

Amendment to Pennsylvania Mechanics' Lien Law Enacted

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As originally published in The Legal Intelligencer, September 24, 2014

Effective Sept. 7, Pennsylvania's Mechanics' Lien Law was amended pursuant to Act 117, which was approved in July. The purposes of the act were twofold: to clarify and strengthen the provisions intended to subordinate mechanics' liens to open-end mortgages securing construction loans; and to provide residential property owners with certain additional protections against mechanics' liens that may be imposed by subcontractors.

Clarifying the Construction Loan Provision

Mechanics' liens have always posed unique challenges for the title industry and lenders, because of the fact that the lien of such claims generally arises and obtains priority based not upon the filing of a lien, but simply upon the commencement of visible improvement to the property by the contractor. Not too long ago, then, it was standard practice in the title industry to require assurances (maybe even photos) confirming that no dirt had been turned prior to the delivery of a construction loan mortgage, in order for the title company to insure first lien priority for the mortgagee. If work had in fact commenced, a much more complex set of underwriting standards, indemnities and other measures might be required to obtain a loan policy free of a mechanics' lien exception.

On Jan. 1, 2007, Section 508 of the Mechanics' Lien Law was amended so as to vastly simplify this inquiry, by providing that a mechanics' lien would be subordinate to any open-end mortgage where the proceeds of the mortgage were used to "pay all or part of the cost of completing erection, construction, alteration or repair of the mortgaged premises secured by the open-end mortgage." In effect, a construction mortgage was granted "super-priority" over mechanics' liens regardless of whether work had commenced.

In 2012, the Pennsylvania Superior Court rendered a decision in *Commerce Bank/Harrisburg N.A. v. Kessler*, 46 A.3d 724 (Pa. Super. 2012), which greatly undermined the 2007 fix and created a new case of heartburn for title companies, real estate lawyers and construction lenders. In *Kessler*, the Superior Court, interpreting this section of the law, held that Section 508 of the Mechanics' Lien Law would only serve to give construction mortgages priority over mechanics' liens where literally all of the proceeds of the loan were used for the actual, physical construction work. The borrower in *Kessler* had used some of their loan proceeds to pay refinancing costs, for tax claims and other typical closing costs, constituting approximately 37 percent of the loan amount. Even though the contractor had commenced work before the loan, the lender relied on the statute to give it priority. The court, however, concluded that the general contractor's mechanics' lien had priority over the mortgage because a portion of the proceeds were used for expenses other than "erection, construction, alteration or repair," as set out in Section 508.

In light of the *Kessler* decision, title companies began to resist deletion of the mechanics' lien exception where any question existed about the status of work (including earth moving or demolition), because of the fact that every construction loan provides for at least some advances for items other than hard construction costs. Regardless of the merits of the case, this strict interpretation of the Mechanics' Lien Law effectively eliminated the benefits of the super-priority of the open-end mortgage otherwise granted by Section 508, as title companies were reluctant to take the risk of insuring it.

Act 117 amended Section 508 by clarifying that priority is enjoyed by all open-end mortgages “where at least 60 percent of the proceeds are intended to pay or are used to pay all or part of the costs of construction.” The intent was apparently to address the argument raised in Kessler that a \$1 improvement should not carry with it the ability to give priority to a \$1 million non-construction. The amendment added a definition for “costs of construction” to the law, to include “all costs, expenses and reimbursements pertaining to erection, construction, alteration, repair, mandated off-site improvements, government impact fees and other construction-related costs, including, but not limited to, costs, expenses and reimbursements in the nature of taxes, insurance, bonding, inspections, surveys, testing, permits, legal fees, architect fees, engineering fees, consulting fees, accounting fees, management fees, utility fees, tenant improvements, leasing commissions, payment of prior filed or recorded liens or mortgages, including mechanics’ liens, municipal claims, mortgage origination fees and commissions, finance costs, closing fees, recording fees, title insurance or escrow fees, or any similar or comparable costs, expenses or reimbursements related to an improvement made or intended to be made to the property.”

Under the new Act 117 changes, lenders like the one in Kessler have priority over all mechanics’ liens so long as at least 60 percent of the mortgage proceeds are used to pay the costs of construction. In addition, the broad new definition of “costs of construction” will capture most, if not all, of the costs funded in a typical construction loan. In short, the super-priority granted to open-end mortgages securing construction costs is now far more robust.

Protections for Residential Property Owners

Act 117 also amended certain parts of the Mechanics’ Lien Law adding protections for residential property owners. Section 301 of the law gives subcontractors the right to a lien if they are not paid by the prime contractor. This section was amended by eliminating the right to a lien with respect to improvements to residential property, if the owner of the property has paid the full contract price to the prime contractor. However, this only applies to “a single townhouse or a building that consists of one or two dwelling units” intended to be used by the owner or a tenant of the owner.

Related to this, Section 510 was amended to allow an owner or tenant of residential property, as above, to discharge a subcontractor’s mechanics’ lien if the owner or tenant has paid the full contract price to the prime contractor. Where the full price was not paid, the amount of the mechanics’ lien can be reduced to the unpaid amount of the contract price.

Together, these two changes prevent a subcontractor from filing or maintaining a mechanics’ lien where the residential property owner has already paid the prime contractor.

More Clarity and Certainty

With respect to commercial real estate transactions, the principal benefit of Act 117 is that it adds clarity and certainty to the Mechanics’ Lien Law by specifically setting the 60 percent requirement for use of construction loan proceeds and by very broadly defining “costs of construction.” This should make it easier for title companies to remove this exception, as title companies can once again take comfort in the priority provided to open-end mortgages used for construction loans. It is likely title affidavits will be revised to incorporate some of these criteria.

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