New York Law Journal
Real Estate Trends
WWW.NYLJ.COM
An ALM Publication
VOLUME 246—NO. 91
WEDNESDAY, NOVEMBER 9, 2011

Construction Loans

Construction Lenders: Keep Your Priorities Straight!

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The financial crisis has left a plethora of abandoned construction projects riddled with mechanic's liens and burdened by mortgages that are deep under water. At the same time, New York State courts have sustained a triple-whammy: enormous existing caseloads, a barrage of foreclosure actions and deep recessionary cutbacks that have drastically winnowed already scarce resources. Under the heading, "desperate times call for creative measures," rather than commencing a foreclosure action, taking a number and then taking a loss somewhere far down the road, increasing numbers of construction lenders are attempting to salvage value by modifying the terms of their loans to developers, either formally in a writing or, perhaps, informally, by performance (and such informal changes may occur more frequently in the private lender context). Examples of the kinds of modifications being made include changes to the contemplated use of the project, decreasing the loan amount, increasing the borrower's consideration for the loan, changing the equity or retainage percentages or easing bonding requirements.

Modifying the terms of a building loan may make great business sense in today's environment, but not if it means the construction lender sacrifices the priority of its building loan mortgage lien over those of later-filed mechanic's liens. That is precisely what can happen if the modification is "material," but no filing is made with the County Clerk within 10 days. Pursuant to N.Y. Lien Law §22, for a building loan mortgage lien to have priority over later-filed mechanic's liens with respect to advances made prior to the filing of the mechanic's liens, not only must a building loan contract satisfying the statute's requirements have been filed with the County Clerk, but additional filings must be made within 10 days of any material modifications to the contract's terms. If not, the construction lender's lien will lose priority with respect to *all* advances made on the building loan—whether before or after the modification—a result to be avoided at all costs.

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Summary of Lien Priorities

Very generally, most real estate development is financed by an acquisition loan (for funds to acquire the underlying real estate), a project loan (to pay for "soft costs" that are not direct construction costs, such as the fees of architects, engineers and attorneys, operating expenses and marketing costs) and a building loan (for demolition, renovation and/or construction of the improvement). Both the acquisition loan and the project loan will usually be funded in one lump sum, and mortgages securing the loans will be recorded in the Register's Office. Once properly recorded, the acquisition loan mortgage and project loan mortgage have priority over later-filed mechanic's liens, in the full amount of the loan secured by the mortgage.[1]

The building loan is different, and, accordingly, the rules relating to its priority over mechanic's liens are different. A building loan is a loan made for the express purpose of funding the construction, renovation and/or demolition of an improvement on real property.[2] It is funded in tranches, or "advances," commensurate with the progress of the improvement and the concomitant payment of contractors and materialmen. The Lien Law is essentially a notice statute, and when it comes to the building loan, the purpose of the Lien Law is not only to provide notice of claims against the property ("acquaint[ing laborers and materialmen] with the fact that they furnish labor and materials subject to the claims prior to theirs against the property, so far as advances thereunder are prior to their liens when filed"), but also to prevent lenders and owners from having secret arrangements regarding the funds available for the improvement by informing such contractors of the net amounts to be advanced and the

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times of such advances.[3] The Lien Law achieves this purpose by conditioning (and dating) the priority of the building loan mortgage lien on the filing of the building loan contract, not the recordation of the building loan mortgage.[4]

Pursuant to Lien Law §22:

> A building loan contract either with or without the sale of land, and any modification thereof, must be in writing and duly acknowledged, and must contain a true statement under oath, verified by the borrower, showing the consideration paid, or to be paid, for the loan described therein, and showing all other expenses, if any, incurred, or to be incurred in connection therewith, and the net sum available to the borrower for the improvement, and, on or before the date of recording the building loan mortgage made pursuant thereto, to be filed in the office of they clerk of the county in which any part of the land is situated, except that any subsequent modification of any such building loan contract so filed must be filed within ten days of the execution of any such modification. No such building loan contract or any modification thereof shall be filed in the register's office of any county. If not so filed 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.

The requirement of filing modifications to the building loan contract accords with the purpose of the statute by ensuring that contractors and materialmen on a construction project are operating—and providing value to the project—based on current and accurate information.[5] Nonetheless, a lack of clarity over precisely what constitutes a "modification" requiring filing (particularly, it seems, where the modification is not a formal written amendment to the building loan contract), has led to the unfortunate result for some construction lenders of having their building mortgage liens subordinated in their entirety to later-filed mechanic's liens.

Modification Requiring Filing

Although §22 provides that "any" modification must be filed to preserve priority, New York courts have long held that not every change in the building loan contract rises to the level of a "modification," and that the statute's filing requirement applies only in the case of "material" changes.[6] A material change constituting a modification is one that either alters the rights and liabilities of the parties to the building loan contract or the rights of any third party beneficiaries to the building loan contract (such as, importantly, potential mechanic's lienors).[7] To be sure, changes to "essential" terms of the building loan contract, such as the amount or manner of payment or the net sum available to the borrower for the construction constitute material modifications that must be reduced to writing and filed within 10 days of execution, in accordance with §22.

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Of course, problems usually arise with changes that are not so obvious, where what might ultimately be determined to be a priority-divesting modification if not filed is not even memorialized in writing to begin with. For instance, the construction lender may simply have agreed (verbally) not to enforce what is otherwise a mandatory contract term, or to hold off in foreclosing even in the face of an uncured default. Because of the severe consequences of Lien Law §22, it is important for construction lenders to be sensitive to the possibility that what they may view as simply rolling with the punches may alter the essential terms of the building loan contract and, accordingly, must keep counsel informed to avoid potentially disastrous consequences.[8]

Set forth below are some typical circumstances that should cause a construction lender at least to make a call to counsel to discuss whether it is necessary to file a modification to its building loan contract.

Changes to Planned Use

Observers of real estate development in New York City are no strangers to mid-project changes to the planned use of the improvement. Whether a change in contemplated use constitutes a material modification requiring filing will depend on whether it reduces or impairs the extent of funds or property available to contractors and materialmen. Thus, for example, changing the intended use of a project from rentals to condominium apartments will be held to be a material modification, because it diminishes the extent of the property to which any contractors or subcontractors could attach a mechanic's lien (with the sale of interests in the condominium by the borrower-developer to unit owners).[9] Based on this reasoning, one might predict that a change in the opposite direction (contemplated use as condominium changed to rentals), where the equity remains accessible to the mechanic's lienors, would not be viewed as material. However, where the change goes so directly to the heart of the project as its use, in light of the horrific consequences of failing to file a modification, prudence counsels filing a modification no matter what.

Retainage Requirements

Failure to comply strictly with the retainage requirements of the building loan contract may not immediately strike a lender as a material modification. From the lender's perspective, retainage is the percentage of each contract price withheld from the borrower to ensure that the project will be completed, a protective device for the lender. From the perspective of subcontractors, however, retainage constitutes a fund assuring that they will be paid. Accordingly, retaining less than the required percentage (with contractor knowledge) may be found to consti-

tute a material modification requiring filing.[10] Case law suggests that this is particularly true the closer the project is to completion, at which point less, if any, funds remain to be advanced, and thus accessible to the potential mechanic's lienors.[11]

Easing Bonding Requirement

The lender's acceptance from the borrower of a bond that does not comply with the requirements of the building loan contract has been held to constitute a material modification. In *HNC Realty v. Bay View Apts.*, the building loan contract required the borrower to post a surety payment bond (which guarantees that all subcontractors will be paid, and vests them with a right of action thereon). However, the lender accepted a performance bond (which merely guarantees that the contractor will complete the project, and provides no right of action to subcontractors). The court held that there was "no question that HNC's failure to exact compliance with the contract's requirement that Bay View procure a surety payment bond 'covering***subcontractors' worked to impair the rights of those subcontractors. Had the required bond been given, the subcontractors would have been paid directly by the surety and this lawsuit would have been avoided."[12]

It can probably be safely inferred that expanding subcontractors rights, by insisting on a surety payment bond where only a performance bond is required by the building loan contract, will not be found to be a material modification.

One Very Valuable Lesson

It has been said that wisdom is intelligence with flexibility, and this holds true in real estate financing as elsewhere. Circumstances similar to those in *HNC Realty v. Bay View Apts*. existed in *In re Grossingers Assocs.*, except for one ultimately decisive difference: Whereas the HNC Realty building loan contract conditioned future advances on borrower's securing a payment bond, under the building loan contract in *Grossingers*, "the lending Banks had no *obligation* to make any Building Loan Advances unless certain conditions were met 'to the sole and complete satisfaction of the Lenders…' One of the conditions listed was the receipt of certain documents 'duly executed by the parties,'" including "bonds."[13]

Expressly distinguishing *HNC Realty*, the court thus held that the failure of the lender to require a payment bond from the owner did not constitute a modification of the building loan agreement because "there is no language in the Building Loan Agreement executed by the parties and on file in the Sullivan County Clerk's office that expressly requires the debtor to obtain a surety payment bond for the benefit of subcontractors at the Grossinger project… Nor did the defendant Banks make advances in violation of the Building Loan Agreement because it did not unconditionally require the debtor to provide a surety payment bond the original building loan contract did not require the posting of a payment bond as a condition of the lender making future advances."[14]

The performance or non-performance of other terms of a building loan contract phrased as options, rather than conditions or requirements for loan advances, also has been held to fall short of a modification requiring filing under Lien Law §22.[15] The moral of that story in an erratic market like today's, appears to be that flexibility, to the extent it can be tolerated in building loan agreement, may end up serving the construction lender well if and when lien priorities become an issue.

Conclusion

The rule of thumb is that a change is material, and constitutes a "modification" requiring filing, if it either alters the rights and liabilities of the parties to the building loan contract or the rights of any third-party beneficiaries to the building loan contracts (e.g., potential mechanic's lienors). Construction lenders making changes in the terms of their building loans—either formally or in the course of performance—should thus carefully consider, at the time they are doing so, whether the changes impair, enhance or leave unchanged the rights of contractors and materialmen providing labor and materials to the project. In all probability, if those rights are not impaired, a failure to file a modification within 10 days of the change (or execution of the change, if already formalized in an agreement), will not result in the construction lender's loss of lien priority. Nonetheless, considering the stakes, and court's demonstrated willingness to enforce the Draconian consequences set forth in the Lien Law, if in any doubt whatsoever, the best practice will be to file a modification in accordance with Lien Law §22—or at least contact counsel.

1. N.Y. Lien Law §13(1).
2. N.Y. Lien Law §§2(2), 2(4), & 2(13).
3. *In re Lynch III Props. Corp.*, 125 B.R. 857, 861 (Bankr. E.D.N.Y. 1991); *P.T. McDermott Inc. v. Lawyers Mtge. Co.*, 232 N.Y. 336, 341-42 (__).
4. N.Y. Lien Law §13(2) provides that: "[w]hen a building loan mortgage is delivered and recorded a [mechanic's] lien shall have priority over advances made on the building loan mortgage after the filing of the notice of [mechanic's] lien; but such building loan mortgage, whenever recorded, to the extent of advances made before the filing of the notice of lien, shall have priority over the [mechanic's] lien, provided it or the building loan contract contains the covenant required by subdivision three hereof, and provided the building loan contract is filed as required by section twenty-two of this chapter."
5. *Security Nat'l Bank v. Village Mall at Hillcrest Inc.*, 85 Misc. 2d 771, 779 (Sup. Ct. Queens Co. 1976).
6. *In re Lynch III Properties Corp.*, 125 B.R. at 861; *Security Nat'l Bank*, 85 Misc. 2d at 781.
7. See *Security National Bank*, 85 Misc. 2d at 781.
8. Severe consequences flow not only if a material modification is not filed, but also if it is filed past the 10-day deadline set forth in §22, and courts are serious about this. See, e.g., *TD Bank v. Ocean Watch Realty*, Index No. 011399/09 (N.Y. Sup. Ct. Nassau Co. April 21, 2010).
9. See *Sec. Nat'l Bank*, 85 Misc. 2d at 785-86.
10. Id. at 787.
11. Id.; *In re Lynch III Props. Corp.,* 125 B.R. at 861 (holding not material lender's failure to retain the required 10 percent of funds advanced because "[a]bsent any default by the Debtor under the terms of the Agreements, [lender] was obligated to advance the total amount under the Building Loan Agreements, and no more. In addition, even if [lender] had retained the full ten (10%) percent retainage, that fund would not be available to the mechanic's lienors in this case since the building was not completed and [lender] could apply those funds towards its completion").
12. 64 A.D.2d 417, 426 (2d Dept. 1978); see also *Nationwide Mechanical Contractors Corp. v. Hokkaido Takushoku Bank, Ltd.*, 188 A.D.2d 871 (3d Dept. 1992) (lender's failure to require owner to file payment bond provided for in building loan agreement was unfiled modification providing grounds for defeating lender's building loan lien priority).
13. 115 B.R. 449, 452 (Bankr. S.D.N.Y. 1990) (emphasis added).
14. Id. at 452-53.
15. See, e.g., *Howard Savings Bank v. Lefcon P'ship*, 209 A.D.2d 473, 618 N.Y.S.2d 910 (2d Dept. 1994) (building loan agreement set forth "range of options" possessed by bank in connection with funding of project (including level of equity funded by owner) and contingencies under which bank could (but was not required to) terminate or suspend making of advances).