

CONSTRUCTION LAW

Lender Priority Requires Strict Statutory Compliance

The current economic crisis has resulted in the suspension or abandonment of many incomplete construction projects, leaving in their wake competing lien claims between lenders and contractors. The resolution of these claims is generally a function of the lenders' strict compliance with the Lien Law which, when properly followed should give the upper hand to the lender.

Priorities Under the Lien Law

The statutory scheme of the Lien Law, as it relates to construction loans, is to afford a lien priority to construction loan advances over mechanic's liens filed subsequent to the loan advances, even though the work was performed before the advances.¹ However, in order to maintain such priority, there must be strict compliance with the Lien Law, particularly sections 22 and 73 which, respectively, require the filing of the building loan agreement (and the so-called Section 22 Affidavit) and a notice of lending.²

Lien Law Section 22, and the requirement of a borrower's affidavit that states the net funds available for construction, is often found at the heart of many contractor/lender battles. The underlying purpose of Section 22 is to inform contractors of the amount of funds that will be available from a construction loan. Usually, the borrower will be able to pay the contractor only if the bank advances funds under the construction loan. By reviewing the Section 22 affidavit, a contractor can determine for itself whether sufficient mortgage proceeds exist for the project.

Accordingly, Section 22 provides that a building loan contract must contain a borrower's affidavit stating the consideration for the loan, other expenses of the loan, and "the net sum available to the borrower for the improvement." The building loan

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contract itself must be filed in the county clerk's office on or before the recording of the building loan mortgage. "Material" modifications to the building loan contract must be in writing and filed as well. The statute continues by stating that, if either the building loan contract or a "material" modification is not filed appropriately, "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."

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Impact of Non-Compliance

The consequences of the failure to file a correct Lien Law affidavit were first and most notably presented in *HNC Realty Co. v. Golan Heights Developers Inc.*, where the court subordinated the lien of the lender to that of a contractor because of a materially false Lien Law affidavit.³

In *Golan Heights*, the lender advanced its borrower monies for the acquisition of the project as well as for construction purposes. The Lien Law affidavit accompanying the

construction loan recited that the net sum available for the improvement was, essentially, the face amount of the construction loan, whereas, in fact, a significant sum was deducted from that amount and used to acquire the property. The court charged the lender with actual knowledge that the borrower's affidavit was misstated to the extent it reflected that acquisition funds would be available for the cost of the improvement.

At issue in *Golan Heights* was whether the penalty of subordination would flow from the filing of a defective borrower's affidavit. After reciting the history of Section 22, the court concluded that the mortgage loan would be subordinated because of the materially false borrower's affidavit. Moreover, the acquisition loan, as well as the building loan mortgage, was subordinated to the mechanic's liens. The court concluded: "If the foregoing seems harsh, and it is, it must be understood that we are here dealing not with equitable redress, but with a statutorily imposed penalty. That penalty was deemed necessary by the Legislature to vindicate the strong public policy upon which Section 22 is founded...a lender who violated Section 22 must suffer the consequences."⁴

Golan Heights was cited with approval in *Nanuet National Bank v. Eckerson Terrace Inc.*, where the Court of Appeals affirmed the subordination of a mortgage lien to a contractor's lien in the face of a material misrepresentation in the building loan contract.⁵ In *Nanuet*, the borrower's Lien Law affidavit did not deduct certain expenses incurred by the borrower in procuring the loan so that "the net sum available...for the improvement" was overstated.⁶

The Court, after determining that the legislative history of Section 22 supported subordinating the mortgage lien under these circumstances, reasoned that the "threat of a loss of priority is an effective deterrent to a lender's indifference to the truthfulness" of the borrower's affidavit.⁷ To the lender's argument that it should not be held responsible for the misstatement of the borrower, the court noted that the borrower does not have any lien priority to lose. Moreover, the Court's

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reasoning went, the details necessary to make the borrower's affidavit accurate are normally within the lender's knowledge.

Least the seriousness of subordinating a mortgage lien to that of a mechanic's lien be missed, prior mortgages that have been assigned to the current mortgagee and consolidated with a new gap mortgage would also be subordinated. The court in *Golan Heights* determined that Section 22's reference to the "interest of each party" must mean a party's entire interest inasmuch as Lien Law Section 2, subdiv. 14 defines "building loan mortgage" as "a mortgage made pursuant to a building loan contract and includes an agreement wherein and whereby a building loan mortgage is consolidated with existing mortgages so as to constitute one lien upon the mortgaged property."⁸ The conclusion that prior assigned mortgages, as well as the new gap mortgage, would be the victim of subordination obviously was not a difficult conclusion to reach.

'Ritz-Craft'

The requirements of Section 22 were also the subject of intense scrutiny by several levels of courts in *Ritz-Craft Corp. of Pa. v. National Electrical Benefit Fund*.⁹ In *Ritz-Craft*, defendant National Electrical Benefit Fund ("NEBF") appealed from an order and judgment of the U.S. States Bankruptcy Court for the Southern District of New York, which granted Ritz-Craft's motion for summary judgment subordinating NEBF's secured mortgage lien to a mechanic's lien subsequently filed by Ritz-Craft. The Bankruptcy Court subordinated NEBF's construction loan to Ritz-Craft's lien because, according to the court, NEBF filed a materially false affidavit in violation of Lien Law Section 22 by failing accurately to state "the net sum available to the borrower for the improvement." On appeal, the District Court reversed and, in a detailed analysis of Section 22, found that the "net sum available" was accurately stated. The Second Circuit affirmed.¹⁰

The facts leading to the proceedings were typical of defaulted construction projects. Sometime prior to 1995, three limited partnerships were formed to assist in the development of Nob Hill Ridge, a 416-unit rental housing project located in Elmsford, New York ("Nob Hill"). Nob Hill was developed in three sections, and each one of the debtors owned a different section—Elm Ridge Associates ("ERA") owned Section I, Elm Ridge Associates II ("ERA-II") owned Section II, and Nob Hill Partners III, L.P. ("NHP-III") owned Section III. In 1998, the Nob Hill project went into bankruptcy, which in turn spurred the legal battles.

Ritz-Craft was a contractor at Nob Hill and supplied pre-fabricated housing for Sections II and III. For Section III, Ritz-Craft's contract price was more than \$3,000,000, of which Ritz-Craft was paid all but \$384,251.52. To recoup this money, Ritz-Craft filed a mechanic's lien in the amount of the unpaid balance on April 30, 1996. NEBF financed the entire Nob Hill project. In doing so, NEBF lent NHP-III approximately \$14 million, which went unpaid. NEBF filed a claim

in the bankruptcy proceedings for the balance it was due. Ritz-Craft brought an adversary proceeding in an attempt to subordinate NEBF's claim to the claim of Ritz-Craft, based upon an alleged material defect in the Section 22 affidavit filed by NEBF.

The Section 22 affidavit attached to the building loan contract between NEBF and NHP-III showed the "net sum available to the borrower for improvement" as \$7,200,000. NEBF asserted that it distributed \$10,700,000 to the borrower for the improvement. Ritz-Craft claimed that \$4,616,191 of such amount should not be deemed distributed to the borrower for the improvement, because it was paid to ERA-II as reimbursement for preliminary site and infrastructure work (the "Common Site Work") for the entire project completed prior to the purchase of Section III by NHP-III from ERA-II ("ERA-II Reimbursement").

The Bankruptcy Court agreed with Ritz-Craft and determined that the amount paid for the Common Site Work by NHP-III to ERA-II, although labeled a "Reimbursement," was in essence part of the purchase price NHP-III paid for the land, and not part of the "net sum available to the borrower for the improvement." Disallowing the ERA-II Reimbursement reduced the actual amount

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paid to the borrower for the improvement by about \$1,000,000 less than the \$7,200,000 amount represented as being available for the improvement. The Bankruptcy Court further determined that because NEBF was fully aware of the existence of the ERA-II Reimbursement at the time it filed the building loan contract, it knew of a material defect in the Section 22 affidavit, and thus materially misstated the net sum available.

NEBF appealed the Bankruptcy Court's decision to the District Court, arguing that the amounts stated in its affidavit were the actual amounts available to the borrower for the improvement. The District Court agreed, stating that "the moneys transferred to ERA-II by NHP-III covered the cost of the Common Site Work" and there was no misstatement in the Section 22 affidavit.¹¹ The decision of the Bankruptcy Court was reversed and the Second Circuit affirmed.

In affirming the District Court, the Second Circuit likewise rejected the arguments of Ritz-Craft and stated that the contractor failed to demonstrate that there was any legislative purpose in enacting Section 22 "to provide more than a generalized notice of the amount available

for the improvement."¹² The court further ruled that there was no prohibition against the use of construction loan proceeds to reimburse the borrower for work completed prior to the issuance of the construction loans and that the focus of the inquiry should be on the nature of the goods and services for which the expenditures were made, not the time when the borrower incurred the obligation to pay. The court concluded, "the issue here, then, is whether the goods and services for which ERA II was reimbursed, the Common Site Work, can properly be considered as part of 'the improvement' under section 22."¹³ The court ruled that the expenditures made by the borrower were properly included in the "cost of the improvement."

On appeal to the Second Circuit, Ritz-Craft also raised the argument that its lien was superior to the lien of NEBF because NEBF failed to file a Notice of Lending pursuant to Lien Law Section 73. The court, however, observed that the argument was not raised in the lower courts and would not be considered. More recently, the failure to file a Notice of Lending was raised by a contractor and proved to be the key to success in establishing the priority of its mechanic's lien over the lien of the construction loan.

In *Aspro Mechanical Contracting Inc. v. Fleet Bank, N.A.*, the New York Court of Appeals ruled that the failure of a lender to file a Notice of Lending under Lien Law Section 73 violated the trust fund provisions of Article 3A of the Lien Law, resulting in a breach of fiduciary duty owed to the contractor and the imposition of damages equivalent to the amount of the contractor's lien against the lender.¹⁴

Conclusion

Ritz-Craft and *Aspro* are indicative of the complex issues raised in disputes between lenders and contractors. While the statutory scheme of the Lien Law would appear to provide adequate protection to lenders, strict compliance with the statute's provisions is essential to maintain lien priority and avoid damages for diversions of trust assets.

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1. *Ritz-Craft Corp. of Pa. v. Nat'l Elec. Benefit Fund (In re Elm Ridge Associates)*, 241 B.R. 321, 327 (S.D.N.Y. 1999).

2. *Aspro Mechanical Contracting Inc. v. Fleet Bank, N.A.*, 1 N.Y.3d 324, 773 N.Y.S.2d 735 (2004).

3. *HNC Realty Co. v. Golan Heights Developers Inc.*, 360 N.Y.S.2d 954, 79 Misc. 2d 696 (Sup. Ct. Rockland County 1974).

4. *Id.*, 360 N.Y.S.2d at 961-962, 79 Misc. 2d at 703.

5. *Nanuet Nat'l Bank v. Eckerson Terrace Inc.*, 47 N.Y.2d 243, 417 N.Y.S.2d 901 (1979).

6. *Id.*, 47 N.Y.2d at 246, 417 N.Y.S.2d at 902.

7. *Id.*, 47 N.Y.2d at 248, 417 N.Y.S.2d at 904.

8. *Golan Heights*, 360 N.Y.S.2d at 956, 79 Misc. 2d at 702.

9. *Ritz-Craft*, 241 B.R. at 327.

10. *Ritz-Craft Corp. of Pa. v. Nat'l Elec. Benefit Fund (In re Elm Ridge Associates)*, 234 F.3d 114 (2d. Cir. 2000).

11. *Ritz-Craft*, 241 B.R. at 327.

12. *Ritz-Craft*, 234 F.3d at 122.

13. *Id.*

14. 1 N.Y.3d 324, 773 N.Y.S.2d 735 (2004).