

New York's Lien Law and Building Loans

New York State's Lien Law is straightforward for the basic real estate conveyance. A contractor, subcontractor or laborer doing work, or a materialman furnishing materials, for the making of an improvement on real property has four months from the final date on which the work was performed or the materials for the improvement were furnished to file a mechanic's lien for property which is or is intended to be improved by a single family dwelling, and eight months to file a mechanic's lien in respect of any other type of property. [FN1] A mechanic's lien is a lien on the property from the date of its filing, as is the case with other typical liens and encumbrances. [FN2]

The grantor of a deed, a mortgagor, and a leasehold assignor will covenant in its deed, mortgage or lease assignment to hold the proceeds of the transaction in trust, under Section 13 of the Lien Law, to ensure the payment of those who have done work or furnished materials. By reason of that "Lien Law covenant", the grantee, mortgagee, or leasehold assignee need not verify the proper application of the consideration paid or the loan proceeds advanced, and their interests are protected against the claims of any mechanics lienors remaining unpaid. The application by the transferor of the funds it holds in trust for any purpose other than to pay mechanics or materialmen constitutes larceny punishable under New York's Penal Law. [FN 3]

When dealing with a mortgage that secures advances to be made to fund the making of improvements to real estate, however, the requirements of the Lien Law can be confusing, particularly to non-resident Counsel first dipping their toes in the waters of the Lien Law. What is a building loan contract, when is it required, what must it set forth, and what are the penalties for a failure to comply with the relevant requirements of the Lien Law?

A building loan contract, also known as a building loan agreement, is required to be filed when an "owner" has made an "express promise" to use loan proceeds to improve its real property [FN 4], and the loan will be secured by a mortgage, which is generally known as a building loan mortgage. The purpose of a building loan agreement is to inform mechanics and materialmen of the amount of the funds available for the improvement and, in doing so, it sets forth a schedule for and the conditions to the lender's advancing of the loan proceeds. It is irrelevant whether the mechanic or materialman relied on, or even reviewed, the terms of the building loan agreement and the Section 22 Affidavit, discussed below. [FN 5]

By filing a building loan agreement which complies with requirements of the Lien Law, the lien of the related building loan mortgage, to extent of advances made, has priority over later filed mechanic's liens. [FN 6] However, for the lien of the mortgage to have such priority, a building loan agreement must be filed in the County Clerk's Office in the county in which the property in question is located prior to the recording of the building loan mortgage. [FN 7]

Building loan proceeds can only be used to fund a "cost of [an] improvement" [FN 8]. These costs are generally referred to as including "hard costs" and "indirect costs". Hard costs include amounts to pay the real construction costs incurred to contractors, subcontractors, laborers, and materialmen. Indirect costs are

expenses integral to the improvement which are not brick and mortar types of expenses and include, for example, payments to be made to architects, engineers and surveyors, fair and reasonable sums for obtaining building loan and subsequent financing, amounts for title insurance, mortgage recording tax, lender's counsel fees allocable to the building loan, premiums on payment bonds and amounts to take existing mortgages which are to be consolidated with the building loan mortgage, interest on the building loan mortgage, amounts to reimburse the owner for costs of the improvement incurred prior to the date of the initial building loan advance (provided that the payments are itemized in the Section 22 Affidavit noted below), amounts advanced by the building loan lender to repay itself advances it previously made for the costs of the improvement in question pursuant to notices of lending filed pursuant to Lien Law Section 73, and ground rents, real estate taxes and water charges to be incurred during the making of the improvement.

These costs are set forth in a statement annexed to the Building Loan Agreement, generally identified as a Lien Law Statement or a Section 22 Affidavit. [FN 9] After itemizing in the Affidavit certain indirect costs of the improvement being funded, amounts, if any, being advanced to reimburse the borrower and to repay the lender sums it previously advanced pursuant to filed notices of lending, the affidavit sets forth the estimated amount of indirect costs of the improvement which may later be funded and the net sum that will be available to pay hard costs. The statement of the net sum is typically followed by the recital "less such amounts as may become due and payable for insurance premiums, interest on building loan mortgages, ground rent, taxes, assessments and water rents accruing during the making of the improvement after the date hereof". A Lien Law Statement, affixed to the Building Loan Agreement, needs to be accurate and care must go into its preparation.

If there is a material misstatement of an amount, such as the net sum available for the improvement, the lien of the building loan mortgage may be subordinated in its entirety to the claims of mechanics lienors [FN 10], who have parity, amongst themselves, as to any funds available for payment. [FN 11] In addition, when a change in the terms of a building loan agreement is "material" but an amendment is not duly filed, mechanic's liens filed after the change will have priority over the lien of the mortgage. [FN 12]

An amendment to a building loan agreement, including an updated Section 22 Affidavit, is required to be filed within ten days of its execution. Failing to do so, "the interest of each party to such contract...is subject to the lien and claim of a person who shall thereafter file a notice of lien..." [FN 13]

Items not properly includable as building loan expenses, generally known as "soft costs", are expenses for land acquisition [FN 14] (although a funded acquisition mortgage can be assigned to the building loan lender and consolidated with the building loan mortgage), the legal fees of the borrower's Counsel, marketing expenses, the developer's supervisory construction fees and overhead costs, and leasing and brokerage commissions (other than for brokerage services to obtain a lessee under a commercial lease for a term of more than three years, which is within the definition of an "Improvement"). [FN 15] Soft costs are typically secured

by a separate project loan mortgage. A Project Loan Agreement is not required to be filed and it rarely is filed.

A number of issues commonly arise under the Lien Law when dealing with mortgages securing advances for the making of an improvement to real property.

For example, a building loan agreement need not be filed if the owner does not make an express promise to the lender that it will use the loan proceeds to make an improvement to real property. This is a fine line, but counsel for mechanics and materialmen will most likely challenge the absence of a building loan agreement, and seek priority over advances under a mortgage for the failure to file an agreement, if loan documents indicate that the owner agreed to use the loan proceeds for an improvement to its real property. Treating the loan as a non-building loan may be difficult when the lender conditions advances on the prior receipt of lien waivers or certifications as to the status of construction by an architect or engineer. A mortgage loan to fund for tenant improvements and a mortgage loan advanced in full either to the borrower or into a pledged account controlled by the lender are presumably building loans as the borrower has undertaken to use the proceeds to fund an improvement.

How are amounts allocated between the building loan and the project loan? Expenses incurred or to be incurred by a borrower which are not set forth in the Lien Law's definition of "cost of improvement" should generally be treated as being project loan expenses and should be secured by a project loan mortgage. Title insurance premiums, mortgage recording tax, and the legal fees of lender's counsel will apply to both the building and project loan mortgages and an allocated amount is a proper building loan expense.

What if an ongoing building loan mortgage is being assigned to a new lender which will fund the remaining disbursements? The new building loan lender should expressly assume an assignment of the obligation to complete advances under the filed building loan agreement, and the assignment and assumption should be referenced in a filed amendment to the building loan agreement. For the remaining advances under the existing building loan to be made by the assuming lender without the re-payment of additional mortgage recording tax on that amount, the State Tax Commission has informally advised this author that there must also be a period of time remaining within which the proceeds were to be advanced by the initial building loan lender.

What is the preferred priority of the mortgage liens when there are mortgages in addition to a building loan mortgage? A mortgage executed and delivered to the building loan lender to fund the acquisition of the real property and a project loan mortgage are often senior to the lien of the building loan mortgage on the theory that those senior mortgages, to the extent that they secure advances which were made, can be foreclosed to cut-off rights under mechanics liens filed after those advances if there is a defect in a building loan which impairs the priority of the building loan mortgage.

What if there is an insufficiency in the amount of the building loan or in the project loan, requiring a reallocation between the two loans? Moving funds from building loan to project loan, or visa versa, may, to avoid a challenge by unpaid mechanics

lienors or the payment of additional mortgage recording tax, require modifying the mortgage with the overage to clearly allocate the secured amount between building loan and project loan funds and amending the building loan agreement and its Section 22 Affidavit to reduce or increase the building loan amount, as applicable. When there is believed to be an excess in the building loan and a shortage in the project loan, the lender and its title insurer, before there is a reallocation from the building loan to the project loan, should ensure that all mechanics and materialmen have been paid to date and that there are sufficient funds remaining under the building loan to pay for all of the project's remaining work and material.

This article can only minimally treat the subject of building loans. Care needs to be taken when dealing with the requirements of New York's Lien Law.

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Footnotes:

1. Lien Law, Section 10 ("Filing of notice of lien").
2. Lien Law, Section 3 ("Mechanics liens on property")
3. Lien Law, Section 79-a ("Misappropriation of funds of trust").
4. Lien Law, Section 2 ("Definitions"; Building loan contract").

An "Owner", for application of the Lien Law, includes such interests as that of the owner in fee of real property or a lesser estate therein, a lessee for a term of years, or a vendee in possession. Lien Law Section 2 ["Definitions"; Owner"]

5. in Re Elm Ridge Associates, 234 B.R. 349 (Bkrtcy. S.D.N.Y.. 1999)
6. Lien Law, Section 13 ("Priority of liens").
7. Lien Law, Section 22 ("Building loan contract").

When a loan is to be advanced to fund an improvement to real property a notice of lending under Lien Law Section 73 or a notice of assignment under Lien Law Section 15, should also be filed in the County Clerk's Office to allow re-payment to the lender free of the claims of unpaid mechanic's lienors. This should be done even when there is no building loan agreement or building loan mortgage so long as the lender should know that the loan proceeds are to be applied to pay for the making of an improvement on real property. See the decisions of the New York

Court of Appeals in Aspro Mechanical Contracting, Inc. v. Fleet Bank, N.A., 1 N.Y. 3d 324, 773 N.Y.S. 2d 735 (2004) and LeChase Data/Telecom Services, LLC v. Goebert, 6 N.Y.3d 281, 811 N.Y.S. 2d 317 (2006), and Berey, "The Lien Law Trust: Lenders Beware", NYSBA Journal, February 2007.

8. Lien Law, Section 2 ("Definitions; Improvement").

9. Lien Law, Section 22.

10. HNC Realty Company v. Golan Heights Developers, 360 N.Y.S. 2d 954 (Sup. Ct. Rockland County, 1975).

11. Lien Law, Section 13 ("Priority of liens").

12. HNC Realty Company v. Bay View Towers Apartment, Inc., 409 N.Y.S. 2d 774 (2nd Dept., 1978).

13. Lien Law, Section 22.

14. Yankee Bank for Finance and Savings, FSB v. Task Associates, Inc., 731 F. Supp. 64 (N.D.N.Y, 1990) But see Amsterdam Savings Bank v. Terra Domus Corporation, 470 N.Y.S. 2d 448 (3rd Dept., 1983).

15. Lien Law, Section 2.