

New York’s Court of Appeals Rules on the Lien Law

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The Court of Appeals, in *Altshuler Shaham Provident Funds V. GML Tower*, decided June 11, 2013¹, held that when a mortgage secures both construction and acquisition loan financing and a building loan contract is not filed as required by Section 22² of New York’s Lien Law, the mortgage will be subordinated to mechanics’ liens filed against the property to the extent of loan proceeds intended to fund the making of improvements³; the mortgage is not subordinated as to funds advanced to acquire the property. The decision of the Court of Appeals can also be interpreted as holding, perhaps more significantly, that a building loan contract is required when a mortgage loan is advanced by the lender into an escrow to be drawn upon when work is done and contractors are to be paid. This article is intended for educational and informational purposes only. The views and opinions are solely those of the author.

The Lien Law protects a bona fide purchaser for value, accepting a deed or an assignment of a leasehold, from the successful enforcement of mechanics’ liens filed after the delivery of the deed or assignment so long as the deed or assignment contains a so-called Lien Law trust fund clause⁴. The trust fund clause also protects the priority of a mortgage lien for advances made before a mechanic’s lien is filed. However, when a borrower, an Owner, in the parlance of the Lien Law⁵, makes an “express promise”⁶ to apply a mortgage loan to pay the costs of an improvement the transaction must comply with the building loan requirements of the Lien Law⁷. Otherwise, the lien of the mortgage will not, as to advances under the building loan⁸ whenever made, have priority over mechanics’ liens.

Under Section 22, if a building loan contract, when required to be filed⁹, is not timely filed, a subordination penalty applies. Under Section 22, when there is a failure to comply with the requirements for a building loan, “the interest of each party to such contract in the real property affected thereby, is subject to the lien and claim of a person who shall thereafter file a notice of lien under this chapter.”

‘Altshuler’ Case

The relevant facts of Altshuler are, in 2007 the foreclosing Plaintiff's predecessor agreed to make a \$10 million loan divided into two tranches. One tranche, for \$5.5 million, was to be advanced to refinance a \$7 million mortgage executed in 2005 for the purchase of the property. The other tranche, for \$4.5 million, was to be advanced to make improvements on the property. The existing mortgage was taken by assignment and, as modified, secured a maximum principal amount of \$5.5 million; but the modification referenced the \$10 million loan.

The tranche for improvements was, as noted by the Court of Appeals, funded in escrow into, as required by the 2007 loan agreement, a "dedicated bank account...to be 'held...and disbursed, used and applied solely to finance' improvements...based on construction progress as determined by an inspector appointed by Altshuler." Over the next year, \$2.5 million of the escrow was advanced, secured only by personal guarantees. No building loan contract was filed.

In 2008, the original loan agreement was amended and the final \$2 million held in escrow was advanced. A "Mortgage Increase, Modification and Spreader Agreement", increasing the principal amount secured to \$10 million, was recorded. The mortgage, as modified, was treated as a conventional mortgage, rather than a building loan mortgage.

In an Action to foreclose the \$10 million mortgage, the Supreme Court, Onondaga County, held¹⁰ that the 2007 loan agreement constituted a building loan requiring the filing of a building loan contract; no building loan contract having been filed, the \$10 million mortgage was subordinate in its entirety to subsequently filed mechanics' liens. The Appellate Division, Fourth Department, affirmed¹¹. The Court of Appeals also affirmed, but modified the judgment as to which the appeal was taken.

According to the Court of Appeals, the 2007 loan agreement, entered into with the plaintiff's predecessor, was a building loan contract because it provided \$4.5 million to make improvements at the property and the agreement modifying the mortgage stated that it secured the "payment and/or performance of all indebtedness [of the borrower] described in the [2007 loan agreement]." Therefore, a building loan contract should have been filed before the mortgage was recorded. When the 2008 amendment to the loan agreement was executed, a modification to a filed building loan contract should have been filed.

Altshuler argued, unsuccessfully, that since all the loan proceeds for improvements were advanced before a mortgage securing those sums was recorded, the recorded mortgage was not a building loan agreement within the meaning of Section 22.

The Court of Appeals, in holding that a building loan contract should have been filed, held that Appellant's mortgage, insofar as it secured money earmarked for improvements on the property, was subordinate to mechanics' liens. However, the Court of Appeals further held that the mortgage had priority over filed mechanics' liens to the extent of the \$5.5 million advanced in 2007 to refinance the existing acquisition loan mortgage. According to the Court,

[s]ection 22 does not state that the entire interest of each party to an unfiled building loan contract is subject to a later-filed notice of lien...the subordination penalty logically applies only to funds loaned to pay for improvements. Here, the 2007 loan agreement allocated \$5.5 million of the loan proceeds to pay

off the existing purchase money mortgage. This tranche closed before any monies were advanced for construction, and the 2007 mortgage was in this amount recorded before any contractor began work on the project. The 2008 mortgage [modification]...simply extended the reach of and increased the principal amount secured by the 2007 mortgage. We therefore conclude that \$5.5 million of the loan proceeds, secured by the 2007 and 2008 mortgages, was not subject to the subordination penalty.

Whether acquisition loan funds were disbursed before any funds held in escrow were advanced for construction and the mortgage was recorded before work commenced is truly essential to the Court's ruling is questionable. The Court cited favorably the 1990 decision of the United States District Court, Northern District of New York in *Yankee Bank for Savings v. Task Associates*¹² in which the district court held that a mortgage securing both purchase money and money loaned for construction was subordinate to mechanics' liens but only to the extent of the loan proceeds intended to pay for the making of an improvement. In so ruling, the Court of Appeals essentially overruled the 1996 ruling of the Appellate Division, Second Department, in *Atlantic Bank of New York v. Forrest House Holding*¹³ holding that a mortgage securing funds for both construction and acquisition loses priority as to mechanics' liens in its entirety for a violation of Section 22.

According to the federal District Court, "[b]y definition a 'building loan contract' and 'building loan mortgage' only operate with respect to money lent for improvements on real property. Lien Law Section 2 (13), (14). Therefore, the proceeds from the loan which were lent for the purchase of the property are not subject to the subordination penalty of Lien Law Section 22." The ruling in *Yankee Bank*, stated the Court of Appeals in *Altshuler*, "does not contravene the statute's purpose, to give contractors and material suppliers notice of how much money a building loan makes available for construction."

Funds to Escrow

The other issue which the Court of Appeals addressed in *Altshuler*, albeit indirectly, is whether a building loan contract is required when mortgage loan proceeds for the making of an improvement, on which the borrower is paying interest, are advanced by the lender into an escrow to be released on the satisfaction of certain conditions set by the lender. This issue was previously considered in a 2011 decision of the Supreme Court, *Monroe County, Lehman Brothers Holdings v. Genwood Strathallan*¹⁴.

In *Lehman*, the loan agreement required that funds advanced by the lender, secured by a mortgage, be deposited into two interest bearing accounts to be advanced in accordance with the terms of two "Repair Escrow Agreements". The First Repair Escrow Agreement, into which loan proceeds of \$1,872,750 were deposited, was to be applied by the borrower to complete repairs and remedy items of deferred maintenance listed in an exhibit to the loan agreement; this amount was secured by a first mortgage. The Second Repair Escrow Agreement, into which loan proceeds of \$1.65 million were deposited, to also be used to complete work at the property, was secured by a second mortgage. The first and second mortgages were consolidated into a single lien.

A mechanic's lienor claimed that the Loan Agreement, together with the Repair Escrow Agreements, constituted a building loan contract. No building loan contract having been filed, it claimed that liens of the mortgages should be subordinated to its filed mechanic's lien. The lender countered that no building loan contract was required, since the Consolidated Note, the Loan Agreement and the first and second mortgages did not contain either an express promise by the borrower to use the loan proceeds to make an improvement or an express promise by Lehman to fund the making of an improvement. The lender also argued that since the loan secured by the consolidated mortgage, \$12.85 million, was fully disbursed by the lender day the mortgage documents were executed (although into the restricted escrow accounts), there was no building loan because a building loan must be a loan disbursed in installments.

The Lehman Court, while granting the foreclosing Plaintiff summary judgment, denied the Plaintiff's motion to dismiss the counterclaim of the mechanic's lienor, holding that the consolidated mortgages being foreclosed were, by operation of law, subject to its mechanic's lien. According to the Court:

While it is true that the entire amount of the \$12,850,000 loan secured by the Consolidated Mortgage was in a sense disbursed on January 30, 2007, the money was not made available to the Borrower in a lump sum. By the terms of the Loan Agreement, and the First and Second Escrow Agreement, the borrower was required to immediately fund the escrow accounts described in those agreements with part of the funds disbursed on that date. The funds could not be used for any other purposes than the PIP Repair Work and Immediate Repair Work, and could only be disbursed by permission of the Lender upon request of the borrower as the Work was completed. Use of this escrow arrangement, which some commentators have described as an attempt to circumvent Lien Law Section 22 requirements, still requires periodic disbursements as the Work is completed by the Lender of the monies dedicated to completion of the Work.

The Court of Appeals in *Altshuler* took the same position as the Lehman court. Loan proceeds advanced into a restricted account to be later advanced to pay for the making of an improvement on the mortgaged premises require the filing of a building loan contract¹⁵.

How the courts will apply this ruling to mortgage loans not funding significant capital improvements remains to be seen. A lender may require a borrower to put loan proceeds into a reserve earmarked to pay ongoing building maintenance. Funds from a pledged account may be funded to pay for the "performance of brokerage services in obtaining a [commercial] lease for a term of more than three years of all or any part of the property"¹⁶. A portion of a loan may be advanced into escrow to enable the mortgagor to reimburse space tenants for their leasehold improvements, the Owner having some degree of control or merely approval rights over the work. Each of these situations, and others, may be held by courts, applying *Altshuler*, to require the filing of a building loan contract.

Title Insurance

When a building loan mortgage is to be insured by a policy of title insurance, lender's counsel needs to bring to the attention of its title insurer or the title insurer's agent that a transaction will

involve a building loan to enable an underwriter to confirm that the closing documents comply with certain requirements of the Lien Law. Furthermore, it is important that it be brought to the attention of the title insurer or its agent that the execution and filing of a building loan contract is not being contemplated when loan proceeds are to be disbursed to pay for the cost of an improvement. For a loan policy of title insurance to be issued without an exception for the failure to file a building loan contract, or an exception of similar import, the filing of a building loan contract may be required. Exclusions of the policy may apply for the failure to disclose that loan proceeds are to fund improvements.

Footnotes

1. 2013 WL 2475863
2. Chapter 33, McKinney's Consolidated Laws of New York, Section 22 ("Building loan contracts")
3. "Cost of improvement" is defined in Lien Law Section 2 ("Definitions")
4. Lien Law, Section 13 ("Priority of liens")
5. "Owner" is defined in Lien Law Section 2
6. A building loan contract is defined in Lien Law Section 2 as "...a contract whereby a ...lender..., in consideration of the express promise of an owner to make an improvement upon real property, agrees to make advances to or for the account of such owner to be secured by a mortgage on such real property..."
7. See Berey, "New York's Lien Law and Building Loans", New York Law Journal, Construction Law Supplement, November 13, 2007.
8. Atlantic Bank of New York v. Forrest House Holding, 651 N.Y.S. 607 (2d Dept., 1966); HNC Realty v. Golan Heights Developers, 360 N.Y.S.2d 954 (Supreme Court, Rockland County, 1979.
9. Under Section 22, a building loan contract is required to be filed before the mortgage is recorded, and a modification of the contract must be filed within ten days of its execution.
10. 900 N.Y.S.2d 846
11. 83 A.D.3d 1563
12. 731 F. Supp. 64 (1990)
13. 234 A.D. 2d 491
14. Index No. 2010/10157, October 20, 2011.
15. An issue for the courts applying Altshuler may, in certain instances, be, as noted in the dissenting opinion, "after a deal has gone south, it may be difficult to discern precisely what proportion of a loan was earmarked for acquisition expenses and what portion was actually expended for that purpose..."
16. Within the definition of an "Improvement" under Lien Law Section 2

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