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New Jersey and New York: Differences in Construction Lien Law

By Lee David Medinets

The physical proximity of New Jersey and New York, and their closely intertwined economies, make it likely that New Jersey commercial real estate attorneys will occasionally be involved in some capacity with New York real estate transactions. When this occurs, New Jersey attorneys must be alert for the substantial differences between New Jersey and New York real estate law and practices. Nowhere are those differences more pronounced than in the handling of construction mortgages and construction liens.

New Jersey real property practice relies heavily on the state's notice of settlement law. Formerly that law was found at N.J.S.A. 46:16A-1, et seq. However, it has just been repealed and significantly revamped by enactment of Assembly Bill *2565*, which adds Chapters 26A, 26B and 26C to Title 46. The principal focus of the new chapters is to provide a better system for electronic recording of documents. However, changes to the notice of settlement law are significant as well. These changes are scheduled to take effect on May 1, 2012.

The new section that deals with notices of settlement is N.J.S.A. 46:26A-11. A notice of settlement is now *recorded* (N.J.S.A. 46:26A-11(a)) rather than *filed* (N.J.S.A. 46:16A-2). There is now provision for execution of notices of settlement by a party or by the party's *authorized representative* (N.J.S.A. 46:26A-11(b)), rather than only by the party or its *legal representative* (N.J.S.A. 46:16A-2). Model language for the form of the notice has been slightly modified. (Compare N.J.S.A. 46:26A-11(c) with N.J.S.A. 46:16A-3.) The most important change from the old law is that a notice of settlement is now effective for 60 days from the date of recording, rather than 45 days as under the old law (N.J.S.A. 46:16A-5), and a notice of settlement may now be extended for an additional 60 days (N.J.S.A. 46:26A-11(d)). A notice of settlement may be discharged prior to its expiration (N.J.S.A. 46:26A-11(e)). There was no similar provision in the old law.

Despite these changes, the purpose of a notice of settlement in New Jersey remains unchanged. Anyone who claims an interest or lien in the real property that arose during the period of time covered by the notice is deemed to have done so with knowledge of the pending real estate transaction (N.J.S.A. 46:26A-11(e) and N.J.S.A. 46:16A-4). This means that a buyer who acquires title or a lender who makes a mortgage loan does not need to be concerned with potential claims and liens that may have arisen (but that may not yet appear in a search of the title record) between the time the notice of settlement was filed (or recorded) and the time that the closing documents are recorded, provided that closing documents are recorded promptly.

New York, in contrast, has no law providing for a notice of settlement or any comparable device that prevents claims

Medinets is general counsel for Madison Title Agency LLC in Lakewood, and all its affiliates. He is also senior counsel for Madison Exchange LLC, where he is responsible for all legal matters related to §1031 exchange transactions. Before joining Madison, Medinets was in private practice for more than 20 years, focusing on real estate, small businesses, municipal land use and §1031 exchanges.

from arising between the record date at the time of a preclosing rundown and the date that closing documents are recorded. For that reason, New York title insurance policies provide for "gap" coverage that explicitly insures against those losses. Exposure to gap claims is a risk that can be reduced but not eliminated in New York real estate closings, and this risk undoubtedly contributes to the high cost of New York title insurance.

The risk of construction-lien gap claims, however, is unacceptable in the case of construction loans. In a construction loan, when the loan documents are executed at closing, more often than not, a portion of the loan proceeds are disbursed at that time. However, some portion of the loan proceeds are held back and disbursed later, in one or more phases, after construction on the property has progressed or has been completed. In many cases, the contractors and subcontractors who supplied goods and services used to improve the property will file construction liens or notices that protect their right to file construction liens at a later date. If lenders cannot protect themselves adequately from construction liens filed after the recording date of their mortgage but prior to the date of a subsequent disbursement, then they cannot risk making construction loans at all.

New Jersey's Construction Lien Law, N.J.S.A. 2A:44A-1, et seq., relies substantially on the availability of notices of settlement in order to protect lenders' rights when they make phased disbursements. N.J.S.A. 2A:44A-22 protects the superiority of a mortgage over a later-filed construction lien in two basic cases: first, where the funds were already advanced or were obligated to be advanced prior to filing a lien claim or "notice of unpaid balance" (N.J.S.A. 2A:44A-22(a)(1)); and second, where the funds are actually applied to pay a portion of the purchase price, to discharge liens on the property, to pay transaction costs or to establish an escrow for those purposes (N.J.S.A. 2A:44A-22(a)(2) and N.J.S.A. 2A:44A-22(b)). It is possible for the lender to ascertain that a particular disbursement qualifies for priority under N.J.S.A. 2A:44A-22(a)(1) only if it can be sure that no intervening lien claims have been filed. This is done by recording a notice of settlement prior to the disbursement, followed by a timely rundown showing no liens predating the filing of that notice.

A similar procedure is not available in New York because there is no notice of settlement. A lender on a New York building loan could never be certain that there are no intervening mechanics' liens that do not yet show up on a rundown. Therefore, New York has adopted an entirely different system for handling building loans. In addition to a mortgage and note, New York Lien Law § 22 requires:

> [A] building loan contract [usually referred to as a "building loan agreement," which] must contain a true statement under oath [often referred to as a "Section 22 Affidavit"], 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 ….

Specific details concerning the mandatory contents of the building-loan agreement and Section 22 Affidavit are beyond the scope of this article.

The building-loan agreement and Section 22 affidavit are filed with the *county clerk*, where mechanics' liens are filed. They are *not* recorded in the register's office, where deeds and mortgages are recorded. The building-loan agreement and affidavit must be filed on or before the date when the building-loan mortgage is recorded, and any modifications to the building-loan agreement must be filed within 10 days after the modification is made. Failure to comply with these strict filing requirements carries dire consequences: the building-loan mortgage will be subordinate to later filed mechanics' liens.

New York Lien Law § 13(3) requires every building-loan mortgage to contain a covenant by the borrower that it will receive advances of mortgage proceeds in trust to be used first for the purpose of paying for the cost of the improvements to the real property. The *lender*, however, is explicitly not a trustee of the loan proceeds, and it has no obligation to supervise application of the funds to pay for improvements. In this respect, the New York law places a lower burden on lenders than the New Jersey law does. In New Jersey, if one or more lien claims are filed prior to a disbursement, the lender is protected in the priority of its mortgage only to the extent that the loan proceeds are actually applied to the expenses enumerated in N.J.S.A. 2A:44A-22(b).

On the other hand, the New York *Lien Law* carries some special risks for lenders that are not found in New Jersey. The New York Court of Appeals ruled in *Nanuet National Bank v. Eckerson Terrace,* 47 N.Y.2d 243 (1979), that a building-loan lender loses the priority of its mortgage to the holder of a subsequent mechanic's lien if the lender knowingly files a materially false statement in the Section 22 affidavit of a building-loan agreement (although the Section 22 affidavit is signed and sworn to by the borrower and not by the lender). In *Nanuet*, the materially false statement consisted of the failure to deduct the bank's closing expenses from the stated amount of loan proceeds available to the borrower to pay for improvements. This ruling by the New York Court of Appeals confirms the earlier ruling in *HNC Realty Co. v. Golan Heights Developers, Inc.,* 79 Misc. 2d 696 (NY Supreme Court, Rockland County, 1974), and it overrules the earlier ruling in *Ulster Savings Bank v. Total Communities, Inc.,* 55 A.D.2d 278 (NY Supreme Court, App. Div., 3d Dept, 1976). In both of those cases, the building-loan agreement failed to disclose that a portion of the loan proceeds would be used to discharge a prior mortgage on the property.

In short, at the risk of losing priority of their mortgage, New York building-loan lenders must exercise great care to ensure that building-loan agreements and Section 22 affidavits: (a) are in proper form; (b) are properly executed, sworn and acknowledged; (c) are accurate in all material respects; (d) are filed no later than the day that the building mortgage is recorded; and (e) that building-loan modifications are filed within 10 days of their execution. ■