White and Williams LLP

The New York Lien Law
Top Ten Things You Ought to Know

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Over the course of my career, I have had the privilege of working with and representing numerous construction lenders (and borrowers/developers) in the financing of some of the largest commercial projects in the United States. A number of these projects have been in New York, where one encounters the New York Lien Law (the "Lien Law"). For construction lenders and borrowers, the Lien Law is, to say the least, unique in its requirements and operation.

Many of my clients, particularly those lenders, borrowers, and their counsel, located outside of New York, are often perplexed by my advice regarding the Lien Law and the loan structuring requirements which result. In the hope that it would be helpful (especially for non-New York counsel), I have compiled a "top ten" list outlining, in my view, the most critical (and most perplexing) aspects of structuring New York construction loans under the Lien Law.

Background

Funds advanced pursuant to a New York building loan agreement, or, as characterized in the Lien Law, a building loan contract (which I'll refer to herein as the "BLA"), will not be "subject to the lien and claim of a person who shall thereafter file a notice of lien . . ."[1] so long as certain conditions are met. In other words, funds advanced pursuant to a proper New York BLA and secured by the building loan mortgage will enjoy a level of lien priority vis-à-vis subsequently filed mechanic's liens not afforded to other funds advanced by the lender throughout the course of construction.[2]

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[1]Article 2 of the Lien Law provides for the mechanisms pursuant to which contractors, including the general contractor on a project, subcontractors, laborers, and material suppliers (each herein referred to as a "Contractor") who are unpaid on a construction project may file and enforce a mechanic's lien against the subject property. For non-residential projects, a lien claimant has 8 months following completion of work within which to file a lien pursuant to Section 10 of the Lien Law.

Section 22 of the Lien Law provides, in relevant part, as follows [emphasis added]:

"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 the 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 after 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.***"

[2]Section 13(2) of the Lien Law provides, in relevant part, as follows [emphasis added]:

"(2) When a building loan mortgage is delivered and recorded a lien shall have priority over advances made on the building loan mortgage after the filing of the notice of lien; ***but such building loan mortgage, whenever recorded, to the extent of advances made before the filing of such notice of lien, shall have priority over the 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***. Every mortgage recorded subsequent to the commencement of the improvement and before the expiration of the period specified in section ten of this chapter for

On the other hand, failure to comply with the conditions and requirements of the Lien Law can result in the subordination of the lien of the entire building loan mortgage to mechanic's liens.

These conditions include, among others, that (1) the BLA is in compliance with the requirements of the Lien Law, including having been timely filed in the office of the clerk of the county where the property is located, (2) the building loan is properly administered throughout its term, including as to the proper application of the proceeds advanced under the building loan (i.e., as we will explore, for "cost of improvement" only), and (3) at the time of any advance of proceeds of the building loan (including any future advance), no outstanding mechanic's liens have been filed.

Chief among these conditions is that funds under the BLA are used only to pay "cost of improvement." Much of the confusion around (and the art in structuring) New York construction loans stems from the fact that the overall loan budget on any given construction project will invariably include cost items which may not, under the Lien Law, constitute "cost of improvement" and, therefore, cannot be advanced under the BLA. As we will discuss, this results in a loan structure and documentation which is unlike any seen outside of New York.

With this background, I now turn to the list.

The Top 10 List

1. "Cost of Improvement" vs. not "Cost of Improvement"

What is "cost of improvement"? This is the fundamental question. All else flows from the answer to this question.

The definition of "cost of improvement" is set forth in Article 1, Section 2(5) of the Lien Law[3], but has been interpreted and supplemented over the years by the courts (at times, confoundedly

filing of notice of lien after the completion of the improvement shall, to the extent of advances made before the filing of a notice of lien, have priority over liens thereafter filed if it contains the covenant required by subdivision three hereof. . . ."

It should be noted, however, that there is some disagreement amongst practitioners as to whether all funds advanced pursuant to the so-called project loan, as hereinafter discussed, and secured by the project loan mortgage, will be subordinated in their entirety to subsequently filed liens. I advise clients that the answer to this (at least as I've learned it) is to expect that the entire project loan mortgage will be subject to subordination, including as to funds previously advanced.

[3]Section 2(5) of the Lien Law provides as follows:

"Cost of improvement. The term 'cost of improvement,' when used in this chapter, means expenditures incurred by the owner in paying the claims of a contractor, an architect, engineer or surveyor, a subcontractor, laborer and materialman, arising out of the improvement, and in paying the amount of taxes based on payrolls including such persons and withheld or required to be withheld and taxes based on the purchase price or value of materials or equipment required to be installed or furnished in connection with the performance of the improvement, payment of taxes and unemployment insurance and other contributions due by reason of the employment out of which any such claim arose, and payment of any benefits or wage supplements or the amounts necessary to provide such benefits or furnish such supplements, to the extent that the owner, as employer, is obligated to pay or provide such benefits or

so). Simply stated, what constitutes "cost of improvement" are those costs incurred or to be incurred as necessary for, and related to, the construction of the building/improvement at hand (including the financing of that construction). A very basic concept, but, as with many things, the devil is in the details.

Hard (or direct) costs to pay Contractors will almost always constitute "cost of improvement." Other permissible direct costs would include, for example, site development (as long as not off-site), tenant improvement work (so long as performed by the borrower/landlord, as opposed to being funded as an allowance to the tenant), and contingency in the budget for other hard or direct cost items (keeping in mind, though, as I will later discuss, that once these hard cost contingency amounts are reflected in the "net sum available" under the Section 22 (or Lien Law) Affidavit, also discussed below, they cannot later be reallocated for soft cost items, including for soft cost contingency).

One common misconception is that "cost of improvement" consists *only* of hard/direct costs. Certain soft (or indirect) costs can be included in the building loan as permissible "cost of improvement." These could include, for example, borrower's architect's and engineer's fees, real estate taxes and water and sewer rents paid during the course of construction, ground rent paid during the course of construction, and the fees and costs of the construction lender *insofar as they relate to the building loan* (but not the senior or project loans discussed below). These lender fees and costs might include the lender's commitment or origination fees as to the building loan only, the lender's appraisal fees, the lender's construction consultant's fees, the lender's title insurance premiums as to the building loan only, any recording or filing fees and taxes, including mortgage recording tax, on the building loan mortgage and the BLA, any amounts to be advanced by lender

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furnish such supplements by any agreement to which he is a party, and shall also include fair and reasonable sums paid for obtaining building loan and subsequent financing, premiums on bond or bonds filed pursuant to section thirty-seven of this chapter or required by any such building loan contract or by any lease to be mortgaged pursuant thereto, or required by any mortgage to be subordinated to the building loan mortgage, premiums on bond or bonds filed to discharge liens, sums paid to take by assignment prior existing mortgages, which are consolidated with building loan mortgages and also the interest charges on such mortgages, sums paid to discharge or reduce the indebtedness under mortgages and accrued interest thereon and other encumbrances upon real estate existing prior to the time when the lien provided for in this chapter may attach, sums paid to discharge building loan mortgages whenever recorded, taxes, assessments and water rents existing prior to the commencement of the improvement, and also those accruing during the making of the improvement, and interest on building loan mortgages, ground rent and premiums on insurance likewise accruing during the making of the improvement. The application of the proceeds of any building loan mortgage or other mortgage to reimburse the owner for any payments made for any of the above mentioned items for said improvement prior to the date of the initial advance received under the building loan mortgage or other mortgage shall be deemed to be an expenditure within the 'cost of improvement' as above defined; provided, however, such payments are itemized in the building loan contract and/or other mortgage other than a building loan mortgage, and provided further, that the payments have been made subsequent to the commencement of the improvement."

from the loan for interest on the building loan (but not for interest on the senior or project loans), and the lender's (but not the borrower's) legal fees associated with the building loan.

Other soft cost items which are permissible might include insurance – such as builder's risk, and bond premiums – survey costs, certain leasing commissions (but only for fully-executed leases of non-residential property for a term of more than 2 years and only if payable pursuant to a written contract between the borrower and the broker), and contingency for other soft or indirect items, so long as they are permissible "cost of improvement" items.

The following are some examples of loan budget items that would not constitute "cost of improvement": land acquisition (other than where, as part of the acquisition, to preserve mortgage recording tax already paid, a pre-existing mortgage is taken by assignment and consolidated with the building loan mortgage), FF&E (furniture, fixtures, and equipment), including, for example, for hotel or apartment projects, marketing or advertising costs, brokers fees and leasing commissions (subject to the exception mentioned in the preceding paragraph), and borrower's accounting fees.

The determination of which items in the construction loan budget constitute "cost of improvement" or not is often the most troublesome aspect of structuring and documenting the loan, especially given the harsh consequences to the lender in getting it wrong. In part, the difficulty arises from the fact that, at least in my experience, the final loan budget often is not shared with counsel until the so-called 11th hour before closing. Intuition and experience are sometimes the best guides in making this determination. However, when in doubt as to whether a budget line item qualifies as "cost of improvement," I advise clients to take the more conservative approach – that is to say, err on the side of caution and fund the matter out of the project loan rather than the building loan to avoid risking potential subordination of the lien of the entire building loan mortgage.

2. Tripartite Loan Structure

Most construction loan budgets will include line items which are both "cost of improvement" and not "cost of improvement." As to those so-called "non-cost" items, to the extent not being funded from borrower equity or other non-construction-loan sources (such as, perhaps, a mezzanine loan), and to the extent intended to be funded as part of the aggregate loan being made by the construction lender, they must be funded under a separate loan or loans. Thus, for New York construction loans, we employ the tripartite or bipartite loan structure.

In this case, the overall loan amount to be made by the construction lender will be divided into 2 or 3 separate loans – more commonly, 3 loans: a senior (sometimes called an "acquisition") loan, and/or a building and project loan. The "non-cost" items under the overall loan will then be allocated to the senior loan (if expended prior to, or at, closing and intended to be reimbursed or paid at closing) or to the project loan (if intended for future advance during the term of construction).

The Senior Loan: under the "senior" or "acquisition" loan, so long as the entire proceeds of the senior loan have been advanced at closing, and so long as no liens have been filed at the time of that advance, the lien of the senior loan mortgage will have priority for that advance (i.e., for the amount of the entire senior loan) over subsequently filed Contractor's liens.

The Building Loan: as outlined above, with respect to funds advanced pursuant to a proper building loan to pay "cost of improvement," so long as no lien has been filed at the time of each such advance, and so long as the BLA and the building loan mortgage comply with all other Lien Law requirements, the lien of the building loan mortgage will have priority over all subsequently filed Contractor's liens.

The Project Loan: future funds not advanced pursuant to a proper BLA – in other words, funds advanced under the project loan for "non-cost" items and secured by the project loan mortgage, will be subject and subordinate to any Contractor's liens filed, regardless of when those liens are filed.[4]

The mortgage for each such loan will, in most cases, be recorded (and the title company in the closing/escrow letter will be instructed to record each mortgage) in the order I've just listed. In addition, each mortgage should contain an express provision which sets forth the order of priority, regardless of the order of recording. For example, the senior loan mortgage will say that, regardless of the actual order of recording, it is superior in lien and priority to the liens of the building loan and project loan mortgages. The project loan mortgage, on the other hand, will say that, regardless of the actual order of recording, it is subject and subordinate to the liens of the other 2 mortgages. The building loan mortgage, being in the middle (so to speak), will provide that it is behind the senior loan mortgage, but ahead of the project loan mortgage.

Further, in order to maintain the priorities outlined vis-à-vis Contractor's liens, each of those mortgages (and the corresponding loan agreements) will also include the "trust fund covenant" (which I will discuss below).

The concept of having a senior loan in addition to a project loan – in other words, the tripartite vs. the bipartite structure – is, in my experience, a relatively recent development. The theory for having a senior loan in addition to the project loan has been explained to me as follows: funds advanced under the senior/acquisition loan would be advanced in full at the closing. Those funds could include, for example, acquisition costs and title premiums and other costs expended at the closing in respect of the senior loan (and, possibly, the project loan) – for example, loan fees and

[4]Although, as mentioned in footnote 2, there is some disagreement as to the degree of subordination of funds advanced under the project loan – i.e., is the entire project loan subject to subordination, or only as to amounts advanced subsequent to the lien? As indicated above, the former is the result I would anticipate. It seems to me that the latter result would put the project loan mortgage on equal footing with the building loan mortgage, which doesn't make sense to me given the overall scheme of the Lien Law.

title costs apportioned to the senior loan (and, possibly, the project loan). Under certain circumstances, these funds might also include reimbursement for certain construction costs incurred and paid prior to, or at, closing. The senior loan mortgage – taking its lien priority from the date of closing vis-à-vis future liens (assuming, of course, that the mortgage includes the trust fund covenant), acts as a "shield" against those future lienors and gives the lender (and its title insurer) a level of additional comfort. In other words, any future lienor would be subject to the entire outstanding principal balance of the senior loan (in addition to amounts theretofore advanced under the building loan) and would, therefore, need to have those balances repaid before being in a position to realize on its lien. Thus, the larger the principal amount of the senior loan, the greater the cushion.[5]

3. Multiple Loan Agreements, Notes, and Mortgages/Security Instruments

The tripartite loan structure requires that the senior, building and project loans be separate from one another – although they may (and should) be cross-defaulted, and each would share in the same collateral, subject to their relative priorities. Each loan will have its own promissory note (or notes, if syndicated or intended to be syndicated), loan agreement, mortgage and assignment of leases and rents, and financing statements. However, guaranties or indemnities (think completion, recourse carve-out, carry, and environmental) and other ancillary documents (such as assignments of interest rate protection, or the various other collateral assignments normally required in connection with a construction loan) would, in each case, typically cover all three of these loans in a single document.[6]

4. Filing the Building Loan Agreement and Section 22 Affidavit

This often catches non-New York counsel and clients by surprise: pursuant to Section 22 of Lien Law, the BLA (and accompanying Section 22 Affidavit) must be in writing, must be signed and duly acknowledged (i.e., notarized) by both the borrower and the lender, *and must be filed in the county clerk's office where the subject property is located on or before the date that the building loan mortgage is recorded in the land records*. The BLA must also contain the block number (and, usually, other identifying information, such as street address) showing the location of the real property which is the subject of the BLA. Any subsequent modification to the BLA must also be filed, along with an updated Section 22 Affidavit, within ten (10) days after execution of the modification.[7]

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[5]Although certain of the costs which are sometimes allocated to the senior loan (for example, costs incurred prior to closing for construction), may constitute "cost of improvement," the reason for including them into the senior loan vs. the building loan would be to increase the principal amount of the senior loan based on the theory just outlined. Of course, the title insurer will need to confirm its willingness to insure the senior loan mortgage with the inclusion of these costs.

[6]I will not discuss it here; however, if an event of default occurs and foreclosure proceeding are considered, it will be important for the lender, in consultation with counsel, to determine the order in which the various mortgages (and, in New York, guaranties) are to be enforced and foreclosed.

[7]See footnote 1, above, for the relevant text of Section 22 of the Lien Law regarding these filing requirements.

Because the BLA (and future modifications, if any) are of public record, some thought and care will need to be taken as to what specific information the borrower and lender decide to include (or omit) in those documents, particularly, as I discuss below in more detail, if there is a likelihood that any information included (such as the specific loan budget) may be subject to likely amendment down the road.

5. Apportioning Certain Budget Line Items

Certain loan budget line items may be of a dual nature, constituting both "cost of improvement" and "non-cost". These items will need to be apportioned between the building and project loans. The best example of this is the interest reserve and other loan fees and costs, to the extent being funded from the loan. As I've discussed in item 1 above, interest (and fees and costs) on the building loan portion of the overall loan is permissible "cost of improvement." Interest (and fees and costs) on the project loan (*and interest on the senior loan*) is not permissible, and would, therefore, need to be funded from the project loan.

Legal fees are another example – and this is not at all intuitive. The fees of lender's counsel associated with the building loan are permissible "cost of improvement," but the fees of borrower's counsel are not.

Also, title costs and premiums, including mortgage recording taxes and fees, would need to be apportioned between the building loan and the project loan (with the latter also including these costs with respect to the senior loan, unless advanced at closing under the senior loan).

I find that the exercise of apportioning or allocating certain of these dual-natured items is sometimes a bit of a guessing game. For example, what's the best way to apportion the interest reserve? As mentioned above, when in doubt, I counsel clients to take the conservative approach and err on the side of allocating questionable amounts to the project loan.

6. The Section 22 Affidavit

Pursuant to Section 22 of the Lien Law, the BLA, as part of the filing requirements, must also contain what is commonly referred to as the "Section 22 Affidavit" or the "Lien Law Affidavit." The Section 22 Affidavit consists of a separate, sworn statement, duly executed and acknowledged by the borrower (or, more commonly, an officer or other authorized signatory on behalf of the borrower), and attached to, incorporated into, and made as a part of, the BLA. The Section 22 Affidavit will set forth and detail the various ways in which the proceeds of the building loan will be (or have been) used, including (i) the consideration and other expenses paid, or to be paid, for the building loan (for example, any commitment or origination fee, title and recording fees and costs, including mortgage recording tax, the fees of the lender's construction consultant, the fees of the lender's legal counsel, and interest on the building loan), (ii) the amount, if any, to be advanced from the building loan to repay amounts previously advanced to the borrower pursuant

to Notices of Lending (discussed below) and expended by the borrower to pay "cost of improvement" items, (iii) amounts, if any, to be advanced from the building loan to reimburse the borrower for any "cost of improvement" items expended by the borrower after the commencement of the improvements but prior to the date of the Affidavit (that is, other than amounts previously advanced to the borrower by the lender pursuant to Notices of Lending), (iv) the amount to be advanced from the building loan for soft or indirect costs of the improvements which may become due and payable after the date of the Affidavit and during the construction of the improvements (such as bond and insurance premiums, fees of architects, engineers and surveyors, ground rents, taxes, assessments and water and sewer rents), and (v) most critically, the net sum available to the borrower for the improvement (i.e., the hard costs anticipated to be advanced under the building loan following the closing, including amounts to be advanced to pay Contractors).[8]

As borrower's or lender's counsel, in order accurately to complete the Section 22 Affidavit, it will first be necessary to receive and review the final building loan budget, confirm that all amounts set forth therein consist only of proper "cost of improvement" items, and then determine into which of the Affidavit categories each budget line item should be placed.

The various amount categories set forth in the Section 22 Affidavit are mutually exclusive (i.e., there can be no double-counting). The process of completing the Affidavit becomes a bit of a math problem (addition and subtraction). What one must keep in mind when completing the Affidavit is that (a) the principal amount of the loan set forth in the Affidavit must always equal the principal amount of just the building loan, not the aggregate principal amount of the 2 or 3 loans (senior, building and project), and the amounts set forth in all of the individual Affidavit categories must add up to that principal amount of the building loan, and (b) the amount set forth as the net sum available will always equal the difference between the total building loan amount minus the amounts set forth in the Affidavit under all other categories.

7. The Trust Fund Covenant

Section 13(3) and Article 3-A of the Lien Law provide Contractors "trust fund" protection, wherein the owner of the project (i.e., the borrower) is designated as a statutory trustee responsible for the proper application and disbursement of building loan funds available for payment of project costs.[9] If the owner/borrower diverts these funds (in other words, if these trust assets are used for the

[8]Again, see footnote 1, above, for the relevant text of Section 22 of the Lien Law setting forth the requirements for the Lien Law Affidavit.

[9]Section 13(3) of the Lien Law provides as follows, in relevant part:

"(3) Every such building loan mortgage and every mortgage recorded subsequent to the commencement of the improvement and before the expiration of the period specified in section ten of this chapter for filing of notice of lien after the completion of the improvement shall contain a covenant by the mortgagor that he will receive the advances secured thereby and will hold the right to receive such advances as a trust fund to be applied first for the purpose of paying the cost of improvement, and that he will apply the same first to the payment of the cost of improvement before using any part of the total of the same for any other purpose, . . ."

payment of costs other than "cost of improvement"), the owner/borrower may incur liability to Contractors (and potential criminal liability under the New York Penal Law for diversion of trust assets under the crimes of larceny/grand larceny).

In order to comply with the priority requirements of the Lien Law, lenders require that a "trust fund covenant" be included in the loan documents – specifically, in the loan agreements and the mortgages/security instruments. The following is a sample of the trust fund covenant which I include in my New York building loan documents: *"This Loan Agreement/Mortgage is subject to the trust fund provisions of the Lien Law, including, without limitation, Section 13 thereof. Borrower/Mortgagor shall comply strictly with Section 13 of the Lien Law, including, without limitation, Section 13(3) thereof. Borrower/Mortgagor shall receive and deposit in the Building Loan Trust Account all advances made hereunder and, pursuant to Section 13 of the Lien Law, shall receive and hold the same, and the right to receive the same, as a trust fund for the purpose of paying only the "cost of improvement," as such quoted term is defined in the Lien Law, including payments for such purpose as itemized on the direct and indirect cost budgets made by Borrower/Mortgagor prior to the initial advance but subsequent to the commencement of construction of the Improvements."*[10]

Alternatively, the BLA, other loan agreements, and the mortgages/security instruments may simply state that they are subject to the trust fund provisions of Section 13 of the Lien Law.

8. Loan Administration, including the issue of "Relation Back"

Particular care must be exercised in administering the building loan after it closes. In the event that there is a subsequent lien filed and a challenge to the priority of amounts advanced under the building loan, the lender (or its servicer) will need to evidence a clean and clear chain showing that loan funds advanced under the BLA were used only for the payment of "cost of improvement."

One mechanism which I suggest that clients employ (although admittedly making the servicing and administration a bit more cumbersome) is to create and maintain separate borrower accounts for building loan and project loan advances. I refer to these accounts in the loan documents as the "building loan trust account" (or "BLTA") and the "project loan trust account" (or "PLTA"). I

[10]A subtle distinction: for the senior and project loan documents (i.e., the non-building loan documents), the trust fund covenant is altered slightly, as highlighted in the following example: *"This Loan Agreement/Mortgage is made subject to the trust fund provisions of Section 13 of the Lien Law. Borrower/Mortgagor shall receive all advances made under this Loan Agreement/secured by this Mortgage and shall hold the right to receive same as a trust fund and apply said advances first to pay the "cost of improvement," as such quoted term is defined in the Lien Law, before using any part thereof for any other purpose.*"

then provide that all advances made under the BLA will be deposited by lender into the BLTA, that all advances made under the project loan will be deposited into the PLTA, and that the borrower will be obligated to provide evidence to the lender in connection with, and as condition precedent to, each subsequent advance that amounts theretofore deposited into the BLTA or the PLTA, as the case may be, were used to pay costs in compliance with the requirements of the Lien Law.

Equally important, in the event that a lien is subsequently filed by a Contractor, it is essential that the lender (and/or its servicer) at that point consult with counsel prior to making any further advances. Although that particular lien may, in amount, be relatively small, any and all liens filed by Contractors after that initial lien (and, this likely will occur), will "relate back" in terms of their priority to the filing of that first lien. In other words, all liens filed will take their priority vis-à-vis advances thereafter made by the lender to the date of that first filing. From the lender's perspective, the risk is completely open-ended.[11]

The "relation back" risk is counterintuitive and the result obviously is not in the best interest of the overall project (i.e., the construction lender stops funding completely). However, if a determination to continue funding is made, it is critical to advise the title insurer(s) and get them on board with providing affirmative mechanic's lien coverage, if available, over these subsequent advances (along with putting in place whatever borrower or guarantor indemnification/recourse the title insurer(s) or the lender may request).

9. Change Orders, Cost Overruns and other Modifications of the BLA

As mentioned, if at any time following the closing there are any modifications made to the building loan and the terms of the BLA, the amendment evidencing same must be filed within 10 days of execution and must include an updated Lien Law Affidavit. Courts have read into this requirement the condition that the modification in question be "material." In other words, any "material" modification to the BLA requires that said modification be filed. What constitutes materiality in this context is subject to interpretation, but might include, for example, a reallocation of certain line items in, or an increase to, the building loan budget which affects the amounts set forth in the Section 22 Affidavit, and, perhaps, a change in the conditions to funding. Rather than run the risk of failing to comply with the requirements of the Lien Law, in my experience, any and all amendments made to the BLA, whether material or not, always get filed, along with the updated Lien Law Affidavit.

Changes in the loan budget, including reallocations of budget line items, are amongst the types of post-closing changes which seem to arise most often. The question then is whether line items within the building loan budget can be reallocated (say in the case of cost savings in one category and/or cost overruns in another) either from one hard cost line item to another hard cost line item,

[11]Section 13(1) of the Lien Law provides, in relevant part, "that Persons shall have no priority on account of the time of filing their respective notices of liens, but all liens shall be on a parity . . ."

or from one soft cost line item to another soft cost line item, or even from soft cost items to hard cost items or *vice versa*.

Outside of New York, these budget reallocations are normally not problematic. However, in New York, under the Lien Law, Contractors will not be bound by modifications to the BLA made subsequent to the Contractor's execution of their contract, unless they have consented thereto.[12]

(In my experience, borrowers will always resist asking for this consent from Contractors and, even when asked, most Contractors will resist giving such consent.)

As a result, as I always advise my clients regarding any post-closing budget reallocations, any amendment to the BLA and building loan budget can never reduce the amounts shown on the original Section 22 Affidavit as being the net sum available for the improvement (in other words, the hard cost loan budget). Notwithstanding the amendment, Contractors will still be entitled to rely on the original "net sum available," which means that the lender will still be obligated to make these funds available for advance.

Questions sometimes also arise as to whether remaining unadvanced loan amounts may be transferred or reallocated from the building loan to the project loan, or *vice versa*. Because of the tripartite/bipartite loan structure, this presents its own unique set of challenges in addition to the "net sum available" concern outlined in the previous paragraph. A reallocation of amounts between what are different loans, each with their own separate notes, loan agreements and mortgages/security instruments, will result in the need of having to amend and modify (via splitters, supplements, amendments and restatements, and/or consolidations) these loan documents, resulting in the need to prepare (and negotiate) a somewhat cumbersome set of modification documents and their ancillaries (e.g., Section 255 Affidavits and the sort). This will also then require the recording of mortgage amendments and the issuance (invariably costly in New York) of updated title insurance for the reallocated mortgage amounts. Depending on the circumstances, the payment of additional mortgage recording taxes may also come into play. Because of the challenges faced, this does not, in my experience, often happen. However, if it is to be considered, a general rule of thumb is that you may shift from the project loan into the building loan, but, generally speaking, not the other way around.

As mentioned, a revised Section 22 Affidavit must also be filed with any filed BLA amendment. In preparing this updated Lien Law Affidavit, I will start with the original filed Lien Law Affidavit, keeping in place the amounts set forth therein where there has been no change, but footnoting,

[12]Section 22 of the Lien Law provides, in relevant part, as follows: "A modification of such contract shall not affect or impair the right or interest of a person, who, previous to the filing of such modification had furnished or contracted to furnish materials, or had performed or contracted to perform labor for the improvement of real property, but such right or interest shall be determined by the original contract."

where appropriate, amounts from each category, including the "net sum available," which have already been advanced through the date of the updated Affidavit.

Because the BLA is of public record, and given the possibility (perhaps likelihood) of subsequent amendments to the BLA, I advise clients to limit the schedules and exhibits which are attached to and made a part of the BLA. I try to avoid making explicit in the BLA those items which are most likely to be the subject of future modification. For example, budgets and the schedule of plans and specifications, among other items, may change over time. Rather than include these in the BLA as exhibits or schedules (which may then require a BLA amendment each time they change), I structure the loan to have these items delivered in a separate certificate executed by the borrower and simply referenced in the BLA as having been delivered to the lender in connection with the closing of the loan ("as such deliveries may be amended from time to time with the lender's prior written consent, which may be withheld or granted by lender in its sole discretion"). Arguably, this approach then avoids the need of a modification to the BLA, as these items are not expressly set forth in the BLA and the possibility of their future modification is provided for, or at least contemplated, in the BLA.[13]

10. The Notice of Lending

Finally, the court's decision in "*Aspro Mechanical Contracting, Inc. v. Fleet Bank, N.A.*", 1 N.Y. 3d 324 (2004), sparked a renewed interest in Notices of Lending. *Aspro Mechanical* involved a convoluted set of facts (and I'm glossing over the details), with the repayment of Fleet's construction loan made through the sale of the various phases of the project. In *Aspro*, the court held that Fleet, in applying proceeds of these sales to repay its construction loan instead of applying the same toward the "cost of improvement" (read "Contractors") then remaining unpaid, breached its obligations under the trust fund provisions of the Lien Law and diverted trust funds. The court, however, also indicated that, had Fleet filed a "Notice of Lending" pursuant to Section 73 of Lien Law, it could have avoided liability for the improper disposition of these trust funds under Article 3-A of the Lien Law in that the Notice of Lending would have put Contractors (i.e., the beneficiaries of the statutory trust) on notice of Fleet's intentions regarding the disposition of these proceeds (and, therefore, the Contractors could have better evaluated their risk, at least in theory).

As the result of the outcome in *Aspro*, many New York finance attorneys now take the position that a Notice of Lending need be filed (with the applicable county clerk within 5 days after the first advance) in connection with the closing of every New York construction loan.

[13]Until tested in the courts, there may be some potential risk in this approach. A Contractor could conceivably argue that the BLA failed to disclose all relevant information required for the Contractor properly to evaluate the risk of entering into their contract. However, there is no requirement in the Lien Law that such information be disclosed in the BLA.

Although becoming commonplace practice, I question the necessity of the Notice of Lending for every construction loan. Historically, the filing of a Notice of Lending arose only in the circumstance where a lender, in anticipation of closing a construction loan, agreed to make certain advances (perhaps even unsecured) to the borrower for payment of project costs prior to the closing of the construction loan on the understanding that, when the construction loan closes, those advances will be reimbursed to the lender out of the initial advance of proceeds of the construction loan. In order to put prospective Contractors on notice that certain proceeds of the future construction loan (i.e., certain "trust assets") have already been, if you will, "spoken for" and, therefore, when repaid to the construction lender out of the building loan, will not constitute a diversion of trust funds in violation of the Lien Law, the lender must contemporaneously file a Notice of Lending particularly describing this arrangement in connection with the making of these advances.

Having said that, arguably, the lessons of *Aspro* may need to be heeded, particularly in a case where the construction lender anticipates repayment through sale proceeds – say, for example, in the construction of a multi-unit for-sale condominium project or a build-to-suit project.[14]

Conclusions

You now have my top ten Lien Law list. Here comes the lawyer's caveat: this list, and this article, is intended merely as a practical guide to the Lien Law based on my experience in representing construction lenders and borrowers. It is not intended as a complete explication on the state of the law in New York regarding building loans or the Lien Law (if such a complete explication was even possible). These are merely highlights. Each item on the list has layers of detail and nuance. And, just like the onion, when peeling back these layers, you may start to cry.

As in all matters legal, for those practitioners not intimately familiar with the Lien Law, my best advice is that, for any given project, consult with a New York attorney having the requisite level of experience.

In the meantime, if you have questions or would like further information, please contact Ralph E. Arpajian (Arpajianr@whiteandwilliams.com; 215.864.6232).

This correspondence should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only and you are urged to consult a lawyer concerning your own situation and legal questions.

[14]In addition, although I've not seen this yet generally in the market, some commentators have suggested including within the construction loan documentation an indemnity from the borrower (and the guarantor(s)?) against any loss, etc., suffered by the lender as the result of any person having instituted any proceeding alleging that borrower or lender violated the trust fund provisions of Article 3-A of the Lien Law.