Equitable Liens: An Important Protection for Contractors and Suppliers

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Equitable liens protect contractors and suppliers when statutory liens on real property are worthless. When an owner of a construction project defaults under its construction loan, the lender may foreclose on the property being improved. Typically, the lender will have a first priority deed of trust securing the construction loan that trumps any statutory contractors’ liens. As the North Carolina Supreme Court recognized, “[w]hen a contractor’s lien is subordinate to a construction loan mortgage . . . or to prior encumbrances such as a purchase money mortgage, any lien on the owner’s property or its improvements is worthless when the owner is insolvent.” Embree Constr. Group v. Rafcor, Inc., 411 S.E.2d 916, 921 (N.C. 1992). In this situation, the common law provides a necessary protection for contractors and suppliers, whose work and material have benefited the property and enriched those whose rely upon that same property for security for loans.

Recognizing that “materialmen, rather than the mortgagee, should have the benefit of materials that go into the property and give it value,” the North Carolina Supreme Court held that a contractor may obtain an equitable lien on funds that is enforceable by a direction to pay the contractor out of the fund. Id. at 920 (citing Carolina Builders Corp. v. Howard-Veasey Homes, Inc., 72 N.C. App. 224, 229, 324 S.E.2d 626, 629 disc. rev. denied, 313 N.C. 597, 330 S.E.2d 606 (1985)). The Supreme Court based its holding on the purpose of North Carolina’s lien statute, which “is to protect the interest of the contractor, laborer or materialman.” Id. The Court noted, “Chapter 44A does not provide relief for the contractor or subcontractor, in privity
of contract with only the insolvent owner, who seeks payment from construction loan funds held by the lender.”  *Id.*  “Notably, however, Chapter 44A does not expressly bar equitable relief to this end.”  *Id.*

In the case of *Embree*, the North Carolina Supreme Court noted that equitable liens had been recognized in other jurisdictions. Following these decisions in other jurisdictions, the Court held that the plaintiff contractor had alleged sufficient facts in its complaint to state a claim under North Carolina law for an equitable lien in an undisbursed construction loan balance against the construction lender where the lender had been unjustly enriched. Specifically, the plaintiff contractor had completed the construction of a restaurant pursuant to its contract with the owner in accordance with the contract plans, specifications and requirements. When the owner did not pay the plaintiff the balance owed under the construction contract following completion of the work, the plaintiff contractor notified the lender of the amount due and asked to be paid from the balance of the construction loan. The North Carolina Supreme Court held that when the lender refused to disburse the money remaining in the construction loan despite receiving all the security for which it had bargained – in the form of a completed restaurant – the lender had been unjustly enriched at the expense of the plaintiff. The Court found an equitable lien in plaintiff’s favor upon the undisbursed loan balance and found that the court could direct the bank to pay the plaintiff the amount of the equitable lien pursuant to the Court’s equitable powers. 411 S.E.2d at 922–923.

In deciding the *Embree* case, the North Carolina Supreme Court examined a line of federal decisions finding an equitable lien upon undisbursed construction loan balances in favor of unpaid contractors against HUD in order to prevent HUD’s unjust enrichment. The cases cited by the North Carolina Supreme Court in *Embree* include *Spring Constr. Co. v. Harris*, 562
F.2d 933 (4th Cir. 1977); Trans-Bay Eng’rs & Builders, Inc. v. Hills, 551 F.2d 370 (D.C. Cir. 1976); and Bennett Constr. Co. v. Allen Gardens, Inc., 433 F. Supp. 825 (W.D.Mo. 1977). These federal decisions, including the Fourth Circuit Spring case, were recently examined and applied by the United States District Court for the Eastern District of North Carolina in Shelco, Inc. v. Shaun Donovan, in his official capacity as Secretary of the United States Department of Housing and Urban Development, et al., Case No. 5:11-CV-721-BO, where the Court awarded summary judgment in favor of the plaintiff, Shelco, in the principal amount of $700,754.00 for its equitable lien claim against HUD. 2013 WL 5817295 (Judgment entered October 29, 2013). In these cases, the courts have found two requirements for the imposition of an equitable lien: (1) an identifiable res to which an equitable lien can attach and (2) facts giving rise to the equitable lien, namely unjust enrichment.

Undisbursed construction loan proceeds and retainage constitute an identifiable res to which an equitable lien can attach. In Spring, the Fourth Circuit found the identifiable res in two ways:

First, the retainages which had accumulated until the date of the shutdown are identifiable and were intended eventually to compensate the plaintiff for its work. Second, the balance of the undisbursed loan proceeds also constitute an identifiable res, their purpose being to compensate those who further the housing projects, including the contractors. Even if those undisbursed proceeds have now been commingled with other general HUD accounts, they continue to retain an identity as loan proceeds originally earmarked and intended for disbursal to the project contractor.

1 In Shelco, the parties reached a settlement within two months after the judgment was entered and prior to the filing of an appeal by the defendants. The settled outcome included the parties' agreement that the judgment against HUD should be vacated and the underlying lawsuit should be dismissed without prejudice. 2014 WL 279565 (Order entered Jan. 24, 2014).
562 F.2d at 937 (internal citations and quotation marks omitted). In *Trans-Bay*, the court similarly found that the undisbursed mortgage proceeds created by the retainage “hold-back” were an identifiable res subject to the control of HUD on which an equitable lien could be placed, and held that the plaintiff contractor was entitled to an equitable lien on those amounts. 551 F.2d at 382. Likewise, in *Bennett*, the District Court for the Western District of Missouri found that the undisbursed loan proceeds had been intended by the parties to be paid to the contractor for full completion of the project, and that the loan balance and contract retainage constituted an “identifiable res” in which an equitable lien would be recognized in favor of the plaintiff contractor. 433 F.Supp. at 835.

**A lender or mortgage insurer’s failure to disburse loan proceeds or retainage may result in unjust enrichment, giving rise to the need for an equitable lien.** Federal and North Carolina common laws are clear that a lender or mortgage insurer, like HUD, is unjustly enriched as a matter of law where it forecloses on or takes assignment of a fully completed project, but has not authorized the full disbursement of the construction loan. In *Trans-Bay*, the contractor completed construction of the project but was not paid the final one-half of his retainage “hold-back” because the owner defaulted under its HUD-insured mortgage loan and there accordingly was no “final closing” of the loan. 551 F.2d at 373-375. The insured lender assigned the defaulted mortgage to HUD, and HUD subsequently foreclosed on the project, with the contractor owed unpaid retainage of $233,653 and with the final loan balance of $300,000 undisbursed. *Id.* at 375.

The D.C. Court of Appeals first found that the issue before it – whether HUD had an obligation to the plaintiff contractor not rooted in contract, but rather based on equitable rights – was dependent on “federal common law.” *Id.* at 377. The court found that under federal
common law, HUD had been unjustly enriched by the value of the plaintiff contractor’s uncompensated construction services. *Id.* at 381-382. Noting that the mortgagee-lender was fully insured on the loan by HUD, that HUD had the remedy of foreclosure, and that the single asset owner’s loss was limited to the project itself, the court found that the contractor alone was not protected and not even able to use the state law mechanic’s lien remedy normally available. *Id.* at 382. The court stated that it did not square with the court’s “notions of good sense and fair dealing” for the risk of loss to be borne solely by the contractor. *Id.* at 382. The court found that the plaintiff contractor was entitled to an equitable lien on the undisbursed mortgage proceeds created by the retainage “hold-back”. *Id.* at 382.

In another case, *Bennett*, involving facts similar to *Trans-Bay*, the mortgagor-owner defaulted under the mortgage loan following substantial completion of the project but prior to final completion. 433 F.Supp. at 829. The lender filed a formal notice of default and assigned the defaulted mortgage loan to HUD following project completion. *Id.* at 829-830. HUD did not approve disbursement of the final loan proceeds because there had been no “final endorsement” or closing of the loan due to the owner’s default. *Id.* Following the lender’s assignment of the loan to HUD, HUD foreclosed on the completed project. *Id.* at 830. In *Bennett*, the District Court for the Western District of Missouri stated that it was applying precepts of federal common law in deciding the case. *Id.* at 831-832. The court found that the undisbursed loan proceeds had been intended by the parties to be paid to the contractor for full completion of the project, and that the loan balance and contract retainage constituted an “identifiable *res*” in which an equitable lien would be recognized in favor of the plaintiff contractor. *Id.* at 835-836. That was true “even if the funds were now comingled with other general accounts,” as they continued to retain their identity as loan proceeds intended for disbursement to the contractor.
Id. at 835. Citing to the Trans-Bay decision by the D.C. Circuit, the Bennett court found that HUD had played a significant role in the project and that it would be unjustly enriched should it not be required to compensate the contractor, even if HUD were to lose money after foreclosing on the project:

The Court is convinced that HUD will be unjustly enriched should it not be required to compensate plaintiff for its performance. Although it may be unfortunately true that the government will lose money if it now proceeds to foreclose on the project, that fact does nothing to diminish the unjust enrichment which accrued to HUD at the time the project was fully completed. Id. at 836.

In Spring, a case decided by the Fourth Circuit, HUD insured the mortgage loan for construction of an apartment project which was not completed due to a problem in making sewer connections to the property. 562 F.2d at 935. After the project was 80% complete, HUD informed the lender-mortgagee that it would insure no further advances under the loan due to the sewer problem. Id. Thereafter, the project was shut down as the lender refused to make further advances. Id. Up to that point, the lender had withheld 10% retainage, or “holdback” from the contractor’s monthly payment requisitions. Id. The project was never completed, the lender assigned the mortgage loan and related agreements to HUD, and after foreclosing, HUD sold the incomplete projects at a loss of more than $2,000,000. Id. The Fourth Circuit found that the facts of Spring justified the imposition of an equitable lien. Id. at 937-938. The court was persuaded by the fact that HUD would be unjustly enriched if it were not required to compensate the plaintiff contractor for the work it had performed. Id. Even though HUD sold the project for a loss, the court found that the project’s value had been enhanced by the plaintiff’s work. Id. Following the holdings of Trans-Bay and Bennett, the Fourth Circuit held that as a court of
equity, it had the power to avoid unjust enrichment and that HUD would be unjustly enriched if it did not compensate the plaintiff for its work on the project. \textit{Id.}

\textbf{The limits of the \textit{Embree} decision – full disbursements of construction loans and incomplete projects.}

In a fairly recent decision, the North Carolina Court of Appeals focused on a footnote in the \textit{Embree} opinion. \textit{See John Conner Const., Inc. v. Grandfather Holding Co., Inc.}, 732 S.E.2d 367, 371 (N.C. Ct. App. 2012).\textsuperscript{2} In footnote three of the \textit{Embree} opinion, the North Carolina Supreme Court states that:

This situation differs markedly from that in which the lender has disbursed all loan funds to the borrower, who diverts the funds to purposes other than paying contractors. \textit{See} Lefcoe & Shaffer, \textit{Construction Lending and the Equitable Lien}, 40 S. Cal. L. Rev. 444 (1967) (if funds disbursed once already, lender not unjustly enriched); [Edmund T. Urban and James W. Miles, Jr., \textit{Mechanics' Liens for the Improvement of Real Property: Recent Developments in Perfection, Enforcement, and Priority}, 12 Wake Forest L.Rev. 283, 350 (1976)] (“[T]here is justification for the [equitable lien] doctrine's application when the contractor has completed performance, the entire project itself is completed, and the lender forecloses, becoming the owner of the completed project seeking to retain undisbursed funds. But there is little justification for the doctrine's application when the lender has made a disbursement for all labor or materials furnished up through foreclosure without any knowledge of any unpaid claims, and funds are diverted from the project by the borrower. In that instance, application of the doctrine results in the inequity of the lender having to in effect pay twice for the same thing. Any application of the doctrine, therefore, should be restricted to obvious cases of unjust enrichment.”).

411 S.E.2d at 922 at fn 3. The distinguishing factor between \textit{Embree} and \textit{John Connor} is the presence of remaining loan funds. In \textit{Embree}, there was a resulting balance remaining in the

\textsuperscript{2}On review, the North Carolina Supreme Court was equally divided on the issue raised in the dissenting opinion in \textit{John Connor} that addressed whether one who contracts for the provision of labor and materials who is not under an enforceable contract for sale, but who subsequently acquires title to the subject property, may subject such real property to a materialman's lien as the “owner” under Chapter 44A. \textit{John Conner Const., Inc. v. Grandfather Holding Co., LLC}, 742 S.E.2d 802 (N.C. 2013).
loan fund, which the bank refused to disburse; however, in John Connor all of the loan funds had been disbursed. Therefore, the Court of Appeals in John Connor held that there was little justification for imposing an equitable lien since there was no remaining balance of loan funds. 732 S.E.2d at 371. In other words, there was no identifiable res to which an equitable lien could attach and the lender had fully “paid” for the project it foreclosed upon by disbursing all of the construction loan proceeds.

Although the contractor in Embree had completed all work according to the plans and specifications prescribed by the contract, the holding in Embree should not be limited to fully completed projects for which the lender has not disbursed the full amount of the construction loan. An equitable lien may also be justified for the project that is not complete and for which retainage or the earned loan amount has not been disbursed. As the Eastern District of North Carolina recently observed, contractors and materialmen should not be forced to bear a disproportionate risk of nonpayment. Shelco, 2013 WL 5817295 at *8. In Shelco, the Court noted:

The Owner was a single asset entity that was able to rely on bankruptcy to avoid liability. HUD and the lenders were able to rely on foreclosure. Certainly, [the contractor] should have (and did) file liens against the Project under state law, but these liens were subordinate to the lender’s claims, and because the Owner was insolvent, were worthless . . . . It is for these reasons that courts allow contractors to assert equitable liens to recover amounts owed for their services that are enjoyed by lenders without compensating the contractor for their work.

Id. Thus, in the situation where a lender forecloses on an incomplete construction project, the courts may impose an equitable lien on funds remaining in the lender’s hand, namely any retainages withheld and any amounts of the construction loan that had been earned by virtue of the work actually completed. Otherwise, the lender is unjustly enriched because it receives the benefit of the labor and materials, but does not have to “pay” for that benefit by disbursing the
retainage or earned loan proceeds. The Fourth Circuit concurred in this reasoning in *Spring*, where the project was 80% complete, but the lender still held 10% retainage from the contractor’s monthly requisitions. 562 F.2d at 935. Even though the project was never completed and, after foreclosing, HUD sold the incomplete project at a loss of more than $2,000,000, the Fourth Circuit found that the facts of *Spring* justified the imposition of an equitable lien. *Id.* at 937-938. The same result should be applied by North Carolina state courts for incomplete construction projects.

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