

Getting Paid on Construction Projects:

A Guide to Utilizing Arizona's Mechanic's Lien, Payment Bond, Stop Notice and Private Prompt Payment Remedies

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**GETTING PAID ON CONSTRUCTION PROJECTS:
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I. INTRODUCTION.

The Arizona Legislature has developed methods to make certain that material suppliers, rental equipment suppliers, subcontractors, and prime contractors are paid for the labor and material they supply to improve property. The material supplier, rental equipment supplier, subcontractor or general contractor that utilizes these remedies will dramatically increase their chances of collecting on the material, equipment or labor it supplies. This Guide is a summary of the three remedies, as well as an explanation as to how to utilize those remedies. This Guide will also point out pit-falls that can be caused by not using these remedies properly.

II. THE BASICS OF MECHANIC'S LIENS.

1. Overview.

A Mechanic's Lien is an encumbrance that a supplier, subcontractor or general contractor can place upon land when that supplier, subcontractor or general contractor has constructed, altered, repaired or improved a building, structure or parcel of land.

2. Benefits of Mechanic's Liens.

Mechanic's Liens provide the supplier, subcontractor or general contractor with at least two benefits. First, from a practical standpoint, placing a Mechanic's Lien upon property will keep the property from being sold. That is, a recorded Mechanic's Lien will usually keep title from passing to a buyer until the Mechanic's Lien has been released. Normally, title companies will not close upon properties encumbered by a Mechanic's Lien because the title company must insure to the buyer that clear title will pass at the time the property is transferred. If a lien is recorded and is encumbering the property, clear title cannot pass to the buyer.

The second benefit of a Mechanic's Lien is that the supplier, subcontractor or general contractor can foreclose upon a Mechanic's Lien and, in the long run, own the property. Of course, in the overwhelming majority of cases, Mechanic's Liens never are fully foreclosed upon; the lien claimant is paid beforehand or the lien is otherwise released prior to foreclosure.

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3. Prerequisites to Recording Mechanic's Lien.

In order to take advantage of the Mechanic's Lien laws, the supplier, subcontractor or general contractor must serve a Preliminary 20-day Notice¹ upon the following:

- A. The owner or reputed owner;
- B. The prime contractor or reputed prime contractor; and
- C. The construction lender or reputed construction lender.

The most important portion of the Preliminary 20-day Notice is the name of the owner. If the name of the owner is wrong, the Mechanic's Lien (as well as a Payment Bond under the Little Miller Act and a Stop Notice) will not be valid. In order to ascertain the correct owner name, a title search is most appropriate.

A 20-day Notice must contain a general description of what was furnished, a price estimate of the material, equipment or labor to be supplied, the name and address of the entity furnishing the material, equipment or labor, the name of the entity that contracted for the material, equipment or labor, a legal or commonly known address for the property and certain language required by statute. The Notice should be served within 20 days of first supplying material, equipment or labor. A failure to timely serve the 20-day Notice does not cause the subsequent Lien (or Little Miller Act bond claim or Stop Notice claim) to be invalid. However, the Lien (or Stop Notice) only secures the material, equipment or labor supplied 20 days prior to the service of the Preliminary Notice.

4. Deadline to Record Mechanic's Liens.

The supplier, subcontractor, and general contractor all have the same deadline within which to record a Mechanic's Lien. The Lien must be recorded within 120 days of completion of the project unless a Notice of Completion is filed. If a Notice of Completion is filed, a Mechanic's Lien must be recorded 60 days after the project is complete.

The Arizona lien statutes defines completion as either:

- A. Thirty (30) days after final inspection; or
- B. Cessation of labor for 60 days.

¹20-day Preliminary Notices are also commonly called 20-day notices, prelims, and pre-liens.

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Accordingly, as a practical matter, if no Notice of Completion has been recorded, the supplier, subcontractor and general contractor all have 150 days after final inspection to record the Mechanic's Lien.

The Lien must be recorded with the county recorder in which the property is located. The Lien must also be served on the holder of record title within a reasonable time after its recording.

5. Lien Priorities.

All Mechanic's Liens recorded on a project have equal footing. That is, regardless of when material, equipment or labor are supplied to a project, the priority of the liens relate back to the commencement of the project. For example, the bulldozer operator performing grading work and the landscape professional planting the landscaping near the end of the project both have the same lien priorities.

In Arizona, a lender that lends money to another to enable that person or entity to buy property will take back a Deed of Trust on the property. The Deed of Trust is a security device that allows the lender to foreclose upon the property, i.e., take back the property if and when the buyer defaults. Deeds of Trust are afforded their own priority privileges. Deeds of Trust recorded within ten days after commencement of the project have a greater priority than Mechanic's Liens recorded on the project.

6. Requirements of Liens.

A Mechanic's Lien must have:

- A. The legal description of the subject property;
- B. The name of the record owner of title;
- C. A copy of the contract attached;
- D. A demand for payment; and
- E. The date of completion of the supplying of material, equipment or labor.

Because of the necessity of the legal description and name of record owner of title, when preparing a Mechanic's Lien, a title search is normally required.

7. Blanket Liens.

Blanket liens are Mechanic's Liens that cover more than one unit, building or home. Blanket

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Mechanic's Liens are valid. However, under the Mechanic's Lien laws, residential multi-building projects have separate completion dates. For example, in the case of a condominium project with ten buildings, each building having five condominiums, each separate building has its own date of completion. Accordingly, with each complex having a different date of completion, a Blanket Lien likely could not be used; five different Mechanic's Liens would likely be necessary, one for each building.

8. Exceptions to Mechanic's Lien Laws.

An owner-occupied dwelling cannot be liened unless the supplier, subcontractor or general contractor has a written contract with the owner-occupant. An owner-occupied dwelling is

- A. real property upon which there has been constructed or is to be constructed a building designed for single one-family or single two-family residential purposes; and
- B. title is in the owner-occupant's name at the commencement of the project.

An owner-occupant is someone who holds title and intends to reside in the building at least 30 days in the 12-month period following completion of the project.

Recording a lien on an owner-occupied dwelling without having a contract with the homeowner (or recording any clearly invalid Mechanic's Lien) will subject the supplier, subcontractor or general contractor to penalties of the greater of \$5,000.00 or actual damages plus attorneys' fees incurred by the homeowner.

9. Lien Waivers.

Owners normally will require a lien waiver in exchange for payment. If a supplier, subcontractor or general contractor is asked to sign a lien waiver and that company 1.) has not been paid or 2.) is not being paid by certified funds or cash, that company should only sign a conditional release.

Alternatively, if a supplier, subcontractor or general contractor is receiving certified funds or cash in exchange for a lien waiver that company should agree to execute an unconditional release. An unconditional release will waive any right to lien or any right to payment even if the supplier, subcontractor or general contractor executing the waiver has not been paid.

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10. Joint Checks.

A check that is written jointly to two parties, one of whom is a Mechanic's Lien claimant, acts as a lien waiver (and a waiver of right to payment) up to the amount of the check.

11. Deadline to Foreclose Lien.

A Mechanic's Lien must be foreclosed upon within six months of its recording. Foreclosing upon a Lien means commencing judicial proceedings to ask a judge to order title to the property to be transferred to the unpaid supplier or laborer. A Lien that has not been foreclosed upon after six months must be released.

III. LIEN DISCHARGE BONDS AND BONDS IN LIEU OF LIEN RIGHTS.

Mechanic's Liens can be discharged (that is, removed from the chain of title of the property) by the owner by recording a lien discharge bond. A Lien discharge bond is a private bond in the amount of one and one-half times the amount of the lien. Upon its recording and service upon a lien claimant, the Lien claimant must discharge its lien.

Prior to the commencement of a project, an owner can obtain a bond in lieu of lien rights. A bond in lieu of lien rights is a private bond for the amount of the project. Recording the bond prevents the property from being liened. Only those persons or entities that would have had valid lien rights can commence an action against the bond in lieu of lien rights.

IV. LICENSE BONDS.

Contractors desiring to perform work on commercial projects must have a commercial contractors' license bond. Parties that can make claims upon the commercial contractors' license bonds include (1) licensees (that is, one with a contractor's license) and (2) owners or lessees of non-residential property. The commercial contractors' license bonds are designed for remedying workmanship complaints. The commercial contractors' license bond is not available to parties whose sole complaint against the holder of the commercial license is non-payment.

Contractors performing work on residential units must have a residential contractor's license bond. Parties that can make a claim on a Residential License Bond include:

1. Any person furnishing material, equipment or labor;
2. Owners; or

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3. the Registrar of Contractors.

As to homeowners, a Preliminary 20-day Notice is required if the supplier, subcontractor or the general contractor is in direct contract with the homeowner. A Preliminary Notice is unnecessary for suppliers and subcontractors that are not in direct contract with the owner.

V. PAYMENT BONDS: MILLER ACT AND LITTLE MILLER ACT.

Because state and federal property cannot be liened, statutory schemes have been set up to allow for security for suppliers, subcontractors and general contractors that supply material, equipment or labor on state and federal projects. The statutory scheme devised for federal projects is commonly known as the Miller Act. Arizona has enacted a very similar statutory scheme which is commonly called the Little Miller Act. Under both schemes, subcontractors supplying to general contractors, suppliers supplying to general or subcontractors, and renters of equipment are protected by a payment bond that must be obtained by the general contractor for the benefit of the suppliers and subcontractors. Suppliers to suppliers and sellers of equipment are not protected by the Little Miller Act.

On Little Miller Act projects, a Preliminary 20-day Notice is required if the claimant is not in direct contract with the bond principal. For example, a supplier contracting with a subcontractor that contracts with a general contractor must serve a Preliminary 20-Day Notice to make a claim upon a bond. The subcontractor in direct contract with the general contractor need not serve a Preliminary 20-Day Notice. However, the better practice is to serve a Preliminary 20-Day Notice and avoid any legal arguments that the Notice was not necessary.

On both Miller Act and Little Miller Act projects, suppliers, subcontractors and general contractors without a direct contract with the general contractor or the owner must also give a 90-day Notice. The 90-day Notice must be actually received by the owner within 90 days of last supplying material, equipment or labor to the project.

The Notice must indicate the amount of material, equipment or labor supplied and the entity to which the material, equipment or labor was furnished. The 90-day Notice should be served by certified or registered mail upon the bond principal (i.e., the general contractor).

The prevailing party in a Little Miller Act case is entitled to an award of attorneys' fees. The prevailing party in a Miller Act case is entitled to an award of attorney's fees if the parties' contract has an attorneys' fees provision. If the parties' contract does not have an explicit attorneys' fees provision, an award is discretionary with the judge.

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VI. STOP NOTICE.

A Stop Notice acts as lien on undisbursed funds. Any person or entity entitled to record a lien, other than the original contractor, may serve a Stop Notice on the project owner. Any person or entity entitled to record a lien, including the original contractor, may serve a Stop Notice on the lender.

Stop Notices apply to private construction projects, excluding owner-occupied residences. The aggrieved party must have served a Preliminary Notice. The Stop Notice must be served prior to the deadline to record a lien. A Stop Notice can be served by personal service or certified mail.

A Stop Notice may be bonded or unbonded. A bonded Stop Notice requires a lender or owner to withhold payment. If the owner or lender erroneously releases money after being served with a bonded Stop Notice, that owner or lender will be liable to the entity that filed a Stop Notice for the amount of the claim. If a Stop Notice is unbonded, the Stop Notice is not binding on the lender or the owner. The lender or owner may choose to honor the Stop Notice, but there is no penalty if it does not do so.

Stop Notices have at least two benefits over Mechanic's Liens. If the project has no equity, foreclosing on a Mechanic's Lien will result in the supplier, subcontractor or general contractor owning property with no equity. However, Stop Notices are effective even if the project is upside down, that is, more money is owed on the property than the property is worth.

Second, in a lien foreclosure action, the entity foreclosing on the property becomes the owner of the property. Being an owner of the property is generally not within the business plan of the Mechanic's Lien claimant.

A Stop Notice must contain:

1. A description of material, equipment or labor;
2. The name of the person to whom the material, equipment or labor was furnished;
3. The amount of the material, equipment or labor furnished to date;
4. The total amount agreed to be furnished;
5. The name of the owner;
6. The amount received by the claimant; and
7. It must be verified under oath.

A suit on the Stop Notice must be filed after ten days but prior to three months after the

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deadline for recording liens.

The general contractor can bond around Stop Notices. That is, the general contractor can record a bond similar to a lien discharge bond which will allow the entity the Stop Notice was served upon to pay out the retained money.

The Stop Notice statute allows for an award of attorneys' fees to the prevailing party.

VII. PRIVATE PROMPT PAYMENT.

On April 12, 2000, Governor Hull signed into law a Private Prompt Payment bill. The law became effective July 18, 2000 as to some projects and July 1, 2001 as to all projects. As to the projects on or after July 18, 2000, it applies to those projects upon which the owner initially distributed any plans, including bid plans and construction plans, specifications or contract documents before the owner and the general/subcontractor entered into a contract.

1. Owner-Contractor.

A thirty day billing cycle is presumed. If the owner and contractor do not have a thirty day billing cycle, it must explicitly state as such on each page of the bid plans and construction plans.

A. Billing.

The billing estimate submitted by the contractor to the owner is deemed approved 14 days after the owner or owner's agent receives the billing unless before 14 days the owner or owner's agents produces a written statement detailing those items unapproved. An owner may decline to pay a billing or a portion of the billing for:

1. Unsatisfactory job progress;
2. Defective construction work or materials not remedied;
3. Disappeared work or materials;
4. Failure to comply with other materials provisions other construction contract;
5. Third party claims filed or reasonable evidence that a claim will be filed;
6. Failure of the contract or subcontractor to make timely payments for labor, equipment and materials;
7. Damage to the owner.

The owner can only can withhold a reasonable amount to correct the items listed in 1-7 of

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page 9 above. The owner can extend the time within which the billing is approved beyond 14 days if the contract extends the billing approval time and each page of the construction plans and bid plans state the owner is allowed an extended time.

B. Payment.

The owner must pay the general within seven days of approval of the bill. The penalty for not promptly paying is 12 per month interest. Upon written request by a subcontractor, the owner shall notify the subcontractor within five days of progress payment or final payment. If the owner and general are the same entity, the owner must pay the subcontractor or suppliers within 14 days after the billing is certified and approved unless the approval or payment deadlines have been modified.

Regarding any litigation, attorneys' fees shall be awarded to the successful party,

2. Subcontractors.

If the general does not pay subcontractors or material suppliers within seven days of receipt of payment, the subcontractor or material supplier can complain to the Registrar of Contractors, which may suspend or revoke the license of the non-paying general or subcontractor. However, to file a claim based upon Private Prompt Payment, the claimant must post a cash surety bond of \$500.00 or 2 of the amount due, whichever is less. If the Registrar of Contractors determines the Complaint to be frivolous, 2 of the money deposited will go to the Respondent and 2 will go to the State of Arizona general fund. Interest is allowed at 12% per month on late payments (after the general or subcontractor has been paid and seven days has elapsed)

3. Interruption-Termination of Contract.

If a general and/or subcontractor must stop work due to a hazardous situation, the general and/or subcontractor is/are entitled to damages. However, under that circumstance, the owner can terminate the general or subcontractor's contract.

The general may suspend work if it gave an owner seven days written notice to the owner of not receiving payment and still has not obtained payment.

The subcontractor may suspend work if the subcontractor is not paid on time. If the general was paid, the subcontractor need only provide a three day notice to the owner and the general that it will walk off the job without getting paid. If the general was paid, the subcontractor must provide a

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seven day notice to the owner and the general. However, if the owner has a compliant with the work but not with a particular subcontractor's work, that subcontractor may terminate by serving a seven day notice on the general and the owner.

If interruption or termination of contract is necessary, and litigation or arbitration ensues, the prevailing party is entitled to an award of attorneys' fees.

4. Void Provisions Within Private Prompt Payment.

A construction contract that purports to be based on the laws of another state or requiring the place of the litigation to occur in another state is void. Additionally, parties cannot contractually agree that a general or subcontractor cannot suspend or terminate if the owner or general fails to make prompt payments.