

The Lien Law Trust: Lenders Beware

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A mortgage encumbering real property in New York will typically contain a so-called Lien Law covenant in which the mortgagor agrees that it will, in compliance with § 13 of New York's Lien Law, receive the loan proceeds in trust and apply the proceeds first to pay for any improvements made to the property. If the mortgage contains such covenant, the lender has no obligation to see to the proper application of advances by the owner. A deed delivered in New York contains a similar recital.(1)

A lender may therefore assume that when it is repaid it does not need to verify that mechanic's lienors and materialmen (collectively referred to as "mechanics"), performing work or furnishing materials for an improvement at the mortgaged property, were paid. Due to recent decisions of the Court of Appeals, however, failing to verify that mechanics have been paid may have consequences for a lender; and that may be the case even when the lender did not advance funds on the security of a real estate mortgage.

Under Lien Law Article 3-A ("Definition and Enforcement of Trusts"), funds received by the owner of real property in connection with the making of an improvement are trust assets to be held by the owner as a trustee² to ensure that the claims of mechanics have been paid or discharged. If a trust asset is paid, transferred or applied other than to pay those claims, there is a diversion of trust assets.(3)

In addition to filing a mechanic's lien against the real property,(4) a mechanic can commence an action to enforce a trust claim against the owner within one year of the completion of the improvement. In such an action, trust assets in the hands of "any person," including a transferee who received the trust assets with the knowledge that they were trust funds, together with interest thereon from the time of the diversion, can be recovered, and the trust fund assets that are recovered are distributable to all beneficiaries of the trust whose claims are then payable.(5) A transferee of trust assets has a defense if it can establish that it is "a holder in due course of a negotiable instrument or a purchaser in good faith for value without a notice that the transfer to him [was] a diversion of trust assets."(6)

Until the 2004 decision of the Court of Appeals in *Aspro Mechanical Contracting, Inc. v. Fleet Bank, N.A.*,(7) a mortgage lender was not generally considered to be the trustee of an Article 3-A

trust. In *Aspro Mechanical*, Berry Street Corp. entered into an arrangement with the New York City Housing Authority (NYCHA) under which Berry Street acquired title to three parcels of land in Brooklyn under a so-called turnkey arrangement. Berry Street was to construct residential buildings on the sites and, on completion of construction, transfer title to the parcels to the NYCHA (the "Turnkey Contract"). Loans secured by a building loan mortgage and a project loan mortgage were made by Norstar Bank, which assigned the loans and mortgages to Fleet Bank, N.A. (collectively referred to as the "Lender"). The loans were also secured by an assignment to the Lender of Berry Street's rights under the Turnkey Contract.

Once the project was completed, the balance due under the Turnkey Contract was advanced by NYCHA but paid directly to the Lender, which applied the money to the repayment of its loans. An action was commenced by the mechanics to recover the funds allegedly diverted by the Lender.

The Court of Appeals held that when the Lender was assigned the Turnkey Contract it became an owner-trustee of an Article 3-A trust and was required to administer the trust solely in the interests of the trust beneficiaries. The Court indicated that the Lender would not have been charged with a diversion of trust assets if it had filed either a notice of lending under Lien Law § 73, to notify trust beneficiaries that trust assets would be applied to repay advances that it had made, or a notice of assignment under Lien Law § 15, to give notice of the assignment of moneys due or to become due under a contract for the improvement of real property.

Before the Court's decision in *Aspro Mechanical*, notices of lending were typically filed by a mortgage lender only when it was advancing funds for an improvement prior to the execution of a building loan contract.⁽⁸⁾ (The filing of a notice of assignment has not been common in real estate mortgage lending.) Since the *Aspro Mechanical* decision, certain construction lenders are routinely filing notices of lending on any building loan. They do so to avoid a charge that they participated in a diversion of funds when their loans are repaid before the claims of mechanics are satisfied. This may be a manageable procedure for a construction lender.

Following its decision in *Aspro Mechanical*, the Court of Appeals expanded the net of Article 3-A. It held, in *LeChase Data/Telecom Services, LLC v. Goebert*, decided February 21, 2006,⁽⁹⁾ that a lender that is a "Factor"⁽¹⁰⁾ may be an Article 3-A trustee even if it did not have actual knowledge that money repaid to reduce its loan constituted assets of a Lien Law trust.

In *LeChase Data*, Light House Communication Design, Inc., entered into an agreement with Mel WorldCom Network Services, Inc., to construct for WorldCom "telecommunications network infrastructure" at sites in Monroe County, New York. To secure working capital, Light House had entered into an accounts receivable purchase agreement with Business Funding Group, Inc., a Factor, under which Business Funding would advance money to Light House in exchange for an assignment of its accounts receivable. Light House instructed WorldCom to pay all invoices directly to Business Funding with a portion of each payment to be rebated by Business Funding to Light House. Business Funding filed a UCC-1 financing statement; it did not file a notice of lending or a notice of assignment.

LeChase Data/Telecom Services, LLC, a subcontractor, was to receive progress payments as

Light House was paid by Worldcom. When it was not paid in full, LeChase filed mechanic's liens against the property, and it also commenced a separate action against Business Funding alleging a diversion to it of trust funds. Business Funding moved for summary judgment to dismiss the complaint, contending that because it had no actual knowledge of construction or installation activities by Light House it was a "purchaser in good faith for value and without notice" and should not be subject to an action to enforce the Article 3-A trust.

The Court of Appeals stated that there was no dispute that the contracts between Worldcom and Light House and between Light House and LeChase were contracts to improve real property, Light House's assignment to Business Funding was an improper diversion of statutory trust funds,

"The Court of Appeals has broadly applied the trust fund concept"

and LeChase was a trust beneficiary entitled to recover trust assets. The only issues were the standard of notice that would be applied to determine if Business Funding would be protected by the "good faith purchaser" exception to Article 3-A liability and whether there were triable issues of fact concerning notice.

The Court held that the proper standard of notice for the case was not whether Business Funding's principal had actual knowledge that the funds it received were trust assets but whether Business Funding, as a transferee of trust funds, knew or should have known that it had received payments that should have been applied to pay for the construction of improvements on real property. It quoted from the opinion of the lower court, which had reasoned as follows:

[T]he notice requirement(s) under Lien Law § 72 for a "good faith purchaser" are those defined in vee 1-201(25). Notice that a transfer is a diversion of trust assets . . . occurs when there is actual knowledge, when there is a notice or notification, *or from all of the facts and circumstances known at the time of the transfer there is reason to know that it is a diversion of trust assets.*(11)

According to the Court of Appeals, Business Funding's principal "knew or should have known that Business Funding was receiving payments from WorldCom for construction of improvements to real property."(12) Business Funding had copies of work orders, including one that authorized Light House to construct portions of a telecommunications network. It also knew, from e-mails and notes in its possession, that Light House's invoices were approved by WorldCom's construction managers, which "leads to the inference that Business Funding should have known that these invoices were for construction work."(13) Business Funding was therefore not protected as a good-faith purchaser, notwithstanding its lack of actual knowledge that the funds it received were trust assets. The Court of Appeals, in *Aspro Mechanical and LeChase Data*, has broadly applied the trust fund concept. The lenders in those cases could have been protected, however, by filing either a notice of lending or a notice of assignment. A lender, whether or not its loan is secured by a mortgage, may therefore find it prudent to file a notice, when loan proceeds are being used, or after a reasonable inquiry, it is determined that loan proceeds may be used, for the construction of an improvement to real property.

1. "Nothing in this subdivision shall be considered as imposing on the lender any obligation to see to the proper application of such advances by the owner." Lien Law § 13(3)("Priority of liens").
2. Lien Law § 70("Definition of trusts").
3. Lien Law § 72("Diversion of trusts funds").
4. Lien Law § 10("Filing of notice of lien").
5. Lien Law § 77("Action to enforce trust").
6. Lien Law § 72(1). The diversion of trust funds by a trustee of a Lien Law trust also constitutes the criminal offense of Larceny. Lien Law § 79-a("Misappropriation of funds of trust"); 1958 Op Att'y Gen. Mar. 18(informal).
7. 1 N.Y.3d 324, 773 N.Y.S.2d 735 (2004).
8. The Lien Law § 22 affidavit filed as part of a file Building Loan Contract may recite the amount, if any, to be advanced from the loan to repay amounts previously advanced to the Borrower pursuant to Notices of Lending for costs of the improvement.
9. 6 N.Y.3d 281, 811 N.Y.S.2d 317 (2006).
10. "[A] company that lends money to others on the security of their accounts receivable." *Id.* at 284.
11. *Id.* at 288(emphasis in original).
12. *Id.* at 292.

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13. *Id.* at 293.