

Construction Lenders and Mechanics' Liens



Practical Considerations for Construction Lenders Regarding Mechanics' Liens



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Until the recent COVID-19 pandemic, development was strong in Delaware. Construction scaffolding, temporary fences, and proud bank signs sharing that construction financing was placed by a certain bank were plentiful. Hopefully, as our state and nation begin to emerge from quarantine lockdowns we will see economic activity resume, led by development. Life will resume and projects will be developed.

Development necessarily involves construction financing secured by the real estate. These loans are risky for many reasons, including the potential for mechanics' liens. Mechanics' liens are harbingers of an array of concerns for a lender, including the overall health of a project. And if a project is in trouble, serious considerations about how a mechanics' lien could affect priority of a lender's mortgage and future construction draws are paramount. Construction lenders expect to be "first in line" when it comes to repayment. If loan funds have been allocated toward a trade or materials and the contractor has not been paid for the work he or she has completed, something has gone wrong. For these reasons, it is almost always an event of default in a construction loan agreement if a mechanics' lien is filed against the property and is not discharged, bonded over, or contested in good faith within a reasonable period of time after filing.

Lenders often focus intensely on when lienable work began and whether, prior to closing a loan, contractors have been paid or will be paid out of loan funds. Delaware's mechanics' lien statute dates the priority of a mechanics' lien as of the date work first began or materials were first furnished to the property, regardless of the actual filing date of the mechanics' lien. Fortunately, Delaware law provides relatively robust protections for construction lenders with respect to mechanics' lien filings. In addition to the law, the practices and customs in which lenders engage in construction financing help to minimize the risk of mechanics' liens taking priority over the lien of a mortgage. This article reviews those practices and customs in relation to the law governing mechanics' liens so lenders can spot the transactional risks associated with construction lending and make informed lending decisions.

A mechanics' lien is a lien on real property—including fixtures—for the benefit of a person who has furnished labor or materials for the erection, alteration, or repair of a structure.¹ The priority of mechanics' liens differ from state to state; in Delaware, the priority dates from the day labor began or the materials were first furnished, meaning that even if a mechanics' lien is not filed until months after the work was completed, its priority will be dated as of the first day the work began.² However, a mechanics' lien will not have priority over a first mortgage lien that secures existing indebtedness or future advances, provided that at least 50% of the loan proceeds are used for the payment of labor or materials, or both, for the applicable structure.³

The word "structure" is among the broadest words in the English language. The explanation in the foregoing paragraph describes mechanics' liens only with respect to labor performed or materials furnished for the erection, alteration, or repair of a specific structure, which the courts have rigidly interpreted to mean only houses and other buildings permanently situated or erected on the land.⁴ Delaware's legislature specifically extended the applicability of mechanics' liens to items that are necessary or component parts of a house or building, such as plumbing, gas fitting, paving, furnishing of machinery in mills and factories, and services rendered and labor performed by architects, among a few others, but that list of items is exclusive. If an item does not appear on the list, it is not, by itself, lienable.⁵

What about contractors who perform work on, or supply materials to, a property that improves only the land and does not relate to the structure itself? Small and large projects alike often budget for at least some combination of site work such as grading, landscaping, construction of private drives, storm water management, and development of common open spaces. These activities are generally not lienable by themselves and require a written contract before a subcontractor can enforce a mechanics' lien. A subcontractor can enforce a mechanics' lien for improvements made to land (and not related to a structure) if and only if (1) there is a signed, written contract with the names of all parties; (2) the contract contains a metes and bounds description of the land; (3) the contract contains a statement of the general character of the work to be done, the

total amount to be paid, and the amounts of partial payments; and (4) the contract contains the time when payments are due and payable.⁶

Two recent cases illustrate the dichotomy in Delaware's mechanics' lien statutes. Most recently, one subcontractor that performed landscaping services on the common areas at a residential subdivision filed mechanics' liens on seven of the residential lots, claiming that because the landscaping services were intended to benefit the houses that would be built on the lots in the future, the subcontractor could rightfully file mechanics' liens against the individual lots without evidence of a contract containing the statutorily required information.⁷ The court disagreed, concluding that the labor and materials used on the common areas were not necessary or component parts of any structure, and accordingly dismissed the subcontractor's claim. In a similar case involving the same defendant and subdivision, another subcontractor filed mechanics' liens on the same seven residential lots after performing "infrastructure construction services."⁸ Although the services performed were more closely related to the houses intended to be built on the lots than landscaping services, the court concluded that the subcontractor's work must be considered an improvement to land because the work was not connected to any ongoing project to construct structures on the lots.⁹ Because the lots were vacant, there needed to be a contract between the parties in order for the subcontractor to enforce the mechanics' liens. Although there was a contract between the parties, it did not contain a metes and bounds description of the land. Accordingly, the court dismissed the plaintiff's claims for failure to meet the statutory requirements. As illustrated by these two cases, the statutory requirements that must be met before a contractor can enforce a mechanics' lien are rigid and must be closely followed.

How does a lender protect itself from mechanics' liens being filed against its construction loan collateral? Before funding the loan and recording the mortgage, a lender should pay special attention to whether "vertical" construction of the project has begun. As vertical construction generally refers to the construction of the structure itself, and not site work or other improvements to the land, a contractor or subcontractor, if left unpaid, could enforce a mechanics' lien against the property without needing evidence of a contract between the parties.

If vertical construction has commenced and the loan has yet to close, lenders have two useful and routine tools in their toolbox: the title search (and "bring-down" title search immediately before closing) and lien waiver requirements. A property's title search will tell a lender whether any liens have been filed against the property as of the search date. Because title searches are backward-looking, they should always be "brought down" immediately prior to closing to ensure no intervening liens have been filed between the original search date and the closing date. A lien waiver, as the term suggests, prevents a person from enforcing a mechanics' lien and is typically provided to a construction borrower simultaneously

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with payment, after payment, or conditionally in expectation of payment by a certain date; lien waivers under any circumstances not involving the payment for labor or materials are void and unenforceable as a matter of public policy.¹⁰ If vertical construction has started, the borrower should either request a conditional lien waiver from the contractor and pay the contractor out of the closing funds, or pay the contractor out of pocket, obtain a lien waiver, and reimburse itself out of the loan funds if desired. As a practical matter, a lender will not close on a construction loan without receiving a policy of lender's title insurance. While the title company may wish to include an exception from coverage for mechanics' liens, lenders will not close with this exception. This tension usually results in the title company being the "police" and verifying that lien waivers have been obtained and that contractors are paid for their work on the closing statement.

Almost every construction lender requires copies of the agreements between the borrower and its contractors and subcontractors as a part of the pre-closing diligence package. Some subcontractors will inevitably perform work solely on the land, such as landscaping, grading, and storm water management, to name a few, and not the structure itself. Given the rigid statutory requirements for contracts concerning improvements made only to land, lenders and their counsel should review these contracts to determine whether the requirements have been met in order for a subcontractor to be eligible to enforce a mechanics' lien against the borrower. However, even if such a subcontractor may be statutorily barred from enforcing a mechanics' lien, nothing prevents a person from exploring all options when seeking compensation for work left unpaid, including initiating litigation for other claims such as unjust enrichment. Litigation takes time and could syphon funds that the borrower would otherwise use to pay debt service. Further, unpaid subcontractors and litigation are major red flags regarding the health of the project—signals that a prudent lender should take seriously. The take-away is clear: prudent lenders should proactively monitor their borrowers' construction activities, paying close attention to the borrower's construction budget and timeline, any completed work, and where each draw ultimately goes in order to ensure no approved work goes unpaid.

Although title searches, lien waivers, contract review, and construction inspections are useful and important tools, lenders have additional protections in Delaware if a lender's mortgage lien is in first position, at least 50% of the loan proceeds are used for labor or materials, and the lender obtains mechanics' lien coverage in its policy of title insurance—by and large the standard in any construction lending transaction. Delaware's statutory "safe harbor" prohibits a mechanics' lien from taking priority over a first lien construction mortgage that secures loan proceeds of which at least 50% is used for labor or materials.¹¹ Without the safe harbor, a subcontractor that performed work on a structure before the recording of a mortgage, waited until

after the mortgage was recorded, and then filed a mechanics lien, if successful, would still have priority over the lien of the mortgage because the priority of a mechanics' lien dates back to the date work was first performed or materials were first furnished. The safe harbor eliminates this risk. Although the foregoing priority issue has never been directly litigated in the 28 years of the safe harbor's existence, the Delaware Supreme Court has generally recognized its effect.¹²

Most recently, the Real and Personal Property Section of the Delaware State Bar Association has proposed an amendment to the statute governing the priority of purchase money mortgages in order to further solidify the priority of first lien mortgages in relation to mechanics' liens. Under the current statute, a "purchase money mortgage" is defined only as a mortgage taken by the seller of a property to secure the payment of the purchase price.¹³ The proposed amendment would expand that definition to include any mortgage taken by any lender for the purpose of securing funds advanced to a buyer to pay all or a part of the purchase price—this change extends the definition to institutional lenders. The amendment would also firmly establish the priority of such a lender's lien as superior to other liens, including mechanics' liens, regardless of the date of the other liens if the funds advanced are for the purpose of acquiring a property and the mortgage is recorded within 10 days of the closing. The amendment, if signed into law, would provide additional protections to institutional lenders who provide acquisition financing to developers, further minimizing mechanics' lien risk in the context of construction financing.

Notwithstanding the proposed amendment and the statutory "safe harbor" for construction financing, a lender should nevertheless employ all available tools to minimize the risk of a mechanics' lien taking priority over the lien of the lender's mortgage. These tools include a thorough review of the property's title, the contracts entered into for work at the project, the borrower's construction budget and schedule, and ongoing review of the construction activities performed at the project. Regardless of the stage of a transaction, a team of the lender's own construction consultants and legal counsel can effectively guide lenders through the nuanced issues that may arise during a property's development.



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Notes:

- 1- 25 Del. C. § 2702(a).
- 2- 25 Del. C. § 2718(a).
- 3- *Id.*

4- See *Pioneer Nat. Title Ins. Co. v. Exten Assocs., Inc.*, 403 A.2d 283 (Del. May 18, 1979).

5- 25 Del. C. § 2702(b).

6- 25 Del. C. § 2703.

7- See *Erosion Control Specials, Inc. v. Hyetts Corner, LLC*, C.A. No. N19L-06-082 MAA (Del. Super. Mar. 6, 2020).

8- See *Pearce & Moretto, Inc. v. Hyetts Corner, LLC*, 2020 WL 532748 (Del. Super. Jan. 31, 2020).

9- The court in this case engaged in a helpful review of prior cases in determining what kind of work is considered actually related to a structure: “paving around a motel” is considered an improvement related to a structure because that work related to the general contractor’s construction of the improvements to the motel itself. See *Jones v. Julian*, 195 A.2d 388 (Del. 1963); “the paving of a driveway, not a part of construction of the building erected on the premises” is considered an improvement to land alone. See *Pioneer Nat. Title Ins. Co.*, 403 A.2d 283 (Del. 1979) (citing *Whittington v. Segal*, 193 A.2d 534 (Del. Super. 1963)); paving and curbing of streets within a vacant development is considered an improvement to land only. See *C&J Paving, Inc. v. Hickory Commons, LLC*, 2006 WL 3898268 (Del. Super. Oct. 6, 2006). As demonstrated by the court’s review of these cases, the determination of whether work performed is related to a structure is both rigid and nuanced.

10- 25 Del. C. § 2706(b).

11- 25 Del. C. § 2718(a).

12- See *Builder’s Choice Inc. v. Venzon*, 672 A.2d 1, 4 (Del. 1995) (“As a matter of substance, Section 2718(a) gives priority to those first construction mortgages that comport with the statutory definition.”).

13- 25 Del. C. § 2108.

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