



Legal Alert

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Mechanic's Liens vs. Secured Loans: A Blow to Equitable Subrogation

Weitz Company v. Heth, No. CA-CV 11-0788 (Ariz.App., Div. 1, December 3, 2013)

With construction picking up, Arizona courts are being asked to revisit the laws governing mechanic's liens. A recent opinion changes how mechanic's liens are treated vis-à-vis secured loans.

As most readers likely know, contractors (and subcontractors, suppliers, etc.) may assert liens—known as mechanic's liens—against improved property to secure payment for the services and materials they provided to the property. A few types of projects are exempt (such as owner-occupied residences unless the owner and contractor have a direct agreement), but otherwise the liens arise automatically. Contractors must follow specific statutory procedures to perfect and then foreclose mechanic's liens.

When a project fails, contractors and secured lenders often dispute whose lien has priority. This is important if the property is not worth enough to pay all creditors, which is frequently the case. In general, the contractor's priority is determined by when construction began (with each contractor sharing pro-rata), and the lender's priority is determined by when the mortgage or deed of trust was recorded.

What happens when a loan is recorded prior to the start of construction, but the loan is refinanced after construction had commenced? This scenario is not uncommon; the property might be sold to a purchaser with its own financing, or perhaps the initial loan was a land-acquisition or construction loan being refinanced for a longer term.

Previously, Arizona courts applied "equitable subrogation." This doctrine allows the second lender to "step into the shoes" of the first lender, at least to the extent of the first lender's claim. The policy justification is that the contractor suffers no prejudice. The contractor should have been aware of the initial loan when it started work, and its mechanic's lien would have been behind the initial loan—so the contractor should not benefit simply because the loan was refinanced. The case often cited for this doctrine is *Lamb Excavation v. Chase* (a 2004 decision from the Arizona Court of Appeals, Division Two), which involved a construction loan that the owner had refinanced to obtain permanent financing after construction had commenced.

Now, however, equitable subrogation is curtailed in *Weitz v. Heth* (a 2013 decision from the Arizona Court of Appeals, Division One). First National Bank of Arizona had financed construction of a condominium project in downtown Phoenix known as

Summit at Copper Square. The bank recorded a deed of trust to secure its loan. Summit hired Weitz Company as general contractor. Weitz followed all procedures to perfect a mechanic's lien. Summit started selling individual units before construction was completed. The sales were generally financed, with the proceeds used to pay allocated portions of the construction loan. Meanwhile, Weitz still had an outstanding balance on its contract that was never paid.

Eventually there was a dispute between the contractor Weitz, who sought to foreclose, and the purchasers and lenders of individual units (or more likely, their title insurers). Under equitable subrogation, the second lenders and purchasers would have prevailed. But the court rejected *Lamb Excavation* and refused to apply equitable subrogation. Section 33-992(A) of the Arizona Revised Statutes provides that mechanic's liens have priority over "all liens, mortgages, or other encumbrances upon the property attaching subsequent to the time labor was commenced." The court focused on the word "all" and reasoned that an equitable doctrine cannot overcome plain statutory language, especially in light of the historical preference afforded to mechanic's liens.

Based on the opinion in *Weitz v. Heth*, equitable subrogation can no longer be used to overcome mechanic's liens. But this is an evolving area of the law, and given the conflicting opinions from the Court of Appeals, the Arizona Supreme Court might soon weigh in.

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