Litigation and Arbitration of Mechanics' Lien Claims

March 2014

By: David L. LeBas
Naman, Smith, Howell, & Lee, PLLC
8310 N. Capital of Texas Hwy, Ste 490
Austin, Texas 78731
Office: (512) 479-0300
Mobile: (806) 679-6641
Email: dlebas@namanhowell.com

David LeBas graduated from the University of Texas with a B.A. in 1979 and a J.D. in 1982. He is Board Certified in Civil Trial Law. His practice is concentrated in the areas of agriculture, construction and banking. He is a member of the Texas Cattle Feeders Association, past president of the Amarillo Area Young Lawyers Association, past director of the Texas Young Lawyers Association, a Life Fellow of the Texas Bar Foundation, a former chair of the State Bar's Agricultural Law Committee, and a member of the Construction Specifications Institute.

Bibliography

1. Editor, Construction Law Compendium: A State by State Analysis, ALFA International (2012)
2. Livestock Owner's Liens; American Agricultural Law Journal June 2011
3. Common Legal Issues in the Texas Beef Cattle Industry; Texas Bar Journal, May 2010
4. Where's the Beef? Legal Foundations in Texas Cattle Marketing and Lending for 4th Annual John Huffaker Agricultural Law Conference, May 20-21, 2010
5. Recovering Expert Witness Fees and Taxable Court Costs in State and Federal Court, State Bar of Texas 2010 Conference on Strategies for Damages and Attorney Fees
6. Cattle Feedyard Lending and Marketing in Uncertain Times; Texas Cattle Feeders Association, February 2009
7. Litigation and Arbitration of Mechanics' Lien Claims, March 2009
8. Marketing and Lending Problems in Cattle Wrecks, Farm, Ranch and Agri-Business Bankruptcy Institute, 2008
9. Cattle Marketing and Lending, State Bar of Texas Agricultural Law Course, 2008
10. Texas Cattle Law, Justice Court Judges Association of Texas Seminar, 2007
11. Professional Liability Actions Against Design Professionals, 2006
12. Current and Emerging Theories of Recovery for Breaches of Fiduciary Duties, Texas Bankers Association, 2005
13. Livestock Law Update, Agricultural Law Seminar, State Bar of Texas, 2005
14. OCIPs, Wrap-Ups and Workers' Compensation, Annual Meeting of the Construction Law Section, State Bar of Texas, 2004
15. Temporary Workers and Protection from Liability Under the Exclusive Remedy Provision of the Texas Worker's Compensation Act, 16th Annual Construction Law Conference, State Bar of Texas, 2003
16. Contractual and Involuntary Agricultural Liens, Agricultural Law Seminar, State Bar of Texas, 2003

17. Perfection Rules Changed Under Revised Article 9, Texas Bankers Journal, 2001
18. Lenders' Laws and Liabilities: The New Uniform Commercial Code, Texas Cattle Feeders' Association Seminar, 2001
19. Creating and Protecting Agricultural Liens, Texas Association of Bank Counsel Annual Convention, 2000
20. Risks to Lenders in the Use of Forward Contracts by Borrowers, Texas Tech Agricultural Lending School, 1999
21. Creating and Protecting Agricultural Loans, Agricultural Law Seminar, State Bar of Texas, 1999
22. Texas Livestock Law, Agricultural Law Seminar, State Bar of Texas, 1998
23. Insurance Code Art, 21.21 and Art. 21.55 Highlights, Texas Association of Defense Counsel, 2000
24. Recent (and Relevant) Texas Supreme Court Cases, Texas Association of Defense Counsel, 1997
25. The Recovery of Expectancy Damages in Misrepresentation Cases, Texas Association of Defense Counsel, 1997

I. Representative Clients

- American Bank of Commerce
- Cactus Feeders, Inc.
- Central Texas Highway Constructors, L.L.C.
- Ferrovial Agroman
- Friona Industries, L P
- JBS USA Holdings, Inc
- Smith Cattle Co.
- Texas Cattle Feeders Association
- Western Builders of Amarillo, Inc.
- Zachry Construction Corporation

1. Litigation and Arbitration of Mechanics' Lien Claims

I. Interplay Between Litigation and Arbitration 6

A. Major Procedural Differences Between and Litigation and Arbitration 6
B. Rules for Determining Whether an Agreement to Arbitrate Exists 7
C. Whether a Court or an Arbitrator Decides Whether an Agreement to Arbitrate Exists 8
D. Exceptions to Signing Requirement 8

II. Common Litigation Issues 9
A. Whether Arbitration Been Waived by Participation in Litigation 9
B. Place of Suit 9
C. Determining the Proper Court 9

III. Common Arbitration Issues 10
A. Choice of Arbitrator and Arbitration Rules 10
B. Does the Federal or the Texas Arbitration Act Apply 10
C. Fraudulent Inducement to Sign Arbitration Agreement 12
D. Place of Arbitration 12
E. Statute of Limitations Trap 12
F. Who Are the Proper Parties to an Arbitration 13
G. Appeal Procedures From Arbitrations 13
H. Time to Challenge Award 14

IV. Factors to Consider When Choosing Litigation or Arbitration 15
A. Time and Expense of an Arbitration Compared to Litigation 15
B. Recovery of Expert Witness Fees 15
C. Witness or Proof Problems 16
D. Enforcing the Arbitration Award 16
E. The Impact of State "Contingency Payment" Statutes 16
F. Recovery of Attorneys' Fees 16

V. Substantive Legal Issues 15
A. Prompt Payment Statute 17
B. Payments to Downstream Parties/Lenders/Trust Fund Statute 18
C. Implied Contracts 18
D. Implied Warranties 19
E. Notice of Claims 19
F. Statutes of Limitations and Repose 20
G. The Sham Contract Doctrine 22

VI. How to Enforce Mechanics' Liens 22
A. Foreclosure of Liens 22

1. Time Limits 22
2. Arbitration/Litigation 22
B. The Removables Doctrine 23

VII. Statutory Payment Bonds and Potential Impacts on Lien Claims 23
A. Statutory Requirements for Payment Bonds 24
B. Attempted Compliance 25
C. Exclusive Remedy for Claimant 26
D. Owner's Potential Counterclaim for Fraudulent Lien Claim 26

VIII. Performance Bonds in the Public and Private Construction Context 27

Litigation and Arbitration of Mechanics' Lien Claims

By: David LeBas[1]

This article addresses issues that often arise in litigation or arbitration of mechanics' lien claims. A threshold issue, and the first that we discuss, concerns the effort to determine whether the claim should be decided in litigation or in arbitration. This involves determining whether an arbitration agreement exists and, if so, where the arbitration must occur and which parties and claims are to be involved. Next, we will discuss issues specific to either litigation or arbitration, address substantive legal issues that are common to both, and then discuss how a successful lien claimant can enforce that lien.

II. Interplay Between Litigation and Arbitration

Litigation will be required to enforce every valid mechanics' lien even if the amount of the claim and the perfection of the lien is decided by an arbitrator. The Texas Property Code provides that only a court of competent jurisdiction can order foreclosure of a mechanic's lien and order the sale of the property. TEX. PROP. CODE §53.154. Suits to foreclose on mechanic's liens generally will involve proving that the all of the notice and filing requirements were met in order to obtain a judgment foreclosing the lien. However, if the contract between the owner and the original contractor contains an agreement to arbitrate, an arbitrator might first decide the technical issues such as whether the notices and lien affidavits were timely. *CVN Group v. Delgado*, 95 S.W.3d 234 (Tex. 2002). If the original contractor obtained a favorable arbitration award upholding the validity of the lien, suit would then be filed to enforce the arbitration award and foreclose on the lien.

Subcontractors and sub-subcontractors that do not have a contract with the owner should not be required to arbitrate the amount of their mechanic lien claims because they generally do not have contracts with the owner that require arbitration. However, clauses in subcontracts or sub-subcontracts that "incorporate" into them the terms of the contract between the original contractor and the owner or that list the owner/original contractor as a subcontract document might contain arbitration provisions. In addition, the liquidation of the amount of the claim might be required to allow arbitration of direct contracts with an upstream party.

A. Major Procedural Differences Between and Litigation and Arbitration

Although litigation and arbitration are closely related, there are major procedural differences that can cause significant differences in result, expense, time of resolution and other considerations, such as:

[1] The author gratefully acknowledges the assistance of Sandra Webb, AGC Amarillo and Lauren Freeland, Naman, Howell, Smith & Lee, PLLC.

- The rules that permit joinder of parties in arbitration are much more restrictive that those in litigation.

- The elaborate rules that allow appeals from virtually every aspect of a court trial are almost non-existent in challenges to arbitrations.

- Discovery is usually much more limited in arbitration than in court cases.

- The parties usually have some flexibility in choosing arbitrators but little choice of judges.

- The place where the arbitration occurs may be different from the place where the court case to foreclose the lien is located.

As a result of these and other differences, parties often spend much time and money arguing whether the merits of the dispute should be decided by a judge or an arbitrator before they ever get to the substance of the dispute.

B. Rules for Determining Whether an Agreement to Arbitrate Exists

The general rule is that a party must agree to arbitrate before it is bound to do so. Deciding this can be a difficult issue in a construction case. Construction contracts come in many forms, but almost all share a common feature: the document that will be presented for signature does not contain within its four corners all of the terms, conditions, specifications, and requirements that will apply to that contract. Instead, these terms will be supplied by a process known as “incorporation by reference” and the whole is typically described as the “Contract Documents.” This definition will typically be phrased very broadly and will include documents that may not be readily accessible to lower tier parties, and will almost always involve terms and conditions that have been negotiated or agreed to by other parties and which therefore cannot be modified. As a result, all of these documents must be reviewed and considered before making a decision about whether to proceed with litigation or arbitration.

For example, in *In re Premont Indep. School District* 225 S.W.3d 329 (Tex. App. — San Antonio 2007, orig.. proceeding) the Court of Appeals had to decide a “reverse” incorporation by reference case. In that case the school district sued its construction manager for delays and defective work. The manager asserted a contractual right to arbitrate but the trial court denied the motion. On appeal the school district argued that there was no arbitration agreement because although the A121 contract incorporated section 4.5 of the A201 (containing the arbitration clause), the parties had adopted a supplementary condition striking that section. The construction manager argued that the supplementary conditions were not signed and therefore the arbitration clause was still valid. The Court of Appeals held that "an arbitration agreement that is not signed may be incorporated by reference in the signed contract .... Likewise, an agreement to not arbitrate that is not signed may be incorporated by reference in the signed document." Because the contract documents did not require the supplementary conditions to be signed the Court of Appeals held that no valid arbitration agreement existed.

C. Whether a Court or an Arbitrator Decides Whether an Agreement to Arbitrate Exists

Whether an agreement to arbitrate exists involves two inquiries, although this is referred to as the single concept of "arbitrability." The Supreme Court's decision in *First Options of Chicago v. Kaplan*, 514 U.S. 938 (1995), discussed this point: "This determination [whether there is an agreement to arbitrate] depends on two considerations: (1) whether there is a valid agreement to arbitrate between the parties; and (2) whether the dispute in question falls within the scope of that arbitration agreement." The question of who decides these questions (arbitrator or judge) can be critical.

Parties are free to agree that an arbitrator may decide whether an agreement to arbitrate exists. But if there is no "clear and unmistakable evidence" of the parties' intention to have the arbitrator decide that issue, a reviewing court does so. *Kaplan, supra*. This means that a participant in an arbitration who has not agreed to submit the question of arbitrability to the arbitrator can later argue the point in court without waiving its right to independent court review, so long as it objects to jurisdiction during the arbitration proceeding. *Id.* at 946.

First Options of Chicago v. Kaplan also discussed that issue. It noted that if parties to a contract agree to allow the arbitrator to decide the issue of arbitrability the decision of the arbitrator is reviewable under traditional standards of review of arbitration decisions. On the other hand, if a party does not agree to arbitrability, it is entitled to an independent review of the issue by the courts. This flows "from the fact that arbitration is simply a matter of contract between the parties: it is a way to resolve those disputes—but only those disputes—that the parties have agreed to submit to arbitration." *Kaplan*, 514 U.S. at 943.

D. Exceptions to Signing Requirement

In *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d 732 (Tex. 2005), the Texas Supreme Court considered whether a non-signatory to an arbitration agreement could be compelled to arbitrate. The Court in *Kellogg* recognized the following six exceptions to the general rule that non-signatories are not obligated to arbitrate because they have not agreed to arbitrate:

> Federal courts have recognized six theories that, arising out of common principles of contract and agency law, may bind non-signatories to arbitration agreements: (1) incorporation by reference; (2) assumption; (3) agency; (4) alter ego; (5) equitable estoppel; and (6) third-party beneficiary.

These rules can require a party that did not sign an arbitration agreement, such as a subcontractor, to arbitrate its disputes if it agreed to be bound to all provisions of a contract that was incorporated by reference into its subcontract which contained an arbitration provision.

III. Common Litigation Issues

A. Whether Arbitration Been Waived by Participation in Litigation

A frequently disputed issue is whether an agreement to arbitrate has been waived by a party's participation in litigation. The Supreme Court said in *Perry Homes v. Cull*, 258 S.W.3d 580, 584 (Tex. 2008):

> Since 1846, Texas law has provided that parties to a dispute may choose to arbitrate rather than litigate. But that choice cannot be abused; a party cannot substantially invoke the litigation process and then switch to arbitration on the eve of trial. There is a strong presumption against waiver of arbitration, but it is not irrebuttable and was plainly rebutted here. The Plaintiffs vigorously opposed (indeed spurned) arbitration in their pleadings and in open court; then they requested hundreds of items of merits-based information and conducted months of discovery under the rules of court; finally only four days before the trial setting they changed their minds and decided they would prefer to arbitrate after all. Having gotten what they wanted from the litigation process, they could not switch to arbitration at the last minute like this.

Thus, a party that intends to rely on an arbitration clause should raise the issue early if a suit is filed that might involve an arbitration clause.

B. Place of Suit

A provision in the Texas statutes (TEX. BUS. & COM. CODE §35.52) provides that if a contract is "principally for the construction or repair of improvements to rural property located in this state" and if it provides that the contract is subject 1) to the law of another state, 2) to litigation in another state, or 3) arbitration in another state, such a provision is voidable by the party obligated by the contract to perform the construction or the repair. This law will be re-codified in Chapter 272 of the Government Code April 1, 2009. Absent this statute, presumably the general rule that allows "forum selection" clauses to be enforced would govern. This could require a contractor to arbitrate its dispute related to a Texas project in an another state, and subject to that other state's rules. *In re: Lyon Finan. Servs*, 257 S.W.3d 228 (Tex. 2008). The *Lyon* case also recited the rule that fraudulent inducement to sign an agreement containing a dispute resolution agreement, such as an arbitration clause or a forum selection clause, will not bar enforcement of that clause unless it was the product of fraud or coercion, as opposed to a claim that the entire agreement, including the dispute clause, was the subject of fraud in the inducement or coercion.

C. Determining the Proper Court

One issue that is unique to court actions concerns the possibility of removal of a case to federal court if it is filed in state court, or to seek remand of a case to state court if

it is filed in federal court. Federal courts are said to have "limited" jurisdiction, compared to state courts, which have "general" jurisdiction. The most common reason for jurisdiction in federal court is on the basis of "diversity jurisdiction," which requires that there be complete diversity of citizenship among all parties to the case. That is, the plaintiff must be a resident of a different state than all of the defendants; if there are multiple defendants and one defendant has the same citizenship as the plaintiff, diversity jurisdiction does not exist. *See* 28 U.S.C. §1332. In the construction context, another basis of jurisdiction would be suit under the Miller Act (40 U.S.C. §§ 3131, et seq.) if a federal construction project were involved.

A similar situation exists in Texas state courts because a suit can be litigated in different counties. A defendant can seek a change of venue from the county where the suit is filed to a different county if certain factors are met. Venue can be significant because the judges or juries may vary from county to county.

IV. Common Arbitration Issues

A. Choice of Arbitrator and Arbitration Rules

In arbitrations there are two very significant issues that arise even before any proceedings begin. The first is the choice of the arbitrator. The standard AIA contracts provide for arbitration by the American Arbitration Association (AAA). The AAA's standard procedure calls for the submission of a list of potential arbitrators to all parties in the arbitration to seek information about potential disqualification. In some cases, parties may rank arbitrators who do not have a conflict. We have developed a chart to assist in this ranking process:

Rank	Name	Profession	Experience	ADR Experience	Compensation

A second issue that arises in arbitration cases before formal proceedings begin concerns the rules under which the arbitration is to be conducted. In some arbitrations the parties choose their own rules, and in others the parties use existing AAA rules. These rules can have an effect on the outcome and so they must be studied carefully before any commitments are made.

B. Does the Federal or the Texas Arbitration Act Apply

The question of whether the Texas General Arbitration Act (TGAA) or the Federal Arbitration Act (FAA) applies can have important consequences. One effect is how, and when, the trial court's decision on whether to enforce the arbitration clause can be challenged. If the TGAA applies the challenge must be by mandamus, but if the FAA applies the challenge may be taken by interlocutory appeal.

In *Northwest Constr. Co. v. Oak Partners, L.P.*, 248 S.W.3d 837, 844-845 (Tex. App. Fort Worth 2008, orig. proceeding), the court addressed whether the state or the

federal act applied because this issue would govern whether it had jurisdiction to hear the case under the following rules:

> In Texas, a trial court's denial of arbitration under the FAA may be challenged only by mandamus and not by interlocutory appeal. *In re D. Wilson Constr. Co.*, 196 S.W.3d 774, 779 (Tex. 2006) (orig. proceeding); *Jack B. Anglin Co. v. Tipps*, 842 S.W.2d 266, 272 (Tex. 1992) (orig. proceeding). But a party may seek to enforce an arbitration agreement under both the FAA and TGAA if, like the agreement here, it does not say whether the FAA or TGAA applies. *D. Wilson Constr. Co.*, 196 S.W.3d at 778-79. Texas appellate courts have jurisdiction over interlocutory appeals from the denial of arbitration under the TGAA only or under both the FAA and TGAA. TEX. CIV. PRAC. & REM. CODE ANN. §71.098(a)(1); *D. Wilson Constr. Co.*, 196 S.W.3d at 778-79.

The court ultimately decided that state law governed because the party seeking arbitration produced no evidence that the contract involved interstate commerce under the following test:

> To determine whether an agreement that does not purport to be under either the FAA or TGAA is governed only by the FAA (i.e., whether the FAA pre-empts the TGAA), thus precluding an appellate court's jurisdiction over an interlocutory appeal, we must determine whether (1) the agreement is in writing, (2) it involves interstate commerce, (3) it can withstand scrutiny under traditional contract defenses, and (4) state law affects the enforceability of the agreement. 9 U.S.C.A. § 2; *D. Wilson Constr. Co.*, 196 S.W.3d at 780; *In re Nexion Health at Humble, Inc.*, 173 S.W.3d 67, 69 (Tex. 2005) (orig. proceeding). For the FAA to pre-empt the TGAA, state law must refuse to enforce an arbitration agreement that the FAA would enforce, either because (1) the TGAA has expressly exempted the agreement from coverage, or (2) the TGAA has imposed an enforceability requirement not found in the FAA. *D. Wilson Constr. Co.*, 196 S.W.3d at 780. In other words, the FAA pre-empts only contrary state law, not consonant state law. *Id.* at 779.
>
> We conclude that the FAA does not pre-empt the TGAA here. Northwest has not directed us to, nor have we found, any evidence of interstate commerce in the record. Likewise, Northwest did not direct the trial court to any such evidence. Because this suit involves a construction project, it is possible that materials may have come from out of state, but Northwest has not directed us to anything in the record to support that conclusion, nor have we found any evidence in the record that would support such a conclusion. *See, e.g., In re Nasr*, 50 S.W.3d 23, 25-26 (Tex. App.--Beaumont 2001, orig. proceeding) (holding that construction contract involved interstate commerce because list of subcontractors in record included Wal-Mart). We hold that Northwest has failed to prove that the arbitration agreement involves interstate commerce; thus, the FAA does

not pre-empt the TGAA in this instance, and we have jurisdiction over Northwest's interlocutory appeal. For the same reason, we do not have jurisdiction to grant relief on Northwest's petition for writ of mandamus. *See In re D. Wilson Constr. Co.*, 196 S.W.3d at 779. Because we have jurisdiction over the interlocutory appeal only, we will address Northwest's issues within the context of that proceeding.

C. Fraudulent Inducement to Sign Arbitration Agreement

According to the Texas Supreme Court, the test is:

[A]rbitrators generally must decide defenses that apply to the whole contract, while courts decide defenses relating solely to the arbitration clause. Thus, for example, arbitrators must decide if an entire contract was fraudulently induced, while courts must decide if an arbitration clause was. *Perry Homes v. Cull*, 258 S.W.3d 580, 589 (Tex. 2008).

D. Place of Arbitration

Many arbitration agreements state where the arbitration is to occur. The agreements are enforceable even if the place specified is inconvenient or if the state law to be applied limits the remedy that the complaining party wishes to obtain. See *In re Lyon Finan. Servs.*, 257 S.W.3d 228 (Tex. 2008).

E. Statute of Limitations Trap

As noted below, Texas law requires suits to foreclose mechanics' liens to be filed either one year (residential projects) or two years (commercial projects) after the lien must be perfected. If an arbitration is ongoing, these deadlines could run before a final decision of the arbitration case is rendered. To avoid the possible running the statute of limitations in this situation suit should be filed in the appropriate county before the statute runs, with a proposal that the court abate the case until the arbitration is decided.

A similar problem can arise because of the structure of the statutes of limitations themselves. Statutes generally run from the time a cause of action accrues and are "tolled" (meaning cease to run) when a lawsuit is filed. Therefore, one can argue that filing an arbitration case will not cause the statute of limitations to stop running. Some courts have adopted this argument. As a result, a contractor seeking to enforce a mechanics' lien could file the arbitration case, obtain an award in the arbitration case, then find that efforts to enforce that claim will fail because a suit to enforce it has not been brought within the time allowed by the statute. Similarly, an upstream party such as a general contractor seeking to obtain relief from a downstream party through arbitration should be careful to preserve its rights to recover a claim required to be decided by arbitration by filing suit with an abatement request, to avoid a hollow arbitration award victory.

In *Galbraith Engineering Consultants, Inc. v. Pochucha*, 290 S.W.3d 863 (Tex. 2009), the Texas Supreme Court recently agreed to decide whether a 10-year statute of repose barring a lawsuit against an engineer prohibits joining an engineer as a responsible third party under another statute that allows joinder despite expiration of a statute of limitations. The Pochuchas sued the contractor who built their house, then joined Galbraith Engineering Consultants as a defendant after the contractor designated Galbraith as a responsible third party. The trial court granted Galbraith summary judgment because it had not been sued within10 years. The Court of Appeals reversed, holding that joinder was permitted even after limitations expired. The Texas Supreme Court reversed again, holding that the statute that allows for joinder despite expiration of a statute of limitations was not intended to allow revival of claims extinguished by a statute of repose. Therefore, the Court dismissed the Pochuchas' claim against Galbraith because it was barred by the applicable 10 year statute of repose.

F. Who Are the Proper Parties to an Arbitration

Because of the rule that a party seeking to compel arbitration must show the existence of an arbitration agreement and show that the claims asserted fall within the scope of that agreement [S*ee Cappa Donna Elec. Mgt. v. Cameron County (In re Cappadona Elec.)*, 180 S.W.3d 364 (Tex. App. — Corpus Christi 2005, org. proceeding)], a question frequently arises whether third-parties may be joined to an existing arbitration proceeding. If there are exceptions to this rule (incorporation by reference, assumption, agency, alter-ego, equitable estoppel, third-party beneficiary, and direct benefit estoppel cited above), the third-party cannot be joined.

An issue of particular interest concerns whether sureties on performance bonds may be joined. Several cases have allowed this to occur if the bond incorporates the terms of the bonded contract by reference, under the "incorporation by reference" theory. *J.S.& H. Construction Co. v. Richmond County Hospital Authority*, 473 F.2d 212 (5th Cir. 1973).

G. Appeal Procedures From Arbitrations

In *Hall St. Assocs., LLC v. Mattel, Inc*., 128 S.Ct. 1396 (2008), the Supreme Court decided that an attempt by contract to expand judicial review was not enforceable under the Federal Arbitration Act. Instead, the Court limited judicial review to those theories which are permitted by the Federal Arbitration Act, which are set in the statute as follows:

> (a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration-- "(1) where the award was procured by corruption, fraud, or undue means; "(2) where there was evident partiality or corruption in the arbitrators, or either of them; "(3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other

> misbehavior by which the rights of any party have been prejudiced; or "(4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made. 9 U.S.C. § 11

In *Nafta Traders, Inc. v. Quinn*, 339 S.W.3d 84 (Tex. 2011), the Texas Supreme Court decided that under the Texas Arbitration Act parties can agree to limit an arbitrator's scope of authority or expand judicial review of an arbitration award and that the Federal Arbitration Act did not preempt the Texas statute.

In that case Nafta challenged a $200,000 arbitration award to Quinn on her sex-discrimination and retaliation claims. An arbitration provision in the company's employee handbook barred arbitration awards that contained reversible legal error or that applied a cause of action or remedy not expressly provided by law. Quinn argued that federal arbitration law controlled, which, under the U.S. Supreme Court's decision in *Hall Street Associates v. Mattel*, did not allow judicial review to be expanded by agreement beyond what the federal arbitration statute provides. The trial court confirmed the arbitration award for Quinn. The court of appeals held that *Hall Street Associates* similarly restricted the Texas Arbitration Act. The Texas Supreme Court held that parties could agree to allow remedies and judicial review beyond what the federal law allows and that the federal arbitration law does not preempt the Texas statute.

H. Time to Challenge Award

Under the FAA, if a party wants to challenge an arbitration award, then it must do so within 3 months after the award is filed or delivered. This is because the FAA expressly requires that "notice of a motion to vacate, modify or correct an award must be served upon the adverse party or his attorney within three months after the award is filed or delivered." 9 U.S.C. § 12.

Similarly, in order to challenge an arbitration award under the TGAA, a party must submit to the trial court an application requesting that the award be vacated not later than the 90th day after the date of delivery of a copy of the award to the applicant. *See* Tex. Civ. Prac. & Rem. Code Ann. §171.088. The only slight exception to this rule is that if the party intends to challenge the award on the grounds that it "was obtained by corruption, fraud, or other undue means," the party must make its application to the trial court "not later than the 90th day after the date the grounds for the application are known or should have been known."

The 90-day period set forth in Section 171.088 is intended to function as a "limitations period after which a party cannot ask a court to vacate an arbitration award." *New Med. Horizons II, Ltd. v. Jacobson*, 317 S.W.3d 421, 428 (Tex. App. Houston [1st Dist.] 2010, no pet.). Unless a challenge to the arbitration award is timely submitted under Section 171.088, the court must confirm the award on the application of any party. *See id.*

V. Factors to Consider When Choosing Litigation or Arbitration

In some cases parties have the opportunity to decide whether litigation or arbitration is more suited for their purpose. This choice can be presented if the parties decide after a dispute arises to submit it to arbitration, if there is a defect in the pre-dispute arbitration agreement that the parties wish to ignore, if other parties to a dispute should be joined despite restrictions on the arbitration agreement, or perhaps for other reasons. Factors that should be addressed in making this decision are discussed below.

A. Time and expense of an arbitration compared to litigation

Arbitration is usually described as cheaper and faster than litigation. In the writer's view this is generally true but it often is a close call. In the case of construction disputes that involve attempts to enforce mechanics' liens which generally need to be addressed to a court anyway, the cost and time advantages may not be great.

B. Recovery of Expert Witness Fees

Recovery of expert witness fees in a court case is allowed either if there is a contract that allows for this or if the underlying substantive law permits it. We have not found many examples of state or federal law grants for recovery of expert witness fees, and most are in the consumer protection area.

However, arbitration agreements might offer a way to recover expert witness fees by contract. Arbitration rules may provide the basis for argument that there is a "contract" for recovery of expert witness fees. The argument is that if parties contract for decision under the arbitration rules that allow for expert witness fee recovery, then this constitutes a contract for recovery of expert fees. This approach was taken in *Thomas v. Prudential Securities*, 921 S.W.2d 847, 851 (Tex. App. – Austin 1996, no writ). In this case, the contract did not provide for expert fees, but it did incorporate the New York Stock Exchange arbitration rules, which give the arbitrator the authority to award costs and expenses to the prevailing party. *Id*. at 849. Additionally, a Houston federal court recently upheld an arbitration award on a breach of contract claim that included almost $75,000 in expert fees. The unpublished opinion states:

> Computer argues that the panel erred in awarding Ford fees for expert witnesses. The contract is silent about witness fees. Under Rule R-50 of the commercial rules, each party pays for the expenses of its witnesses. Rule R-43(c) allows the arbitrators to apportion those fees as the arbitrators decide. Given the latitude in Rules R-43(c) and R-50, the award was assessed within the arbitrators' discretion.

Dealer Computer Servs. v. Hammonasset Ford Lincoln-Mercury, Inc., No. H-08-1865, 2008 WL 5378065 at *2 (S.D. Tex., Dec. 22, 2008) (slip op.).

C. Witness or Proof Problems

In arbitration the arbitrators typically are professionals in the construction business or at least in the dispute resolution business and are not as likely to be impressed by courtroom theatrics or by imaginative claims. Arbitrations, moreover, result in decisions that are almost impossible to overturn, especially after the Supreme Court's decision in the *Mattel* case. As a result, if a party has a claim that is more likely to appeal to an emotional audience such as a jury, arbitration is not preferred.

D. Enforcing the Arbitration Award

The Federal Arbitration Act states that an award can be "confirmed" by a suit for that purpose within three years after the award is issued. 9 U.S.C. § 207. State law, or arbitration rules, might provide for a different result. Before arbitration is started, the party seeking affirmative relief should consider how to enforce the award and when to enforce the award before making a decision to go forward with an arbitration.

E. The Impact of State "Contingent Payment" Statutes

Many states, including Texas[2], have addressed by statute whether "paid when paid" or "paid if paid" clauses (known as contingent payment provisions) are enforceable, and if so, under what conditions. The impact of these statutes can be seen in addressing whether the claim is sufficiently liquidated to support a lien claim, which generally must be filed in real estate records under the same condition as would be a deed, meaning that it must be filed under oath. A claimant must therefore sign an affidavit claiming that a debt is due that enforces the claim, but under a contingent payment provision the debt may not be due if the owner has not yet made payment to allow payment obligations to trickle down to downstream parties. If a contingent payment provision is involved in a particular dispute, the questions concerning preservation of claims must be carefully addressed.

F. Recovery of Attorneys' Fees

The recovery of attorneys' fees in a contested case can become very important, because the amount of fees approaches and sometimes exceeds the amount of actual damages in question.

Under Texas substantive law attorney fees are recoverable under several claims, such as breach of contract, a suit to foreclose a mechanics' lien, declaratory judgment, the prompt payment statute, and for violation of the construction trust fund statute.

In actions concerning construction of federal projects the recovery of attorney fees is more limited. The U. S. Supreme Court has held that attorney fees will not be awarded in a Miller Act suit absent an enforceable contractual agreement or evidence that

[2] *See* Chapter 56 of the Texas Business and Commerce Code.

the opponent has acted “in bad faith, vexatiously, wantonly, or for oppressive reasons.” *F.D. Rich Co. v. United States ex rel. Industrial Lumber Co.*, 417 U.S. 116, 126 (1974).

In addition, although Texas courts have recognized that the Miller Act does not preclude supplemental jurisdiction of state law claims for attorney fees by and against contractors, such claims are not valid against the surety. *United States ex rel. Cal’s A/C and Elec. v. Famous Const. Corp.*, 220 F.3d 326, 329 (5th Cir. 2000); *United States ex rel. Varco Pruden Buildings v. Reid & Gary Strickland Co.*, 161 F.3d 915, 918 (5th Cir. 1999); and *United States ex rel. Howell Crane Company v. U.S Fidelity & Guaranty Company*, 861 F.2d 110, 113 (5th Cir. 1988).

VI. Substantive Legal Issues

A. Prompt Payment Statute

The Texas Prompt Payment Statute is set out at TEX. PROP. CODE ANN. ch. 28. It requires an owner who has received a written payment request from a contractor to make payment of amounts for properly performed work or properly delivered materials to make payment not later than the 35th day after the date the owner receives the request. Similarly, it requires a contractor or subcontractor who receives payment to pay each of its subcontractors the portion of the payment, including any applicable interest, that is attributable to work properly performed or materials delivered by that subcontractor as provided under the contract. *See* Tex. Prop. Code Ann. § 28.002(b)-(c).

However, there is an exception to this prompt payment requirement in the event of a good-faith dispute. Section 28.003 allows an owner, contractor or subcontractor to withhold a certain amount from the disputed payment if a good faith dispute exists concerning its obligation to pay or the amount owed. Further, Section 28.003 clarifies that “a good faith dispute includes a dispute regarding whether the work was performed in a proper manner.”

If it is determined that an owner, contractor, or subcontractor has failed to pay an amount required under the Prompt Payment Statute, and if the good-faith exception does not apply, then the claimant may be able to recover interest on the amount wrongfully withheld. The statute allows interest to accrue at the rate of 1-1/2 percent per month beginning on the date that payment is due, and allows the recovery of attorneys’ fees in a case brought to enforce a claim under the statute. *See* Tex. Prop. Code Ann § 28.004. Title 304 of the Texas Finance Code also contains provisions regarding the accrual of judgment and prejudgment interest.

It should be noted that this Prompt Payment Statute in Chapter 28 of the Texas Property Code applies to private construction projects. If a construction contract with a governmental entity is involved, then Chapter 2251 of the Texas Government Code should be consulted for the requirements for payments for work performed or for materials delivered in connection with the contract and the interest provisions applicable thereto.

B. Payments to Downstream Parties/Lenders/Trust Fund Statute

Contractors frequently find themselves in the middle, receiving payment from one party and then providing payment to another. There are at least two obligations of a contractor to use funds in this fashion. The first will be found in contract documents, such as the contract itself, or in payment applications, which may direct the contractor to pay bills for the project from the funds that the contractor is receiving. The second source of this obligation in Texas is at Chapter 162 of the Property Code, which contains the trust fund statute. Under this law, all monies paid to a contractor or a subcontractor under a construction contract and all loans received by a contractor or subcontractor, or owner, for the improvement of real estate are "trust funds" for the benefit of the persons who furnish labor or materials. In residential cases a contractor is required to maintain separate accounts for each project. Although contract documents might require this, the statute does not require this in the case of commercial construction. A contractor can defend a claim that it has violated the trust fund statute if it shows that funds were used to pay its "actual expenses directly related to the construction or repair of the improvement." Case law adopts a fairly generous view of this. For example, overhead expenses can be paid with construction trust funds as long as they were actually incurred and necessary to obtain or complete the project. *Lively v. Carpet Servs., Inc.*, 904 S.W.2d 868, 876 (Tex. App.—Houston [14th Dist.] 1995, pet. denied).

Another situation in which a problem can be encountered occurs when a contractor grants a security interest in its accounts receivable to a lender. The trust fund statute does not apply, under its terms, to a lender, title company, closing agent, or payment bond surety. TEX. PROP. CODE ANN. §162.002. The Texas Supreme Court has held that a bank's perfected lien on a contractor's accounts receivable has priority over the claims of subcontractors and suppliers which fail to perfect their mechanic's liens. *Republic Bank Dallas, N.A. v. Interkal, Inc.*, 691 S.W.2d 605 (Tex. 1985). After the *Interkal* case was decided, the mechanic's lien statute (TEX. PROP. CODE ANN. § 53.151(a) was amended to provide that subcontractors, suppliers, and mechanics obtain a priority interest in funds over other general creditors. *In re Waterpoint Int'l LLC*, 330 F.3d 339 (5th Cir. 2003) held that Section 53.151 protected subcontractors, laborers and materialmen which had perfected their lien rights, but not otherwise.

C. Implied Contracts

If there is no formal contract between a claimant and an alleged responsible party (or sometime even if there is) the claimant may seek recovery under the theories of quantum meruit or unjust enrichment. These are equitable remedies based on an implied agreement to pay for benefits received.

A common situation arises when a contractor agrees to perform work for a set fee, but then encounters changed conditions and performs extra work without an agreement for the amount to be charged for the extra work. This was the case in *Brender v. Sanders Plumbing, Inc.*, 2006 Tex. App. Lexis 6354 (Tex. App.--Fort Worth 2006, pet. denied), which affirmed a judgment for a contractor. The court said:

> The right to recover in quantum meruit is based upon a promise implied by law to pay for beneficial services rendered and knowingly accepted. *Black Lake Pipe Line Co. v. Union Constr. Co.*, 538 S.W.2d 80, 86, 19 Tex. Sup. Ct. J. 318 (Tex. 1976), overruled on other grounds by *Sterner v. Marathon Oil Co.*, 767 S.W.2d 686, 32 Tex. Sup. Ct. J. 266 (Tex. 1989); *Residential Dynamics, LLC v. Loveless*, 186 S.W.3d 192, 198-99 (Tex. App.--Fort Worth 2006, no pet.). To recover under quantum meruit, the plaintiff must prove that (1) valuable services and/or materials were furnished, (2) to the parties sought to be charged, (3) which were accepted by the parties sought to be charged, and (4) under circumstances that reasonably notified the recipient that the complaining party, in performing, expected to be paid by the recipient. *Heldenfels Bros., Inc. v. City of Corpus Christi*, 832 S.W.2d 39, 41, 35 Tex. Sup. Ct. J. 802 (Tex. 1992). If a valid express contract covering the subject matter exists, there can be no recovery upon a contract implied by law. *Woodard v. Southwest States, Inc.*, 384 S.W.2d 674, 675, 8 Tex. Sup. Ct. J. 145 (Tex. 1964). However, the existence of an express contract does not preclude recovery in quantum meruit for the reasonable value of services rendered and accepted that are not covered by the contract. *Black Lake Pipe Line Co.*, 538 S.W.2d at 86.

D. Implied Warranties

In a situation involving a residential construction project, the claimant may seek recovery under a cause of action for breach of an implied warranty. With regard to a residential construction project, a builder or vendor impliedly warrants to his purchaser that the building which has been constructed for residential use (1) has been constructed in a workmanlike manner and (2) is fit for habitation. *See Gupta v. Ritter Homes, Inc.*, 646 S.W.2d 168, 169 (Tex. 1983) (*citing Humber v. Morton*, 426 S.W.2d 554 (Tex. 1968)). This implied warranty covers "latent defects not discoverable by a reasonably prudent inspection of the building at the time of sale." *Id.* For example, the Supreme Court of Texas determined that defects in a chimney flue, in a vent of a heating apparatus, and in plumbing work covered by a concrete foundation are the types of latent defects to be covered by the implied warranties. *See Humber v. Morton*, 426 S.W.2d 554, 561 (Tex. 1968).

The claimant must show that the defendant is the builder of the residential building in order to bring a claim against that defendant for breach of implied warranty. *See Wiggins v. Overstreet*, 962 S.W.2d 198, 202 (Tex. App.—Houston [14th Dist.] 1998, pet. denied). "Builder" means "the actual contractor who constructs the building, not the nonbuilder owner." *Id.* (*citing Gupta*, 646 S.W.2d at 169). The claimant must also show that he or she purchased the complained of residential property, but the implied warranties do extend to both the original purchaser and subsequent purchasers. *See March v. Thiery*, 729 S.W.2d 889, 892 (Tex. App.—Corpus Christi 1987, no writ).

The Supreme Court of Texas has held that implied warranties for good and workmanlike repair of tangible goods and property and for good and workmanlike

construction of a new home are "gap-filler," default warranties and can be superseded "if the parties' agreement specifically describes the manner, performance, or quality of the services." *Gonzales v. S.W. Olshan Found. Repair Co., LLC*, 400 S.W.3d 52, 53 (Tex. 2013). In *Gonzales*, the homeowner had hired a foundation repair company to repair the foundation problems in her home and sued the company after an engineer had subsequently determined that the company had improperly repaired the foundation. *See id.* at 53-54. Gonzales' claims included, among others, breach of an express warranty as well as breach of the implied, common-law warranty of good and workman like repairs. *See id.* at 54. The Court acknowledged that it had previously "recognized the existence of 'an implied warranty to repair or modify existing tangible goods or property in a good and workmanlike manner' in *Melody Home Manufacturing Co. v. Barnes*…" but held that this implied warranty, like the implied warranty of good workmanship for a new home, serves as a "gap-filler" or "default warranty," only applying "unless and until the parties express a contrary intention." *Id.* at 56. The Court ultimately held that the implied warranty had been superseded by the parties' express warranty provisions which required the foundation repair company to repair the foundation with a particular type of system, "to perform the work in a good and workmanklike manner, and to adjust the foundation due to settling for the life of the home." *Id.* at 57.

It should be noted that the Residential Construction Liability Act (or the RCLA), contained in Chapter 27 of the Texas Property Code, places limitations on the liability of a contractor. These limitations include, among others, a limitation on the contractor's liability for damages caused by the negligence of a person other than the contractor or an agent, employee or subcontractor of the contractor and for damages related to normal wear, tear, deterioration and shrinkage. *See* Tex. Prop. Code § 27.003. Chapter 27 applies to: "(1) any actions to recover damages or other relief arising from a construction defect, except a claim for personal injury, survival or wrongful death or for damage to goods, and (2) any subsequent purchaser of a residence who files a claim against a contractor." Tex. Prop. Code § 27.002(a). Section 27.004 further requires written notice of the construction defects that are the subject of the complaint to be sent to the contractor in certain circumstances.

E. Notice of Claims

Many contracts contain very short time periods for a contractor to provide notice of claims and require the notice in particular forms and to particular parties. Although courts generally hold that a party which breaches its contract first cannot rely on such requirements, contractors are always better off by providing the notices required. The notice requirements cannot be satisfied without knowledge of what they require, so the contractor is advised to read these requirements carefully.

F. Statutes of Limitations and Repose

Statutes of limitations set time periods within which lawsuits must be brought after the right to bring them has "accrued" (begins to run). This occurs when a wrongful act causes an injury, regardless of when the plaintiff learns of the injury. The applicable statute of limitations depends on the nature of the claim that is asserted and who is

asserting it. In Texas, generally claims for personal injuries or for property damages must be brought within two years after the claims accrue. Claims for breach of contract or to recover debt must be brought within four years after the claims accrue.

It appears to be generally accepted that parties can agree by contract when a cause of action accrues. For example, Article 13.7 of the AIA 201 General Conditions has separate accrual provisions for "acts or failures to act" before substantial completion, between substantial completion and final payment, and after final payment. It is also possible to agree to the time period that suit can be brought, although in Texas an agreement that establishes a limitations period that is shorter than two years is void. TEX. CIV. PRAC. & REM. CODE ANN. §16.070.

It is not safe to assume that a tort claim must be brought within two years after the date that a project is completed. A concept known as the "discovery rule," which applies in tort cases, might apply to extend the accrual date of a statute of limitations. For example, an owner might be able to assert that it did not know and could not with the exercise of reasonable diligence have discovered a design defect until a failure occurred, and thereby attempt to extend the accrual date for limitations to the date of actual discovery. *See M.D. Thomson v. Espey Huston & Associates, Inc.*, 899 S.W.2d 415 (Tex. App.—Austin 1995, no writ).

The nature of construction is such that a possible defect could remain hidden for many years until an injury results, meaning that a cause of action might not accrue for years after construction has been completed. In an effort to protect contractors and design professionals from never-ending liability, the Texas legislature has enacted a "statute of repose." This statute (TEX. CIV. PRAC. & REM. CODE § 16.008) provides that a cause of action for wrongful death, personal injury or property damage that arises out of a defective or unsafe condition of any real property must be commenced within ten years after substantial completion of the improvement or commencement of operation of any equipment attached to real property. If the claimant gives written notice of the claim within the ten-year period, however, the filing period is extended for two years from the date of that notice.

The effect of a statute of repose is to cut off a right to bring a claim that otherwise could be filed. After the time period set by the statute of repose expires, no cause of action can be brought for injuries or property damage resulting from damages caused by the unsafe premises.

There is a difference in the statute that protects design professionals and contractors. The statute that protects contractors (Texas Remedies Code § 16.009) does not apply if "willful misconduct or fraudulent concealment in connection with the performance of the construction or repair" has occurred. This provision does not exist in the statute that protects design professionals. In *Dallas Market Center Development Co. v. Beran & Shelmire*, 824 S.W.2d 218 (Tex. App.—Dallas 1991, writ denied), the court held that an allegation that a design firm committed fraudulent concealment did not extend the ten-year period set by the statute of repose, based on this distinction and the

language of the statutes. The design professional is cautioned to take this into account when being asked to indemnify contractors.

G. The Sham Contract Doctrine

The Texas Property Code has a section titled "Sham Contract" (TEX. PROP. CODE § 53.026) that allows a subcontractor to be treated for the purposes of mechanics' lien perfection and enforceability as an original contractor under three situations:

- The owner contracted with the purported general contractor and the owner "can effectively control the general contractor through ownership of voting stock, interlocking directorships, or otherwise";

- The alleged general contractor "can effectively control the owner through ownership of voting stock, interlocking directorships, or otherwise";

- The owner's contract with the general contractor was made with no good faith intention that the general contractor was to perform the contract.

This provision is most frequently litigated or arbitrated if the subcontractor failed to provide proper notices of its lien or failed to prefect its lien timely, or both, because the rules that allow a general contractor to create and enforce its liens against an owner's property are much easier to follow than those concerning subcontractors.

VII. How to Enforce Mechanics' Liens

A. Foreclosure of Liens

Once a lien is properly perfected by sending timely notices to the right entities and filing a timely lien affidavit (if required), a lien claimant must sue to foreclose the lien and get an order to sell the property to collect the debt. Suit to foreclose on a mechanic's lien must be filed "in the county in which the property is located…." TEX. PROP. CODE ANN. § 53.157.

1. Time Limits

The deadline for filing suit to foreclose a lien on a commercial property is within two years after the last day a claimant may file a lien affidavit or within one year after completion, termination or abandonment of the work under the original contract, whichever is later. TEX. PROP. CODE §53.158(a). The deadline for residential properties is shorter. Suit must be filed within one year after the last day a claimant may file a lien affidavit or within one year after completion, termination or abandonment of the work under the original contract, whichever is later. TEX. PROP. CODE §53.158(b).

2. Arbitration/Litigation

The Texas Property Code provides that only a court of competent jurisdiction can foreclose on a mechanic's lien and order the sale of the property. TEX. PROP. CODE §53.154. Suits to foreclose on mechanic's liens generally will involve proving that the all

of the notice and filing requirements were met in order to obtain a judgment foreclosing the lien. However, if the contract between the owner and the original contractor contains an agreement to arbitrate, in an action by the original contractor to enforce its mechanic's lien an arbitrator might first decide the technical issues such as whether the notices and lien affidavits were timely. *CVN Group v. Delgado*, 95 S.W.3d 234 (Tex. 2002). If the original contractor gets a favorable arbitration award upholding the validity of the lien, suit would then be filed to enforce the arbitration award and foreclose on the lien. Subcontractors and sub-subcontractors that do not have a contract with the owner should not be required to arbitrate their mechanic lien claims. However, beware of clauses in subcontracts or sub-subcontracts that "incorporate" into them the terms of the contract between to original contractor and the owner or that list the owner/original contractor as a subcontract document. If the contract between the owner and original contractor called for arbitration, one might argue that by incorporating or referring to that contract a subcontractor or sub-subcontractor also agreed to arbitrate its mechanic's lien claims.

B. The Removables Doctrine

The Removables Doctrine is involved if there is a contractual lien, such as a deed of trust and a mechanics lien on the same property. The general rule is that a mechanic's lien has priority based on the visible construction or supplied materials on the site. TEX. PRAC. & REM. CODE § 53.1424. If a deed of trust is recorded after that date, a properly perfected mechanic's lien should have priority over that lien. The question of whether the work was sufficient can give rise to an issue to be decided by a court or an arbitrator.

Even if the deed of trust existed before visible work began, the claimant has priority for materials supplied that can be removed without causing material damage to the land, pre-existing materials, or the materials themselves. Items that courts have held to be removable without material injury include dishwashers and disposals, carpets, appliances, air conditioning and heating components, smoke detecters, burglar alarms, light fixtures, door locks, fixtures, windows and doors, electrical wiring and conduit, and some floor coverings. Items that are almost certainly not removable would constitute roofing materials, framing materials, the concrete slab, roofing tiles, brick, and other outside items used to shield or protect a structure from damage by the elements.

VIII. Statutory Payment Bonds and Potential Impacts on Lien Claims

Chapter 53 of the Texas Property Code governs the requirements for and effects of payment bonds that may be filed in connection with a construction project. Such payment bonds are intended to provide protection to those who perform work on or provide materials or services for a private construction project. Section 53.201(a) states that, "[a]n original contractor who has a written contract with the owner may furnish at any time a bond for the benefit of claimants." Section 53.201(b) dictates that, "[i]f a valid bond is filed, a claimant may not file suit against the owner or the owner's property and the owner is relieved of obligations under Subchapter D or E." Such a payment bond "protects anyone with a claim perfected in a manner prescribed for fixing a lien under subchapter C of the [Texas Property] Code." *Fondren Constr. Co. v. Briarcliff Hous. Dev. Assocs.*, 196 S.W.3d 210, 214 (Tex. App.—Houston [1st] 2006, no pet.).

A statutory payment bond covers "only the labor, materials, etc., furnished by others to an original contractor for the completion of the project and payment of claims against such contractor." *Fid. & Deposit Co. v. Felker*, 469 S.W.2d 389, 393 (Tex. 1971). Stated otherwise, the beneficiaries of a payment bond include the subcontractors and the suppliers to the project at issue. *Laughlin Envir., Inc. v. Premier Towers, L.P.*, 126 S.W.3d 668, 671 (Tex. App.—Houston [14th Dist.] 2004, no pet.). Another important issue that may arise in litigation is the extent of or scope of coverage afforded by a particular statutory payment bond. If the bond does not cover the work for which the claimant is demanding payment, then the claimant cannot recover on the bond, and the surety is not a proper party to the suit. *Fondren Constr. Co. v. Briarcliff Hous. Dev. Assocs*., 196 S.W.3d at 216.

Certain requirements must be satisfied in order for a bond to qualify as a statutory payment bond. "The payment bond must meet the criteria set forth in section 53.202, be approved by the owner, and be filed in accordance with chapter 53 of the Texas Property Code." *Id.* "If a payment bond meets the statutory requirements, a claimant may not file lien claims against the property owner or seek foreclosure of the claimant's lien on the owner's property," and the claimant may only look to the payment bond for recovery. *Id.*

Section 53.208 permits a claimant to "sue the principal and surety on the bond … if the claimant's claim remains unpaid for 60 days after the claimant perfects the claim," and requires such suit to be brought "in the county in which the property being improved upon is located." However, section 53.208(d) also contains important time limitations: "If the bond is recorded at the time the lien is filed, the claimant must sue on the bond within one year following perfection of his claim. If the bond is not recorded at the time the lien is filed, the claimant must sue on the bond within two years following perfection of his claim." *See Fondren Constr. Co. v. Briarcliff Hous. Dev. Assocs*., 196 S.W.3d at 215 (in which the court determined that the claimant failed to sue on the bond or add the surety as a party to the suit within a year from the date the surety properly recorded its bond, and thus the claimant's suit against the surety was barred by the statute of limitations found in TPC 53.208(d).

A. Statutory Requirements for Payment Bonds

Section 53.202 contains the following requirements for statutory payment bonds. Specifically, Section 53.202 requires that a statutory payment bond must:

(1) be in a penal sum at least equal to the total of the original contract amount;

(2) be in favor of the owner;

(3) have the written approval of the owner endorsed on it;

(4) be executed by:

(A) the original contractor as principal; and

(B) a corporate surety authorized and admitted to do business in this state and licensed by this state to execute bonds as surety, subject to Section 1, Chapter 87, Acts of the 56th Legislature, Regular Session, 1959 (Article 7.19-1, Vernon's Texas Insurance Code);

(5) be conditioned on prompt payment for all labor, subcontracts, materials, specially fabricated materials, and normal and usual extras not exceeding 15 percent of the contract price; and

(6) clearly and prominently display on the bond or on an attachment to the bond:

(A) the name, mailing address, physical address, and telephone number, including the area code, of the surety company to which any notice of claim should be sent; or

(B) the toll-free telephone number maintained by the Texas Department of Insurance under Subchapter B, Chapter 521, Insurance Code, and a statement that the address of the surety company to which any notice of claim should be sent may be obtained from the Texas Department of Insurance by calling the toll-free telephone number.

"In Texas, all payment bonds obtained for private construction projects must conform with the criteria set forth in section 53.202 of the Texas Property Code." *New AAA Apt. Plumbers, Inc. v. DPMC-Briarcliff, L.P.*, 2006 Tex. App. LEXIS 8576, 7-8 (Tex. App. Houston 14th Dist. Oct. 5, 2006) (citations omitted).

B. Attempted Compliance

However, even if a Bond fails to meet all of the requirements set forth in Section 53.202, the Bond may still be deemed valid and effective if it was filed in attempted compliance with the Property Code requirements or if the Bond's terms demonstrate an intent to comply with the statutory requirements. *See* Tex. Prop. Code § 53.211(a). "Although section 53.202 speaks in terms of mandatory requirements for statutory payment bonds, the Texas Property Code does not require perfect compliance with these requirements." *Laughlin Envir., Inc.*, 126 S.W.3d at 671. This is because section 53.211(a) contains a savings clause. *See id.* Specifically, 53.211(a) states: "A bond shall be construed to comply with this subchapter, and the rights and remedies on the bond are enforceable in the same manner as on other bonds under this subchapter, if the bond: (1) is furnished and filed in attempted compliance with this subchapter; or (2) evidences by its terms intent to comply with this subchapter." Thus, pursuant to section 53.211(a), as long as there is "attempted compliance with subchapter I of Chapter 53 of the Texas Property Code," then the payment bond will be treated as valid and conforming even if it does not strictly comply with each of the requirements set forth in Section 53.202. *See id.*

For example, in *New AAA Apt. Plumbers, Inc. v. DPMC-Briarcliff, L.P.*, the Houston Court of Appeals held that there was attempted compliance with the payment bond provisions in section 53.202, despite the fact that the bond did not contain certain language regarding the conditions of prompt payment as required by 53.202(5). *See New AAA Apt. Plumbers, Inc.*, 2006 Tex. App. LEXIS 8576 at *11-13. However, this same court determined in another case that the bond there did *not* make a showing of attempted compliance or an intent to comply with the statutory requirements when it failed to contain any statutory terminology, recitations, or references to the statute or to a payment bond, was not conditioned upon the prompt payments of the items set forth in Section 53.202(5) and contained a penal sum in an amount less than the amount of the original contract yet failed to provide any explanation for the defective amount. *See Laughlin Envir., Inc.*, 126 S.W.3d at 673-75. Therefore, while some defects or instances of non-compliance may not be fatal to a particular payment bond, courts will not always find a non-conforming bond to be within "attempted compliance" or to have demonstrated an intent to comply with the statutory requirements.

If the court determines that a particular bond does not meet the statutory requirements set forth in Section 53.202 and also fails to demonstrate attempted compliance or an intent to comply with the statutory requirements, then the Bond will not be considered a statutory payment bond and "is nothing more than a common-law payment bond." *See Laughlin Envir., Inc.*, 126 S.W.3d at 675. Thus, the Bond will not preclude a lien claim against the owner or owner's property, and the claimant merely must comply with the requirements for making a claim set forth in the Bond and not the statutory requirements contained in Section 53.202. *See id.*

C. Exclusive Remedy for Claimant

Pursuant to Tex. Prop. Code § 53.201(b), a claimant is precluded from bringing an action against the owner or its property when valid payment bonds have been filed. *See Fid. & Deposit Co. v. Felker*, 469 S.W.2d 389, 390 (Tex. 1971); *see Fondren Constr. Co. v. Briarcliff Hous. Dev. Assocs*., 196 S.W.3d 210, 216 (Tex. App.—Houston [1st] 2006, no pet.). Section 53.201(b) states: "An original contractor who has a written contract with the owner may furnish at any time a bond for the benefit of claimants. *If a valid bond is filed, a claimant may not file suit against the owner or the owner's property* and the owner is relieved of obligations under Subchapter D or E" (emphasis added). Therefore, if there is a valid payment bond has been filed, then Section 53.201(b) dictates that the contractor is barred from bringing a suit to foreclose its lien against the owner's property. The claimant's only remedy will be to look to the bond on file.

D. Owner's Potential Counterclaim for Fraudulent Lien Claim

Project owners should keep in mind the potential availability of a counterclaim for the contractor's and/or subcontractor's filing of a Fraudulent Lien Claim. This cause of action is created under Chapter 12 of the Texas Civil Practice and Remedies Code. Section 12.002 prohibits a person from making, presenting or using a document or record with "(1) knowledge that the document or other record is a fraudulent court record or a

fraudulent lien or claim against real or personal property or an interest in real or personal property; (2) intent that the document or other record be given the same legal effect as a court record or document of a court created by or established under the constitution or laws of this state or the United States or another entity listed in Section 37.01, Penal Code, evidencing a valid lien or claim against real or personal property or an interest in real or personal property; and (3) intent to cause another person to suffer … financial injury…."

Thus, if an owner is able to show that valid, complying payment bonds have been appropriately filed and that the claimant had knowledge of such bonds but filed lien claims or suits to foreclose on purported liens anyway, the owner may wish to assert such a counterclaim. Texas Civil Practice and Remedies Code § 12.002(b) states: "[a] person who violates Subsection (a) is liable to each injured person for: (1) the greater of: (A) $10,000; or (B) the actual damages caused by the violation; (2) court costs; (3) reasonable attorney's fees; and (4) exemplary damages in an amount determined by the court."

IX. Performance Bonds in the Public and Private Construction Context

In addition to payment bonds which may be filed in connection with a construction project, Section 2253.021 of the Texas Government Code requires that a governmental entity which makes a public work contract with a prime contractor must require the contractor to execute a performance bond if the contract is in excess of $100,000.00. This performance bond is "solely for the protection of the state or governmental entity awarding the public work contract," and must be executed by a corporate surety in accordance with certain statutory requirements. *See* Tex. Govt. Code § 2253.021(b),(d).

As with statutory payment bonds used for private projects, there is a statutory provision regarding attempted compliance of payment and performance bonds furnished in connection with a public work contract. Tex. Govt. Code Section 2253.023 (a) dictates that a bond furnished by a prime contractor in an attempt to comply with Chapter 2253 shall be construed to be in compliance with Chapter 2253 "regarding the rights created, limitations on this rights, and remedies provided." Additionally, it should also be noted that with regard to a performance bond entered into under Chapter 2253, there is a one year statute of limitations with regard to suits on performance bonds, running from the date of final completion, abandonment or termination of the public work contract. *See* Tex. Govt. Code § 2253.078(a).

It is an established principle that "a performance bond is enforceable only to the extent of the obligee's actual damages." *Great Am. Ins. Co. v. North Austin Mun. Util. Dist. No. 1*, 908 S.W.2d 415, 426 (Tex. 1995). "Likewise, when an obligee's actual damages exceed the penal amount of a bond, a surety's liability generally is limited to the penal sum of the bond." *Id.*

While contractors are not statutorily required to furnish performance bonds for private construction projects, a private entity may still require its contractor to furnish a

performance bond for the protection of that entity. A performance bond entered into in connection with a construction contract between private parties "is to be read and construed in connection with the contract and the obligations imposed upon the subcontractor by the contract are read into the defeasance clause of the bond because the condition is that if the principal shall perform all the terms and conditions of the contract the obligation shall be void." *Employers' Liability Assurance Corp. v. Trane Co.*, 139 Tex.388, 394 (Tex. 1942). However, when it comes to the obligations of the surety under the bond, such obligations "arise out of and are imposed by the bond and are measured and determined by its terms." *Id.*