



Mississippi Valley Title 2017 AL Agency Seminar:

Underwriting Mechanic's Lien Issues

By Jeffrey M. Lang and Gina K. Matthews



OLD REPUBLIC INSURANCE GROUP

Disclaimer

- **The information contained in this presentation is general in nature and for informational purposes only. These materials should not be used or relied upon for any other purpose. The information in this presentation is not intended nor should it be construed as providing legal advice. Any conclusions that readers draw from this information are their own and are not to be attributed to Old Republic or any affiliates of Old Republic. Always seek the advice of competent counsel with any questions you may have regarding any title coverage issue.**

Reasons Mechanic's Liens are a Continuing Challenge

In many states, priority is not dependent upon what notice or instrument is recorded first.

Covered Risk No. 11

11. The lack of priority of the lien of the Insured Mortgage upon the Title
- (a) as security for each and every advance of proceeds of the loan secured by the Insured Mortgage over any statutory lien for services, labor, or material arising from construction of an improvement or work related to the Land when the improvement or work is either
 - (i) contracted for or commenced on or before Date of Policy; or
 - (ii) contracted for, commenced, or continued after Date of Policy if the construction is financed, in whole or in part, by proceeds of the loan secured by the Insured Mortgage that the Insured has advanced or is obligated on Date of Policy to advance; and
 - (b) over the lien of any assessments for street improvements under construction or completed at Date of Policy.

Typical Exception

- Any lien, or right to lien, for services, labor, or material heretofore or hereafter furnished, imposed by law, and not shown by the public records.

Sources of Mechanic's Lien Claims

1. Early starts and split priority; and
2. Insufficient indemnifications.

Early Starts

- Two Types
 - Commencement of Construction Before Recording
 - Split Priority
- Avoiding the Unknown
 - Inspections
 - Priority Pictures
 - Affidavits and Indemnifications

Assessing a Known Early Start Risk

- Items to Review:
 - Construction Contract
 - » Guaranteed Maximum Price
 - » Cost Plus
 - Project Cost Statement
 - » Contingency Amount
 - Sources and Uses of Funds
 - » Owner's Equity Requirements
 - Financials
 - » Audited vs. Unaudited
 - Available Cash
 - Local Knowledge

East End
Development Proforma

Project Costs		Eligible Basis			
		Total Cost	30%	70%	Historic
A. Development Costs					
1. Acquisition/Refinance					
a. Acquisition Cost: Entitled Land Value (estimate)	105	\$ 6,080,000			
b. Legal Fees					
c. Existing Structures					
d. Other: _____					
Total Acquisition/Refinance		6,080,000	-	-	-
2. Site Work					
a. On-site Work					
b. Off-Site Work for Utility/Paving Extension					
c. Demolition					
d. Garages (included in bldg construction costs)					
e. Parking					
f. Landscaping					
g. Other: _____					
Total Site Work		-	-	-	-
3. Construction					
a. New Building (includes \$300k of contingency) Per Unit:	\$ 212,222	\$ 38,200,000			
b. Rehabilitation					
c. Lead Based Paint Interim Control					
d. Accessory Building(s) (incl garages in rent)					
e. Other: _____					
Construction Management Fee		-			
Gross Construction		38,200,000			
f. Skyway		-			
g. General Requirements / Conditions	0.0%	-			
h. Builder Overhead	0.0%	-			
i. Builder Profit	0.0%	-			
j. Builder Bond Fee					
k. Construction Supervision	PSF: \$ 132				
Net Construction		38,200,000			
l. Construction Contingency	5.00%	1,910,000			
m. Environmental Remediation		1,181,700			
Other: _____					
Other: _____					
Other: _____					
Total Construction		41,291,700	-	-	-
Subtotal Site Work & Construction		41,291,700			
Per Unit		\$229,398			
4. Professional Fees					
a. Architect Fees - Design		620,000			
b. Architect Fees - Supervision		180,000			
Total Architect: \$800,000					
c. Engineer Fees		200,000			
d. Architect Consultants		30,000			
e. Other: _____		10,000			
f. Other: _____					
Total Professional Fees		1,040,000	-	-	-
5. Interim Costs					
a. Hazard and Liability Insurance		209,000			
b. Construction Interest		2,538,051			
c. Construction Loan Origination Fee	0.00%	-			
d. Construction Loan Inspection		15,000			
e. Taxes During Construction		75,000			
f. Water, Sewer and Impact Fees		450,000			
g. Other: _____					
Total Interim Costs		3,287,051	-	-	-
6. Financing Fees & Expenses					
a. Environmental Grant Fee to City	7.00%	49,719			
b. Brokerage Fee for Debt	0.50%	247,250			
c. Lender Exit Fee	0.40%	-			
d. Cost of Issuance	\$ 197,800	-			
e. Construction Loan Origination Fee		494,500			
f. Interest Rate Cap (cap LIBOR at 3% for 3 years)	1.00%	112,000			
g. Lender Legal		40,000			
h. Letter of Credit (LOC) Fees					
i. Title and Recording		170,000			
j. Placement Fee					
k. Other: _____					
l. Other: _____					
Total Financing Fees & Expenses		1,113,469	-	-	-

**East End
Development Proforma**

7. Soft Costs

- a. Property Appraisal
- b. Market Study
- c. Environmental Report
- d. Survey
- e. Rent-Up Marketing
- f. Cost Certification/Accounting Fees
- g. Soft Cost Contingency
- h. Tenant Improvements
- i. Legal Fees
- j. Furnishings and Equipment
- k. Permanent Relocation Expenses
- l. Parking Equipment/System
- m. Other: Building Permit/Fees included in gen conditions
- n. Other: City Fees / Permits included in gen conditions
- o. Other: Utility Relocation Fees
- p. Other: Special Inspections
- q. Other: Minneapolis Park Dedication Fee

9,000				
3,500				
15,000				
15,000				
150,000				
125,000				
100,000				
150,000				
250,000				
250,000				
-				
-				
1,450,000				
-				
274,780				
2,792,280				
Total Soft Costs	-	-	-	-

8. Syndication Costs

- a. Bridge Loan Fees and Expenses
- b. Organizational (Partnership)
- c. Tax Opinion
- d. Other: _____

Total Syndication Fees	-	-	-	-

9. Developer's Fees

- a. Developer Fee
- b. Developer Overhead
- c. Consultant Fee
- d. Other: _____

	3.47%	2,000,000			
Total Developer's Fees		2,000,000	-	-	-

10. Project Reserves

- a. LOC Fee for Working Capital Reserve (4% of HUD mortgage loan)
- b. Operating Deficit Reserve
- c. Structural Reserve
- d. Other: Tenant Improvements

	0.0%	-			
Total Project Reserve		-	-	-	-

Total Development Costs	\$	57,604,500
per unit:	\$	320,025
per sqft:	\$	457

**East End
Sources & Uses Summary**

Development Budget

	<u>PERMANENT</u>	<u>PER UNIT</u>
Uses:		
Acquisition	\$ 6,080,000	\$ 33,778
Construction & Site Work	40,110,000	222,833
Environmental Remediation	1,181,700	6,565
Interim Costs	3,287,051	18,261
Soft Costs	3,832,280	21,290
Development Fee	2,000,000	11,111
Financing Costs	1,113,469	6,186
Project Reserves	-	-
Total Uses:	<u>\$ 57,604,500</u>	<u>\$ 320,025</u>
Sources:		
Construction Loan 86% LTC	\$ 49,450,000	\$ 274,722
Environmental Cleanup Grants	710,275	3,946
Owner Equity Contribution	7,444,225	41,357
Total Sources:	<u>\$ 57,604,500</u>	<u>\$ 320,025</u>

CONSOLIDATED BALANCE SHEETS

For the Six Months Ended June 30, 2015 and Year Ended December 31, 2014

	Unaudited 6/30/2015	Audited 12/31/2014
ASSETS		
Cash	\$ 1,290,146	\$ 2,155,437
Cash - buyer deposits	303,162	275,215
Cash - restricted	3,888,163	3,988,025
Receivables and project costs:		
Trade	139,842	129,583
From affiliated development phase projects, less allowance	25,449,447	17,648,488
From affiliated rental projects, less allowance	19,605,927	19,885,262
From Craftsman Construction, Inc.	1,784,471	1,328,847
Inventories - finished units and construction in progress	4,797,388	6,736,442
Land held for development	20,130,977	20,105,977
Prepaid expenses	233,161	208,194
Amortizable assets, net	608,207	836,758
Office furniture and equipment, net	158,088	173,431
Note and Interest Receivable	14,666,218	14,915,129
Investment in rental properties, partnerships and LLC's	27,809,274	53,494,997
	<u>\$ 120,864,470</u>	<u>\$ 141,881,783</u>
LIABILITIES AND STOCKHOLDER'S EQUITY		
Debt:		
Construction loans	\$ 1,530,100	\$ 22,897,074
Revolving credit agreement	18	16,065
Mortgages payable	33,282,888	33,943,628
Notes payable	16,882,381	24,423,539
Total debt	<u>51,695,387</u>	<u>81,280,306</u>
Accounts payable	2,375,439	2,565,188
Construction payables	42,592	2,527,804
Accrued expenses	5,658,980	5,883,269
Tenant and buyer deposits	352,055	373,158
Deferred revenues	2,601,279	2,671,625
Advance from Affiliate	5,718,402	8,123,956
Total liabilities	<u>68,444,135</u>	<u>103,425,306</u>
Stockholder's equity:		
Common Stock, \$1 Par Value, 1,000,000 shares authorized, 10,000 issued and outstanding	10,000	10,000
Additional paid in capital	70,412,548	65,990,088
Non-controlling interest	(3,641,020)	(3,471,470)
Retained earnings	(14,361,192)	(24,072,140)
Total stockholder's equity	<u>52,420,336</u>	<u>38,456,478</u>
Total liabilities and stockholder's equity	<u>\$ 120,864,470</u>	<u>\$ 141,881,783</u>

LIABILITIES AND SHAREHOLDERS' EQUITY

	<u>12/31/15</u>			<u>12/31/16</u>			<u>12/31/2017</u>
Checks Outstanding in Excess of Funds	2,890,790			3,179,868.58			3,686,856.03
Accounts Payable	33,629,277			36,992,204			42,890,116
Accrued Liabilities	2,621,839			2,884,023			3,343,842
Accrued R/E & P.P Taxes	533,570			544,241			555,126
Accrued Payroll and Taxes	3,449,847			3,794,832			4,399,867
Current Portion LT Debt	2,857,128			4,619,056			6,422,716
							<u>61,298,523</u>
Total Current Liabilities	45,982,450			52,014,225			
Revolving Line of Credit	21,636,154	0	0	25,546,007			29,416,141
Other Long Term Debt	98,242,501			93,001,231			85,095,721
Other Long Term Liabilities	54,533			54,533			54,533
Due to Affiliates	36,000			36,000			36,000
							<u>114,602,395</u>
Total Long Term Liabilities	119,969,188			118,637,771			
							<u>175,900,918</u>
Total Liabilities	165,951,639			170,651,996			
Subordinated Debt	1,500,000			1,500,000			1,500,000
Capital	4,428,398			4,428,398			4,428,398
Retained Earnings	43,295,554			57,156,117			71,580,278
Earnings Year to Date	22,790,273			24,134,352			26,243,759
Accumulated Other Comprehensive Loss	(463,530)			-			-
							<u>103,752,435</u>
Total Capital	71,550,695			87,218,867			
							<u>279,653,353</u>
Total Liabilities & Capital	237,502,334			257,870,863			
	<u>=====</u>			<u>=====</u>			<u>=====</u>

Indemnifications

- Need Financial Viability of Indemnitor
 - Even if the financials are strong, they should not be used as a substitute for obtaining priority when and where possible
 - Should contain clear unequivocal statements
 - Avoid “to the best of Affiant’s knowledge”
 - Does it contain a provision that the determination of coverage is strictly up to Old Republic
 - See, *First American Title Ins. Co. v. Spanish Inn, Inc.*, 239 Cal. App. 4th 598 (Cal. 4th District 2015)

ALTA 32 Series

- Specifically designed to be used only in situations in which there is a known loss of priority
- Three Endorsements in the Series
 - Only two of which are designed to be used by an agent.
 - All require the continued involvement of the Company or the Agent in the disbursement process.
 - All have corresponding coverage and exception language.

Language Uniform to all Three Endorsements

1. Covered Risk 11(a) of this policy is deleted.
2. The insurance for Construction Loan Advances added by Section 3 of this endorsement is subject to the exclusions in Section 4 of this endorsement and the Exclusions from Coverage in the Policy, the provisions of the Conditions, and the exceptions contained in Schedule B.

For the purposes of this endorsement and each subsequent Disbursement Endorsement:

- a. “Date of Coverage,” is unless the Company sets a different Date of Coverage by an ALTA 33-06 Disbursement Endorsement issued at the discretion of the Company.
- b. “Construction Loan Advance,” shall mean an advance that constitutes Indebtedness made on or before Date of Coverage for the purpose of financing in whole or in part the construction of improvements on the Land.
- c. “Mechanic’s Lien,” shall mean any statutory lien or claim of lien, affecting the Title, that arises from services provided, labor performed, or materials or equipment furnished.

Language Uniform to all Three Endorsements

3. The Company insures against loss or damage sustained by the Insured by reason of:
 - a. The invalidity or unenforceability of the lien of the Insured Mortgage as security for each Construction Loan Advance made on or before the Date of Coverage;
 - b. The lack of priority of the lien of the Insured Mortgage as security for each Construction Loan Advance made on or before the Date of Coverage, over any lien or encumbrance on the Title recorded in the Public Records and not shown in Schedule B;

ALTA32-06

Coverage Language

- c. The lack of priority of the lien of the Insured Mortgage, as security for each Construction Loan Advance made on or before the Date of Coverage over any Mechanic's Lien, if notice of the Mechanic's Lien is not filed or recorded in the Public Records, but only to the extent that the **charges** for the services, labor, materials or equipment for which the Mechanic's Lien is claimed were **designated for payment in the documents supporting a Construction Loan Advance** disbursed by or on behalf of the Insured on or before Date of Coverage.

ALTA 32-06

Corresponding Exception Language

4. This policy does not insure against loss or damage (and the Company will not pay costs, attorneys' fees or expenses) by reason of any Mechanic's Lien arising from services, labor, material or equipment:
 - a. furnished after Date of Coverage; or
 - b. **not designated for payment** in the documents supporting a Construction Loan Advance disbursed by or on behalf of the Insured on or before Date of Coverage.

ALTA 32.1-06

Coverage Language

- c. The lack of priority of the lien of the Insured Mortgage as security for each Construction Loan Advance made on or before the Date of Coverage over any Mechanic's Lien if notice of the Mechanic's Lien is not filed or recorded in the Public Records, but only to the extent that **direct payment** to the **Mechanic's Lien claimant** for the charges for the services, labor, materials or equipment for which the **Mechanic's Lien is claimed** has been made by the **Company** or by the Insured with the Company's written approval.

ALTA 32.1-06

Corresponding Exception Language

4. This policy does not insure against loss or damage (and the Company will not pay costs, attorneys' fees or expenses) by reason of any Mechanic's Lien arising from services, labor, material or equipment:
 - a. furnished after Date of Coverage; or
 - b. to the extent that the **Mechanic's Lien claimant was not directly paid by the Company** or by the Insured with the Company's written approval.

ALTA 32.2-06

Coverage Language

- c. The lack of priority of the lien of the Insured Mortgage, as security for each Construction Loan Advance made on or before the Date of Coverage over any Mechanic's Lien, if notice of the Mechanic's Lien is not filed or recorded in the Public Records, but only to the extent that **direct payment** to the **Mechanic's Lien claimant** for the charges for the services, labor, materials or equipment **for which the Mechanic's Lien is claimed has been made by the Insured** or on the Insured's behalf on or before Date of Coverage.

ALTA 32.2-06

Corresponding Exception Language

4. This policy does not insure against loss or damage (and the Company will not pay costs, attorneys' fees or expenses) by reason of any Mechanic's Lien arising from services, labor, materials or equipment:
 - a. Furnished after Date of Coverage; or
 - b. To the extent that the Mechanic's Lien claimant was **not directly paid** by the **Insured** or on the Insured's behalf.

Policy Defenses

3. Defects, liens, encumbrances, adverse claims, or other matters
 - a. created, suffered, assumed, or agreed to by the Insured Claimant;
 - b. not Known to the Company, not recorded in the Public Records at Date of Policy, but Known to the Insured Claimant and not disclosed in writing to the Company by the Insured Claimant prior to the date the Insured Claimant became an Insured under this policy.

See, *BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825 (7th Cir. 2015).



What were they thinking?

Mechanic's Liens Basics- AL

General Overview

- In Alabama mechanics' liens are purely statutory and codified at Ala. Code § 35-11-210 to 35-11-234
- The lien arises when the claimant makes the contribution, but remains inchoate until action is taken to enforce the lien
- Two types of liens
 - “Full price” lien-contract between lien claimant and owner. The contract with the owner may be express, or it may be implied by compliance with the pre-contribution notice provision of Section 35-11-210.
 - “Unpaid balance” lien-no express contract between lien claimant contributing materials and the owner.
- Lien claimant must have contributed work under a contract, whether expressed or implied.
- Lien claimant must strictly comply with statutory mandates for the perfection of any claimed lien, and if there is a failure, he becomes merely a general creditor and loses status as a lien claimant

Mechanic's Liens Basics- AL

Lienable Contributions - Labor

- Depends on the nature of the labor contributed
- Must be established that the labor was performed upon or contributed to something that has attached to and become part of the realty upon which the lien is claimed.
- Determined to be contribution of labor for improvement on land:
 - Clearing, grading, and site preparation of raw land
 - Excavation and preparation of well for permanent water supply
- Determined not to be contribution of labor for improvement on land:
 - Mere preparation of building plans by architect
 - Surveying, lot staking and map or plat preparation by a surveyor

Mechanic's Liens Basics- AL

Lienable Contributions - Materials

- Materials must actually be contributed to and incorporated into improvements
- Lien does not attach for materials left lying on the premises and not incorporated into the improvements

Mechanic's Liens Basics- AL

Lienable Contributions - Other

- Waste disposal services
- Equipment
- Machinery

Mechanic's Liens Basics- AL

Verified Statement of Lien - Step 1

- Every person entitled to a lien must record a verified statement of lien in the office of the judge of probate of the county in which the property is situated in accordance with Ala. Code § 35-11-213 .
- The purpose of the lien is to give notice to purchasers and creditors, however there are decisions indicating that notice that a lien may exist may be imputed from the condition of recent construction on the land
- General Requirements
 - State the amount secured by the lien
 - Adequate description of the property
 - Name of the owner of the land
 - Accompanied by an affidavit of a person having knowledge of the facts

Mechanic's Liens Basics- AL

Time for Filing Verified Statement

- See Ala. Code § 35-11-215
 - Original Contractor – 6 Months
 - Day Laborer and Journeymen – 30 days
 - Other Claimants - 4 Months
- Period begins to run after the last item of work or labor has been performed or the last item of any material has been furnished
- Must look to the contractual arrangements or the parties to determine whether or not a lien claimant can be classified as an “original contractor”
- Timing is critical in order to perfect and enforce

Mechanic's Liens Basics- AL

Enforcement by Civil Action - Step 2

- Jurisdiction - See Ala. Code § 35-11-220
- Subject matter jurisdiction over a civil action to perfect and enforce a lien lies in the circuit court of the county where the land is located
- In counties with more than one judicial division, each having distinct jurisdiction, the action to enforce lien must be filed in the judicial division where the land is located

Mechanic's Liens Basics- AL

Enforcement by Civil Action - Step 2

- Statute of Limitations - See Ala. Code § 35-11-221
 - Action MUST be brought within 6 months of the maturity of the indebtedness under the contract
- Debt typically matures, absent a contractual provision, when it accrues as to be due and payable which is typically on the last day work is performed or materials contributed
- Sometimes it can be difficult to determine the date of the lien claimant's last work or other contribution. Question of fact.
- Contract modifications or change orders can result in extensions of the date of maturity of the indebtedness, therefore creating a different time within which to bring the civil action to perfect and enforce a lien.
- For example, modification of material supplier's contract to make indebtedness mature upon the sale of property, an action to perfect and enforce a lien was timely though filed approximately one year after last contribution by the claimant

Mechanic's Liens Basics- AL

Enforcement by Civil Action - Step 2

- Additional considerations regarding determination of maturity date include hiatus between contributions as to create possible separate contracts

Mechanic's Liens Basics- AL

Judgment

- See Ala. Code § 35-11-224
- In order for a lien to be established securing the contract price of labor and materials, judgment must be rendered on the debt or contract claim
- Check for final adjudication of the matter and see if controversy has been reduced to a money judgment and Certificate of Judgment has been recorded

Mechanic's Liens Basics- AL

Priorities

- **Generally.** The lien attaches and is created when the lien claimant makes the contribution, but remains inchoate until action is taken at a later date to enforce the lien. Once a proper verified statement is filed and all necessary steps are taken to perfect and enforce the lien, the lien relates back to the date of the initial contribution and has priority over subsequently created encumbrances.
- **As to Construction Mortgages.** As to those improvements which may not be severed from the land without damage to or impairment of the construction lender's security, and to the extent of advances made under a construction loan, court decisions and Section 35-11-211 give priority to the construction lender over a claimed lien that **arises after the execution and recordation of a valid and enforceable construction mortgage.**

Mechanic's Liens Basics- AL

Priorities- cont'd.

- Commencement of construction before execution and recordation of the construction mortgage is, therefore, problematic to lenders from a priority standpoint.
- Mechanic's Lien Coverage Forms (Commercial Construction Loans)
 - Non-Start Affidavits
 - Indemnity Agreements
 - Sworn Construction Statements
 - Lien Waivers
 - Subordination Agreements (Contractor's Affidavit and Release)
- Mechanic's Lien Coverage for Commercial Construction requires approval from Underwriting Counsel.

Mechanic's Liens Basics- AL

Priorities- cont'd.

- Acceptable Non-Start Affidavits from the owner/borrower and builder/contractor, along with Indemnification from the owner/borrower on Company approved forms is required. Inspections and priority pictures may also be required.
- If construction has commenced prior to the recording of the construction mortgage, additional documents will be required (ex. Sworn Construction Statements, Paid Lien Waivers and/or Subordination Agreements), and various items will need to be reviewed, such as the construction contract, the project cost statement, sources and uses of funds, financials and local knowledge. Depending on the circumstances, Mechanic's Lien Coverage may or may not be available through issuance of one of the ALTA Series 32 endorsements or otherwise.

Mechanic's Liens Basics- AL

Priorities- cont'd

- **As to Permanent Lenders Making New Mortgage Loans.** Commonly, a lender makes a construction loan to a contractor or owner and, after the project is completed, a permanent lender will make a new mortgage loan to the owner or to a purchaser. The construction loan is paid from the proceeds of the new permanent loan and satisfied of record. **Does the new permanent lender have the rights and position of the construction lender, presumably having some priority?**
 - Purchaser. The answer is no if the new permanent loan is made at the instance of a Purchaser, and the prior construction loan is paid from the permanent loan proceeds.

Mechanic's Liens Basics- AL

Priorities- cont'd

- Owner. If the permanent loan is made by the Owner (the money is advanced at the instance of the debtor in order to extinguish the prior construction loan indebtedness), the permanent lender may achieve priority over the lien claimant by way of equitable subrogation, provided the construction lender has priority and all of the five elements of equitable subrogation exist, to-wit: **(1) the money is advanced at the instance of the debtor in order to extinguish a prior encumbrance;** (2) the money is used for that purpose with the just expectation on the part of the lender for obtaining security of equal dignity with the prior incumbrance; (3) the whole debt must be paid before subrogation can be enforced; **(4) the lender must be ignorant of the intervening lien;** and (5) the intervening lienor must not be burdened or embarrassed.

THANK YOU