

PENN ATTORNEYS

TITLE ALERT

DATE: 12/29/06

RE: Title Alert 2006-23

Mechanics' Lien Changes

The law governing mechanics' liens has been little changed for generations, and we have become comfortable, even complacent, when dealing with the risk of possible unfiled mechanics' lien claims. However, **impending changes to the Mechanics' Lien Law require a fresh evaluation of our practices.** January 1, 2007 is the effective date of Act 52 of 2006 (House Bill 1637-2005) that amends the Mechanics' Lien Law of 1963, (49 P.S. §1101, et seq). The amendments apply to any contracts entered into on or after January 1, 2007. The changes pertinent to our title insurance practices are:

- The period during which a mechanics' lien claim may be filed has been extended from 4 months to 6 months from completion of the work, increasing the mechanics' lien risk exposure. (Sec. 502(1))
- The class of potential claimants has been expanded to include those who contract with a subcontractor, in effect a sub of a subcontractor, which previously only included contractors and subcontractors. The revised definition of subcontractor includes this new class of claimants.
- The impact of a properly filed and indexed waiver of liens, which was of significant benefit to title insurance practitioners under the prior statute, has been significantly diminished. The premise of the new amendments is that the waiver of lien rights is against public policy and thus void, unless they meet the new specific statutory criteria. In order to accomplish this, the amendments recognize two categories of property:

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- Residential Building¹ (newly defined for the purposes of this legislation for which a waiver (sometimes referred to as stipulation against liens) may still be filed if the contract is less than \$1,000,000.00. However, even if the contract is for more than \$1,000,000.00, subcontractors may waive their lien rights if (and ONLY if) the contractor has filed a payment bond²
- Non-residential Building, (not defined in the Act, but presumably everything not included in the definition of Residential Building) for which a waiver is unlawful and void except to the extent that a waiver (the Act uses the term “waiver” but in effect, it is more like a release) by a subcontractor is in consideration of payment to that subcontractor for the work, services, materials or equipment provided. (Sec. 401(a) and (b)).
- The most significant benefit of the new Act is that mechanics’ liens by contractor or subcontractor will now be subordinate to:
 - A purchase money mortgage as defined in 42 PA C.S. §8141(1)³; and
 - An open-end mortgage as defined in 42 PA C.S. §8143(f)⁴, the proceeds of which are used to pay all or part of the costs of construction. (Sec. 502(c))
- If a waiver is not void (Residential Building property, contract less than \$1,000,000.00) the lien waiver by the contractor will be binding against a subcontractor, IF the subcontractor has actual notice of the waiver or the waiver was filed in the Prothonotary’s office before commencement of the work or within 10 days of the execution of the principal contract, or at least 10 days before the subcontract with the subcontractor.

Waiver of Liens—Appropriate or Void?

| Is the Property Residential? | Is the Property Non-Residential? | Is the Construction Contract under \$1,000,000.00? | Has a Payment Bond Been Obtained? | Is the Waiver Void? |
|------------------------------|----------------------------------|--|-----------------------------------|---------------------|
| YES | | YES | N/A | NO* |
| YES | | NO | YES | NO** |
| | YES | N/A | YES | NO** |
| YES | | NO | NO | YES |
| | YES | N/A | NO | YES |

*As to Contractor and Subcontractor
**As to Subcontractors only

¹ According to the revised Act, “Residential Building” means property on which there is a residential building or which is zoned or otherwise approved for residential development, planned development of agriculture use, or for which a residential subdivision plan has received preliminary, tentative or final approval pursuant to the Act of July 31, 1968 (P.L. 805, no 247), known as the “Pennsylvania Municipalities Planning Code”.

² Under a Payment Bond, the surety provides security that all persons supplying labor and materials will be paid. Though subcontractors are the “beneficiaries” of a payment bond, they are not parties to it. PA already requires a payment bond on government contracts for more than \$5,000.00 (8 PA C.S. 191).

³ A Purchase Money Mortgage is one taken back by the seller, or one taken by a mortgagee other than the seller, the proceeds of which are used to pay all or part of the purchase price AND which includes within the body of the mortgage an express statement that it is a purchase money mortgage.

⁴ An Open-End mortgage secures advances up to the maximum amount of indebtedness, shall be identified at the beginning thereof as an “open-end mortgage”, and shall clearly state that it secures future advances.

- There are also minor modifications to the procedures for filing and perfecting a mechanics' lien claim. (Sec 501).

Title Insurance Practices

Over the years we have relied upon the efficacy of the Waiver of Liens/Stipulation against Liens, and the strength of the new construction market has enabled builders and developers (and even speculators) to sell completed projects and pay their contractors who in turn have been able to pay subcontractors. When (not if) our sector of the economy contracts, we may well be facing many more mechanics' lien claims. If the developer can't sell the house, he can't pay the contractor, who then can't pay the subcontractor, and so on down the line. Add to that the more narrow applicability of waivers, and we expect a new wave of mechanics' lien claims. The following advice and practices are an effort to reduce the risk of mechanics' lien exposure in the future. We will continue to monitor the effect of the changes and our response to those changes, and will follow the responses of the marketplace in determining if any adjustments are needed to our practices. For now however, and in the foreseeable future, the following are the guidelines for dealing with mechanics' lien risks.

If There has Been No New Construction Within the Preceding 6 Months:

As to existing improvements, if the information available, including the: Mortgagors'/ Owners' Affidavit, Sellers' Affidavit, Mortgagor(s)/Owner(s) Closing Certification and the Buyer's and Seller's Closing Certification, establishes conclusively that no construction or improvements have been made within the 6 month period during which mechanics' lien claims may be filed, the standard mechanics' lien exception⁵ will be removed from the OWNER and LOAN title policies. In such transactions, there is no substantive break with prior practice.

Insuring New Construction or Recently Completed Construction

Owner Policy—For Residential Building property AND Non-Residential Building property, the mechanics' lien exception will appear on every OWNER policy, unless the risk has been evaluated and approval to insure the risk has been given by your servicing Penn Attorneys office. Penn Attorneys will require the following information to make a determination:

1. Confirmation of the residential nature of the property
2. Amount of contract (if Residential)
3. Valid and properly filed waiver of liens (if Residential)
4. Search of contractor and builder/developer/owner for history of mechanics' lien claims, whether or not releases have been obtained from subcontractors during the course of the project; and
5. Indemnity from all parties to the contract with and evidence of the financial stability of the indemnitors.

⁵ “Any lien or right to a lien, for services, labor or material heretofore or hereafter furnished, imposed by law and not shown by public records.”

The New Residential Subdivision—A Special Case

The \$1,000,000.00 limit above which Mechanics' Lien Waivers are not appropriate is based on the CONTRACT, not necessarily the value of the individual home or unit being insured. In a subdivision, PUD or condominium, it is likely that the general contract, and perhaps even the subcontracts, exceeds \$1,000,000.00. In such transactions, it is important to keep in mind that even if the individual home or unit is worth less (even substantially less) than the \$1,000,000.00, the property should be treated as Non-Residential.

Loan Policy-The mechanics' lien exception may be shown by Penn Attorneys as a Schedule B **subordinate item** on any LOAN policies **provided that** the mortgage being insured qualifies as a "Purchase Money Mortgage" or "Open-end" mortgage (see prior footnotes for definitions), **and assuming the lender's instructions do not prohibit subordinate items**. If the mortgage is not a "Purchase Money" or "Open End" mortgage the mechanics' lien exception will appear on Schedule B of the LOAN policy, unless the risk has been evaluated and approval given by your servicing Penn Attorney's office.

For Residential Building property with a contract of less than \$1,000,000.00, the mechanics' lien exception may be removed by Penn Attorneys provided that a valid and enforceable waiver has been filed before visible commencement of work, **BUT ONLY IF THE PROPERTY IS RESIDENTIAL AND WORTH LESS THAN \$1,000,000.00** and Penn Attorneys is indemnified against loss by the owner and the contractor. The mechanics' lien exception may also be removed if it is known with absolute certainty that the insured mortgage has been recorded before commencement of any work.

As to Non-Residential Building property, the mechanics' lien exception may be shown on Schedule B as a **subordinate item** on any LOAN policies **provided that** the mortgage being insured qualifies as a "Purchase Money" or "Open End" mortgage, **and assuming the lender's instructions do not prohibit subordinate obligations**. If the mortgage is not a "Purchase Money" or "Open End" mortgage, the mechanics' lien exception will appear on Schedule B of the LOAN policy, unless the risk has been evaluated and approval given by your servicing Penn Attorney's office.



A few Mechanics' Lien Scenarios:

Please review the following examples that are intended to illustrate different situations involving mechanics' lien risks.

Scenario # 1:

- Mr. Jones is building his dream house, to be worth \$350,000.00 when completed, and having worked construction jobs during the summer when he was in high school, he is acting as his own general contractor, hiring individuals from time to time to perform the heavy lifting. His savings exhausted, he now borrows the additional \$120,000.00 he needs to complete construction.
- No waiver of liens filed by subcontractors
- No General Contractor to obtain a payment bond;
- Work has clearly commenced before the mortgage is recorded;
- As Mr. Jones needs to borrow more money to complete his dream house, his ability to honor the terms of any indemnification are at best, suspect.

Penn Attorneys may insure the new construction loan, raising the possible unfiled mechanics' lien claims exception as a Schedule B subordinate item, provided that the loan is being periodically disbursed by the lender in accordance with a schedule of draws tied to the progress of remaining construction, and no mechanics' lien claims have actually been filed. Any owner policy issued to Mr. Jones (he may want to be covered for the ultimate value of his dream home, even if he already has an owner policy for the land acquisition) will raise an exception for both unfiled AND **filed** mechanics' lien claims.

Scenario #2:

Underbridge Brothers, a developer, is building and marketing a 120 unit residential subdivision. In the course of marketing, the developer enters into a separate construction contract with each individual homebuyer. They don't bother with waivers, and besides they had all the foundation holes excavated at the same time last spring. The developer's response to a request for indemnity and financial statements is "We never do that."

Penn Attorneys may insure the purchase money mortgage, disclosing the mechanics' lien exception on Schedule B. The mechanics' lien exception will also remain on Schedule B of any owner policy.

Scenario # 3:

Conglomerate Investors has just about completed their new office building, and is entering into a permanent loan mortgage, paying off the existing construction loan.

As this new loan is neither a purchase money, nor a construction mortgage, a mechanics' lien exception must still be raised on the loan and owner policies. Contact your servicing Penn Attorneys office if you want to insure without exception for mechanics' liens on the loan policy. Among the factors to be considered are: Indemnity from all parties to the contract, and evidence of the financial stability of the indemnitors.

Scenario #4:

Mrs. Smith is purchasing a nice piece of vacant ground from Farmer Eli, and she has hired Stoltzfoos Home Builders to erect her country cottage. The new loan proceeds are being used partly to pay Farmer Eli for the land, and partly for the new construction contract with Stoltzfoos Home Builders. The contract is for the construction of only this Residential Building, and the amount of the contract is \$327,250.00 Stoltzfoos Home Builders is not only a highly regarded builder, but has also filed a waiver of liens.

Penn Attorneys must still raise the mechanics' lien exception on the Owners policy, but may show the mechanics' lien exception on Schedule B as a subordinate item on the loan policy.