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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"). 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.

So long as certain conditions are met, 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") and secured by the building loan mortgage, will enjoy a level of priority vis-à-vis mechanics' liens not afforded to other funds to be advanced by the lender for the project. On the other hand, failure to comply with the requirements of the Lien Law can result in the subordination of the lien of the entire building loan mortgage to mechanics' liens.

The Top 10 List

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

Chief among these Lien Law requirements is that funds under the BLA are used only to pay "cost of improvement." The definition of "cost of improvement" is set forth in Article 1, Section 2(5) of the Lien Law, but has been interpreted and supplemented over the years by the courts (at times, confoundedly so). Simply stated, what constitutes "cost of improvement" are those costs (which can include both hard and soft 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).

However, as in many things, the devil is in the details. Making 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. Intuition and experience are sometimes the best guides in making this determination.

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, they must be funded under a separate loan or loans. Thus, New York construction loans will often have a tripartite or bipartite structure consisting of a senior (sometimes called an "acquisition") loan and/or a building and project loan.

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

This 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 (usually, the senior loan mortgage first, followed by the building loan mortgage and then the project loan mortgage as the most junior lien). Each loan will have its own promissory note (or notes, if syndicated), loan agreement, mortgage and assignment of leases and rents, and financing statements. However, guarantees 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.

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, discussed below) must be in writing, must be signed and 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*. 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.

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, to the extent being funded from the loan. Interest on the building loan portion of the overall loan is permissible "cost of improvement." Interest on the project loan (*and the senior loan*) is not, 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.

When in doubt as to the nature of a particular line item, I counsel clients to take the conservative approach and allocate questionable items to the project loan rather than risking potential subordination of the building loan mortgage.

6. The Section 22 Affidavit

Pursuant to Section 22 of the Lien Law, the BLA 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 made a part of the BLA. The Section 22 Affidavit will detail the various ways in which the proceeds of the building loan will be (or have been) used, and will set forth, most importantly, 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 the amounts to be advanced to pay contractors).

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. If the owner/borrower diverts these funds (in other words, if these trust assets are used for the 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. Alternatively, these loan documents 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"

Care must also 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 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."

Equally important, in the event that a lien is subsequently filed by a contractor, it is essential that the lender 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.

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

If at any time following the closing modifications are made to the building loan (often involving the reallocation of, or other changes to, loan budget amounts), the amendment evidencing same must be filed within 10 days of execution and must include an updated Lien Law Affidavit. However, contractors will not be bound by modifications to the BLA made subsequent to the contractor's entering into their contract. Therefore, I always advise my clients that any amendment to the BLA and building loan budget should 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.

10. The Notice of Lending

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 the "Notice of Lending" mechanism under the Lien Law. *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 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.

In the aftermath of *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 every New York construction loan. However, a number of commentators (myself included) question whether this approach is what Section 73 intended (and whether the court in *Aspro* got it right).

Conclusion

You now have my top ten Lien Law list. For additional detail, please see the following, which will take you to my article: The New York Lien Law-Top Ten Things You Ought to Know.

Keep in mind, though, that these are merely highlights. Each item on the list has layers of detail and nuance. 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).

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