefore, one may need to examine records of work which took place early on in the project, to determine whether first actual physical improvement occurred prior to the mortgage encumbrance recording.

A clear historical perspective of priority of construction liens and mortgages is contained at MD Marinich, Inc. v Michigan National Bank, 193 Mich App 447, appeal denied 441 Mich 921, reconsideration denied (1992). That opinion cites an example of the traditional lending officer, who would visit the property prior to lending funds against the project, to determine whether construction had in fact begun.

The more common factual setting arises under provisions of Section 119(4) of the Construction Lien Act. That is, as to advances made pursuant to the mortgage, but subsequent to the first actual physical improvement, an examination of the Sworn Statements and Lien Waivers is required. Litigating an

issue of priority of a lien claim against a mortgage advance made pursuant to the mortgage, is document intensive and involves must discovery.

For a mortgagee who has recorded Future Advance Mortgage *before*, but where an advance comes *after* the first actual improvement, the mortgagee must obtain lien waivers from all subcontractors and suppliers who have provided notices of furnishing, and the mortgagee must have made disbursement pursuant to the contractor's Sworn Statement.

Where a construction project came to a halt, and the use of the building was altered (in its commercial/residential mix), then a new contractor hired, the Court of Appeals held that lien claimants had priority relating back to the original work done by the original general contract. Marinich, supra.

**VIII. Other claims: The Builder's Trust Fund Statute and Quantum Meruit (or unjust enrichment) claim.**

The Builder's Trust Fund Statute, MCL 570.151-153 provides that funds which a contractor receives are trust funds for the benefit of subcontractors, suppliers and laborers. Beside providing for a criminal violation, a violation of the building contract fund statute gives rise to a civil cause of action. Further, the violation of the statute may result in personal liability to a building contractor. Such liability has been held to constitute "embezzlement or defalcation", therefore non-dischargeable pursuant to Bankruptcy Code Section 523(a)(4).

Therefore, a contractor must account for funds paid to it. Since the contractor is a trustee, the burden of proof will fall on that contractor to show how the funds were properly applied (the burden of proof is not on the Plaintiff supplier or subcontractor), In Re: Little, 163 BR 497 (Bankruptcy E.D. Mich 1994).

Some unpaid subcontractors or suppliers may also file suit for **unjust enrichment or quantum meruit** directly against the project owner, on the theory that the owner has been unjustly enriched at the expense of the unpaid subcontractor or supplier. The defense made to these “unjust enrichment” claims is lack of privity between owner and subcontractor.

In the event of an irreconcilable difference between contractor or owner on one hand and lien claimant on the other, the contractor or owner may file a surety bond to discharge the Claim of Lien. Section 116 of the Act governs the surety bond requirements, which must be in the amount of two times the amount of the lien claim.

If such an owner or contractor files the surety bond with the County Clerk, the lien claim will be discharged and no longer be on the title. The certificate evidencing the bond filing may be recorded with the Register of Deeds in full discharge of the Claim of Lien.