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TROUBLE IN THE SAFE HARBOR—THE REQUIREMENT OF MECHANICS' LIEN COVERAGE IN LENDERS' TITLE POLICIES IN PENNSYLVANIA[1]

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Financing your construction project is not getting any easier. Even if you obtain a loan commitment, lenders are less likely than ever to waive difficult or expensive closing obligations. Lenders are increasingly taking a "check the box" approach with respect to their closing requirements, which adds cost and complexity to the closing from the borrower's perspective.

One such closing hurdle is the requirement that the lender's policy of title insurance contains "mechanics' lien coverage." Mechanics' lien coverage essentially insures the priority of the lender's mortgage lien over mechanics' liens that might be filed against the property after the date of the mortgage, but that "relate back" to a date prior to the creation of the mortgage lien. Mechanics' lien coverage is becoming increasingly difficult to obtain – not only because of the tepid credit climate, but also because of the ambiguity of certain language inserted in the recently revamped Pennsylvania Mechanics' Lien Law (the "Lien Law") as a "safe harbor" for those making construction loans.

When the Pennsylvania legislature amended the Lien Law in 2006, it chose to invalidate, as against public policy, "up-front" or "prospective" lien right waivers by contractors and sub-contractors with regard to non-residential construction projects. The legislature also chose to leave in force the long-standing rule that a mechanic's lien has priority as of the date of the visible commencement of work on a project. For example, the priority of a lien filed by an electrician who provided materials or labor at the very end of a project, in theory, "dates-back" to the date on which the initial ground-breaking or initial site work occurred on such project, even if unrelated to the electrician's work.

Because of the "dating-back" or "relation back" of the priority of mechanics' liens – coupled with the fact that prospective lien waivers were to be abolished for commercial projects by the amended Lien Law – the legislature added a "safe harbor" protecting lenders providing financing for such construction projects. Specifically, the Lien Law now provides that a lien obtained by a contractor or subcontractor "shall be subordinate . . . to '[a]n open-end mortgage' . . . , the proceeds of which are used to pay all or a part of the cost of completing erection, construction, alteration or repair of the mortgaged premises secured by the open-end mortgage."

Initially, title companies relied, with little hesitance, on the safe harbor to issue mechanics' lien coverage for most, if not all, construction lenders. Perhaps feeling burned by the economic meltdown, and given the absence of legislative history explaining precisely which costs could fairly be considered to be "of completing erection, construction, alteration, or repair," title insurance underwriters began to scrutinize this supposed lender protection and place substantial limits or requirements on the coverage lenders require with respect to mechanics' liens. In essence, the safe harbor is not that safe. The foregoing problem is particularly acute in public or quasi-public projects – such as the construction of new educational facilities – where construction is often funded initially through public sector grants or pledges and then later through private or "match" financing. In such cases, the relevant timeline can look like this:

Property is acquired (possibly with prior loan or donor pledges) → Site Work Begins → Construction Loan Closing and Issuance of Loan Policy → Completion of Work.

When construction begins before the loan is made, title companies are now taking an increasingly strict approach in interpreting the "safe harbor" language, in some cases requiring that every dollar of the loan be used for hard construction costs before agreeing to issue the requisite coverage. In turn,

1. Legal Research for this Alert was performed by R. David Walker.

mechanics' lien coverage now may not be readily available in the following instances, without significant risk-sharing by the borrower:

- if the loan proceeds are used to refinance existing debt, as well as fund the cost of ongoing construction;
- if the loan funds are used, in part, for the acquisition of personal property and equipment (such as movable trade fixtures); and
- if the construction loan contains an option to covert to permanent financing.

Essentially, the decision to issue mechanics' lien coverage in Pennsylvania has become a case-by-case analysis, in which title companies simply weigh the risk of a significant mechanic's lien claim against the benefit of the title premium. This test does not go well for owners in circumstances when construction began in advance of the loan closing, since the likelihood of a "superior" mechanic's lien is often greater. Increasingly, owners are having to sign "mechanics' lien indemnities," in which the borrower indemnifies the title company for any exposure relating to the issuance of mechanics' lien coverage to the lender. Such indemnities may not be palatable to owners in certain circumstances.

While no legislative history is available with respect to the intent of the Pennsylvania safe harbor provision, one can surmise that the safe harbor was not intended to be available to so few lenders and in so few situations. In light of the "relation back" rule, the legislature most likely intended to create an exception to facilitate loan closings, not make them more difficult. Contractors and owners both suffer when loans do not close.

A quick canvassing of the mechanics' lien laws and practices in other states reveals that no general trend exists for how to determine the priority of mechanics' liens. States generally have their own unique way of determining mechanics' lien priority. For example, New York does not have a "relation back" concept – lien priority is generally determined by the order of recording. New Jersey stacks the cards in favor of the lender, whose lien generally takes priority over mechanics' liens if the proceeds of the loan are applied towards any of a broad list of development-related costs.

Pennsylvania is at a crossroad, with borrowers caught in the middle. Pennsylvanian lenders are accustomed to receiving mechanics' lien coverage in their title policies – which was easy to provide *before* prospective lien waivers were ostensibly outlawed for commercial projects. Until the legislature again amends the Lien Law, expanding upon and clarifying the safe harbor language, owners should carefully consider this issue before beginning work on their projects, structuring their credit facilities, or negotiating their construction contracts.

Cozen O'Connor real estate and real estate finance attorneys are frequently called upon to represent borrowers and lenders in connection with construction loans and other secured financing. As a part of such a project, we typically negotiate the form and substance of the title insurance policy given to the lender. If you are considering taking a construction loan or commencing a real estate development project, whether or not the commencement of construction is expected to predate the closing of the construction loan, please contact us.

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