

# THE MORTGAGE OBSERVER

MAY 2013 ISSUE - JOSHUA STEIN IN THE NEWS - PAGE 12

The M.O. Columnists / May 2013

THE MORTGAGE OBSERVER

Stein's Law

## One Reason Construction Loan Closings Are So Complicated

It's utterly incomprehensible. It makes every New York construction loan closing two or three times as complicated and paper-intensive as it needs to be. It produces surprises when a lender messes up in new ways never imagined. And it creates a technique to derail any construction project at any time. What is it?

The New York Lien Law, of course. Whoever wrote it, many years ago, thought it created a wonderful system to protect people who worked on or provided materials for construction projects. If those people weren't paid, they received a special gift: the right to file mechanics' liens against the project. If the owner still didn't pay, then the lien claimant could eventually foreclose, much like a mortgage foreclosure.

That all might sound like a reasonable starting point. After all, systems like these exist throughout the United States, giving certain creditors incredibly powerful rights that normal creditors just don't have. For example, if a real estate lawyer works on a transaction and the client doesn't pay, the lawyer doesn't have an automatic right to foreclose on the client's real estate. The lawyer has to go to court, eventually perhaps get a judgment, and then try to enforce

it. Good luck. For mechanics' lien claimants, it's much simpler and quicker. That's why they are sometimes called "the world's most pampered creditors." If they aren't paid, even because of a genuine dispute with the owner, they simply file a lien, and this often brings the project to a halt.

It gets worse as soon as a lender enters the picture and makes a construction loan. The lender doesn't want to run the risk of losing its mortgage lien because of a mechanic's lien foreclosure. The lender wants to know its mortgage will create a claim on the project that's superior to mechanics' liens. The New York Lien Law allows construction lenders to possibly achieve that result, at least for part of their loan. To do it, though, a construction lender must jump through a series of hoops, some incomprehensible and others merely impractical.

The lender needs to break its loan into two or three separate loans, and each needs its own set of prolix loan documentation. On top of that, any loan that will provide future advances to pay for construction must comply with the Lien Law's technical requirements for a "building loan." It can fund only certain categories of expenses, but some of those categories are quite unclear. For

example, certain types of lighting qualify, but others don't.

The lender also needs to prepare a separate "building loan agreement," accompanied by an affidavit that discloses some limited information and gets filed at the county courthouse. The theory is that people who might work on a job will hike down to the county courthouse and read the building loan agreement and the affidavit to decide whether enough money will be available to complete the project. But does anyone really do that?

The building loan agreement does, however, give the lender a great opportunity to destroy its priority by making a mistake: an incomplete disclosure, miscategorization of loan proceeds or some other technical defect. And the biggest opportunity for error arises after the closing. If the lender agrees to modify the building loan agreement, then the lender needs to file an amendment at the county courthouse within 10 days. It sounds easy and reasonable, but as a practical matter, it isn't always easy to do. And lien claimants can argue that ordinary waivers and accommodations in the course of loan administration amount to a modification of the building loan agreement, which almost certainly no one ever thought of filing. Net result: loss of priority for the construction loan and a happy moment for the lien claimant.

Lawyers for mechanics' lien claimants have been known to boast that they can always find something the construction lender did wrong, some basis to take away its priority. It is a believable boast.

The mechanics' lien system is governed by an ancient statute that is nearly incomprehensible and has become quite impractical and needlessly tedious for modern financial transactions.

Beyond the burden and cost it imposes on construction loan closings, it also contains a few other traps. It creates complex trust fund relationships that are theoretically designed to wall off funds intended to pay for construction, but in practice just create more opportunities for lien claimants to drop little bombs. Lenders can protect themselves from those bombs by making other and different filings in the county courthouse, at least until the next unexpected court case that reaches some other unexpected result based on the tortured and opaque language of the Lien Law.

In a state that sometimes prides itself on being sophisticated, practical and ahead of the curve, the Lien Law is an abject embarrassment. **10**

Joshua Stein is the sole principal of Joshua Stein PLLC. The views expressed here are his own. He can be reached at [joshua@joshuastein.com](mailto:joshua@joshuastein.com).



Joshua Stein