New Jersey and New York: Differences in Construction Lien Law

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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 However, it has just been repealed and significantly revamped by enactment of Assembly Bill 2565, which adds Chapters 26A, 26B and 26C to Title 46.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...
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 poli-
cies provide for “gap” coverage that explic-

tly 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 con-
tributes 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 construc-
tion 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 con-
struction on the property has progressed
or has been completed. In many cases, the
contractors and subcontractors who sup-
plied 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 sub-
stantially on the availability of notices of
settlement in order to protect lenders’
rights when they make phased disburs-
ements. 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 ascer-
tain 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 build-
iling 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 differ-
ent 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 “build-
ing 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 manda-
tory contents of the building-loan agree-
ment 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 regis-
ter’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 record-
ed, 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 require-
ments carries dire consequences: the build-
ing-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 improve-
ments. 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 mort-
gage 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 acknow-
ledged; (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.